

Letter of Comment No: 5446 File Reference: 1102-100

June 28, 2004

Robert H. Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856

Via email: director@fasb.org

RE: File Reference No. 1102-100 - Comments on Exposure Draft Regarding Stock Options

Dear Chairman Herz:

As a small cap publicly-traded technology company, Netegrity strongly supports corporate governance reforms, greater enforcement against corporate fraud and enhanced disclosure to shareholders. However, we continue to strongly oppose the mandatory expensing of employee stock options. We firmly believe that expensing stock options is not an issue of financial transparency or disclosure. The financial information that investors will receive from expensing stock options is currently available in annual reports under current FAS123 disclosures. We believe that employee stock options do not constitute an expense since there is no cash outflows by the company. The cost is borne by the stockholder in the form of dilution and this has already been accounted for and disclosed to investors in the form of the fully diluted share calculation. Our view is that expensing of stock options will not achieve the objective of enhancing the reliability, comparability and consistency of the financial statements. That being said, we recognize that the FASB continues to move forward with this project and we appreciate the opportunity to comment on the following issues with the current Exposure Draft: (1) the lack of a reliable, consistent and comparable option pricing model (2) the proposed measurement date, and (3) the impact from an administrative and auditability perspective.

Stock Option Valuation Methodology

We believe that the FASB should not mandate the expensing of stock options until it determines a more accurate method for valuing stock options. Currently, there is no standardized method that measures the true "cost" of an option with reasonable precision. The most frequently used method for valuing stock options to date has been the Black-Scholes formula, which produces highly misleading results that often significantly overstate the value of employee stock options. The use of this model has been particularly problematic for companies with volatile stock prices, such as Netegrity and our other high-tech peers and emerging growth companies.

While the current Exposure Draft recommends the use of a lattice (binomial) model, it has been proven that the lattice or binomial models are more complex and no more reliable and accurate than the Black-Scholes models. The lattice model requires a great deal of analysis to be completed in order to account for the distinctive characteristics of companies' employee stock options plans. In addition to making assumptions about future volatility and Treasury yields (also required for the Black-Scholes Model), the lattice model requires companies' to come up with statistics on employee turnover and employee exercise patterns. Employee exercise patterns would be extremely challenging for small high-tech companies to predict due to the high volatility of the stock. Even with the additional variables, there is still a question as to whether this model will produce more accurate cost estimates of stock options.

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statements that will mislead the investor community and will ultimately have a negative impact on companies' stock prices. In fact, experts from numerous fields have raised concerns that all of these models are highly inaccurate and unreliable when using them to value employee stock options. First, these models were designed for the short-term trading of liquid, market listed options. The method was not intended to value employee stock options, which have relatively long vesting periods, cannot be freely exchanged and contain restrictions on exercises. Second, the concept of "fair value" applies when options are freely tradable, that is, there is a willing buyer and a willing seller. This concept does not hold true for employee stock options. In fact, the FASB has stated that where it is impossible to estimate fair value of the employee stock option (which we would argue applies in all cases), companies should use an "intrinsic value" method and adjust the value each reporting period. This appears to be nothing more than variable accounting under APB 25 and would bring the changes in stock price onto the income statement each quarter. Third, because the models under consideration fail to incorporate factors unique to employee stock options, we believe this opens the door for companies (and auditors) to manipulate and introduce varying degrees of judgment into the pricing model inputs. The inputs of these models (dividend yield, volatility, risk-free rate) can be easily manipulated to significantly alter the end result. For example, one of the key inputs into the lattice pricing model will be expected volatility. Companies will be required to estimate future stock prices at points in time from the grant date to the expiration date. We believe, particularly as it relates to technology companies, that this is highly subjective and unreliable. If three to five years ago technology companies had predicted or estimated what their stock prices would be today, they would undoubtedly have NO correlation to the actual prices. This is because technology stock prices are extremely volatile and can often have nothing to do with the performance of the company. Therefore, the estimated expense taken to the income statement would have no relation to the actual expense. How does a young, newly public company go about predicting its stock price ten years out and go about getting their auditor to concur that is has a basis for that judgment that gets reflected as an expense in the income statement?

