Letter of Comment No: 100 File Reference: 1102-001 Date Received: 1-3(-0)3



Submitted via email to: director@fasb.org

January 31, 2003

Mr. Robert H. Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference 1102-001

Dear Mr. Herz:

Thank you for the Invitation to Comment on the Financial Accounting Standards Board (FASB) "Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment."

The Software & Information Industry Association (SIIA) is the principal trade association for the software and digital content industry. SIIA provides global services in government relations, business development, corporate education and intellectual property protection to more than 650 leading software and information companies. SIIA's membership consists of some of the largest and oldest technology enterprises in the world, as well as many smaller and newer companies.

SIIA recognizes FASB's ongoing mission to establish high-quality financial reporting standards. Unfortunately, stock options and their valuation have been inappropriately cited as a major factor in the corporate executive abuses and excesses uncovered in 2002. Much of the stock options debate has confused the value of a stock option to the employee with the cost to the corporation for issuing that option. Given FASB's reconsideration of this issue, it is critical that the objective to establish high-quality financial reporting standards not be eclipsed by other objectives, such as striving for uniform international standards, especially when such standards threaten to decrease the quality of U.S. standards. SIIA offers the following reasons why mandatory expensing in the absence of an acceptable valuation methodology remains strongly flawed accounting practice and policy, and why mandatory expensing would not be in the best interest of investors or companies that utilize broad-based plans.

## 1. Employee stock option grants simply cannot be valued accurately.

There are competing measures for valuing employee stock options, but clearly no accurate method to assign value exists. Current option pricing models were designed to value short-term, freely-tradable stock options, rather than employee stock options. It is widely recognized that the Black-Scholes and variations of the binomial model are imperfect in many respects. The assumption that future stock evolution is lognormal with a known volatility ignores transaction costs and market impact, and it assumes that trading can be carried out continuously. The fair value as estimated by pricing models does not accurately reflect the nature of the employee stock transaction, as this amount is not what is realized to the employee. That is, unlike publicly traded shares/options, an employee stock award does not include the ability to sell and receive the remaining time value—the employee will only realize the intrinsic value of the option on the date the award is exercised. SIIA continues to be confused by proposals for mandatory expensing of stock options, given the widely recognized flaws in valuing those options. Even the IASB recognizes the difficulty of accurately determining a company's cost of issuing employee stock options—yet it continues to move forward with a proposal requiring expensing.

## 2. Mandatory expensing of employee stock options—with flawed valuation models—will lead to inaccurate and misleading information for investors.

First, expensing stock options by assigning a value determined by a modified option pricing model would often result in an overstatement of expense in the financial statements. That is, since the impact of outstanding stock options is already established in the diluted earnings per share (EPS) calculation, expensing the value through Black-Scholes and binomial variations would double-count the cost by lowering income through recognition of the expense while, at the same time, increasing the number of shares outstanding in the EPS calculations. Additionally, treating an incorrect and misleading number as an expense in the income statement would not increase financial statement reliability, transparency, or comparability. Rather, it would lead to the inclusion of incorrect, confusing and misleading information in corporate financial statements—an outcome that seems a far cry from the widely-shared goal of finding solutions to the recent corporate abuses. For this reason, the inclusion of such information is already discounted by market analysts; requiring this flawed information across the board simply increases the number of cases in which the analysts will back out this information from their evaluations.

Moreover, inadequacies in the current valuation models are forcing companies to create new approaches to establish a fair market value for a restricted option, when no such value can accurately be estimated. This lack of standardization that exists among current valuation methodologies promises to create more investor confusion and misinformation—a result that is ultimately detrimental to investors and contradictory to the objective of providing high-quality financial reporting standards. The choice of methodology, combined with the series of calculations that are company specific, will result in a significant lack of consistency and uniformity in valuation. From the perspective of an investor comparing the cost of stock options across different companies with different stock option plans and different variations of Black-Scholes (or another valuation method), the results are non-uniform and incomparable. The net

result is that various companies are likely to arrive at different fair value calculations that are equally legitimate but are not meaningfully or uniformly comparable to the investor.