Collectively, the result of these fundamental flaws with the models will raise significant concerns as to the accuracy and reliability of the valuation. The values that result from any of these models are speculative and in most instances overstate the value of employee stock options, simply because a company's optimism will translate into higher valuations. We struggle to find the reasons why that would make the financial statements more reliable, consistent and comparable. This goes against the FASB's stated goal for this project. Since expensing employee stock options will have a significant impact on technology companies who offer broad based stock option plans, we believe that the FASB should strongly consider field testing various pricing models before proceeding any further with this project.

Measurement Date

We believe that the grant date of the option is the appropriate date for public companies to measure the compensation cost of employee stock options

Current stock option accounting rules require that if employee stock options are expensed, they must be expensed at the date they are <u>granted</u> to the employee. This date is the correct valuation date because it is when the employer and the employee agree to the terms of the stock option award.

Exercise date accounting permits reliance on an actual value, rather than estimates. However, it would produce substantial swings in net income based on volatility of the underlying stock. In addition, it would have the perverse result of creating a higher expense when the stock performs well. If employee stock options were expensed at exercise, the better a company is at increasing shareholder value, the worse its reported earnings would be. However, we believe that the FASB still needs to determine the implications if stock options expire out-of-the-money. It does not appear logical that out-of-the-money options would represent an expense of any kind.

Administration and Audit Implications

We believe the FASB should consider the administrative and auditability issues inherent in the Exposure Draft. Currently we are all entrenched in complying with Section 404 of Sarbanes Oxley so that management can certify and the auditors can attest that the internal control system has been designed to ensure that the financial statements are free from material misstatement. How can CEO's and CFO's certify, and auditors attest to, the estimates used in determining compensation expense associated with employee stock options when the ultimate expense is a result of subjective inputs and may bear NO relation to the expense taken to the income statement on the grant date? Additionally, FASB will require that where options vest on a graded schedule, that each set of options constitutes a separate award that must be valued separately. For companies that only grant options to their senior level executives this may not be an administrative burden, but for a technology company with a broad based stock option plan this will be incredibly burdensome. Netegrity currently has approximately 400 employees. Each employee is eligible for an annual grant and each grant vests quarterly over a four year period. An annual employee stock option grant at Netegrity will result in approximately 5,000 different grants to be valued and accounted for separately. This does not even take into account new hire or promotionrelated grants. From an internal perspective, accounting for this would be extremely costly and time consuming. In addition, companies will have to plan for the incremental audit fees related to this which could be significant.

Final Thoughts

There is no question that Netegrity will continue to support efforts by FASB and Congress to craft thoughtful and reasoned responses to issues of corporate accountability. Nevertheless, we do not feel that requiring companies to expense stock options is a sound decision. Mandatory expensing of stock options will put accounting policy on a collision course with innovation, entrepreneurship, competition and new business growth. High-tech companies in particular are bearing the brunt of the struggling economy and as a result have undervalued stock prices. Mandating the expensing of stock options will further increase companies' operating expenses making it more difficult for companies to sustain or in many cases achieve profitability. The mandatory expensing of stock options would most likely result in the elimination of stock option programs for middle management and rank and file employees, as many companies that widely distribute options will be deterred by the prospect of a significant and distorted Impact to earnings. In short, it would undermine a tool that has fueled innovation and growth in the economy, most prominently in the high-tech arena. Requiring companies to expense their stock options is requiring them to erroneously depress their earnings. The resulting distorted earnings will cause investors to see increased volatility as option expensing multiplies the movement of various key metrics such as earnings per share and price-to-earnings ratio. This inaccurate information will mislead investors causing them to make poor decisions or alternatively, choose to just ignore the expense resulting from stock options when they run their models and look at the results on a pro-forma or cash basis. It is important that policymakers focus not on stock option accounting, but on a package of real reforms that will directly address the issues that contribute to corporate abuse.

Thank you for the opportunity to comment on this important matter.

Regards,

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