3. Increased disclosure will appropriately address investors needs for greater information, without negative side effects of mandatory expensing using inadequate valuation models.

Contrary to proposed mandatory expensing, which would lead to inaccurate and confusing information to investors, enhanced information disclosure that improves the clarity and prominence of employee stock options is exactly what is needed for investors. On November 14<sup>th</sup>, more than 30 high-tech companies voluntarily agreed to provide shareholders and the public with expanded information about employee stock options. Specifically, the new disclosures will include relevant information about stock options in a separate section of company quarterly SEC filings displayed in a series of easy-to-read tables and charts that will include increased information on recent option grants and activity, the total number of options held by executives, and information comparing exercise price to current market prices, and the current intrinsic value as of the reporting date. Many SIIA member companies have taken the lead in the process of voluntarily disclosing enhanced information to investors, and we are confident that more will follow. Additionally, FASB Statement 148 will significantly improve the clarity and prominence of disclosures about the pro forma effects of using the fair value based method of accounting for stock-based compensation for all companies by ensuring that critical information is presented more prominently and in a more user-friendly format in the footnotes to the financial statements.

4. Expensing of stock options would deter companies from using broad-based plans—clearly the most effective use of employee stock option grants—in favor of only granting options to senior executives.

The high-tech industry, including many members of SIIA, have perhaps more than any other industry utilized a broad-based approach to stock options for rank-and-file workers. Many company option plans are offered to a majority of their employees. SIIA strongly supports the use of broad-based plans, and we believe that high-quality financial reporting standards would serve to increase the use of these plans, rather than to decrease them. We are concerned that a mandatory expensing requirement would decrease or even eliminate broad-based use of options, which would reverse positive policy gains made regarding employee ownership. That is, because expensing essentially double counts financial ramifications of options, there is a real punitive impact to creating and maintaining broad based plans. In this case, the very people that we should be benefiting and incenting are in fact harmed, with a likely negative impact on productivity—and thus a decrease in shareholder value.

There are several reasons why stock options, particularly broad-based options plans, are the engine of growth of the high-tech economy, and why they need to be preserved. First, and perhaps most importantly, stock options clearly have proven to have the effect of aligning the interests of workers with those of owners, by making workers partial owners of the company. With broad-based plans, virtually every employee has the opportunity to be a partial owner and the promise to reap some of the benefits if the company performs well.

Second, as a burgeoning industry in the late 1980s and early 1990s, high-tech companies were in the difficult position of having to compete with more established companies for a limited pool of talent. It was at this time that broad-based stock options emerged as a highly-successful business model to attract high-quality talent and produce results. By enabling high-tech companies to build and retain a competitive workforce, broad-based plans are a critical tool for innovation. Simply stated, stock options enable companies with little capital to attract and retain workers eager to share in the benefits and risks of corporate growth. Finally, options are inherently designed to only provide reward where it is deserved, in the form of increased stock prices when a company is performing well—usually a result of its intellectual capital, its workers. However, if a company is not performing well and its stock is not rising, the reward to employees does not exist, and nothing is either gained or lost by the company or its shareholders.

## Conclusion

SIIA does not support using proposed valuation methods to account for employee-issued stock options as an expense. The current valuation methods force companies to predict the stock prices, a task that is technically impossible and destined to produce inaccuracy and inconsistency. To this point, the IASB has not specifically mandated any of the existing approaches, but rather remains quite vague as to how valuation should be achieved. Indeed, FASB would be much better suited at this time to try to develop an acceptable model, rather than considering mandatory expensing.

SIIA supports FASB's efforts that focus on developing high-quality financial reporting standards. In particular, we support FASB's exploration of alternative stock option valuation methods that do not cause companies to accrue an expense, and thus do not have the end result of over-reporting the value of employee stock options. SIIA strongly encourages FASB to focus on financial reporting standards that *encourage* the use of broad-based stock option plans, rather than discourage them.

Again, thank you for the opportunity to comment on this critical subject, and we look forward to working with FASB towards our mutual objective of high-quality, financial reporting standards.

Sincerely,

Ken Wasch President

Ken blask