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June 22, 2004

Letter of Comment No: 3425
File Reference: 1102-100

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Attn: Director of Major Projects – File Reference No. 1102-100

To the Members of the Board:

On behalf of the Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF), I am pleased to submit comments on the proposed rule by the Financial Accounting Standards Board that would amend Statements No. 123 and 95 and require public companies to expense their stock options. We strongly support this proposal because:

1. It would recognize that stock options granted to employees are compensation costs and provide more realistic accounting treatment for such costs, and
2. It would remove the primary impediment to better equity compensation plans that link pay to performance by eliminating disparate accounting treatment.

We also believe that this issue – proper accounting for stock options – has for too long (over a decade) not been effectively and appropriately resolved. The increasing number of companies, now about 600, that are expensing stock options demonstrates as well that the time has now come to finally resolve this issue. Thus, the proposal should be adopted and implemented without further delay.

TIAA is a stock life insurance company. Its companion organization, CREF, is registered with the SEC as an investment company. Together, TIAA-CREF comprises the principal retirement system for the nation's education and research communities. TIAA-CREF serves over 3.2 million people at 15,000 United States institutions and jointly manages approximately \$300 billion in assets. In addition to offering fixed and variable annuities, we offer a series of retail and institutional mutual funds that are also registered with the SEC as investment companies.

We have long supported FASB's effort to amend and adopt standards in order to promote financial reporting that is timely, accurate, relevant and complete. Investor confidence in the marketplace is rooted in the integrity of financial statements. It is critical that the standards used to prepare those statements be set by FASB, the nation's independent standard-setting body.

TIAA-CREF's support for improved financial reporting of stock options is longstanding and well known. We recognize that equity-based compensation can be a critical element of compensation. The proper use of equity-based compensation plans can align management and employee interests with those of shareholders and offer terrific incentives for employees. At the same time, equity-based compensation has a cost, and it is important that the cost be reported accurately and thoroughly in financial statements.

We support the basic principles outlined in the proposed statement of March 31, 2004 Financial Accounting Standards. We appreciate that the current proposal is the product of considerable analysis and focused attention by the staff and members of the FASB. We also recognize that you have received comments and suggestion from virtually all of the affected constituencies and have had the opportunity to assess all of these views even before publishing this proposal for comment.

We believe the current proposal represents a balanced and reasonable approach to begin the expensing process. We expect that once it is implemented, FASB will subject expense accounting for stock options to the same monitoring process of all accounting standards and make adjustments, as necessary. Therefore, we urge your prompt adoption of accounting standards based on following principles:

- Stock or stock options that are used to attract, retain or compensate employees should be reported as an expense on income statements
- Similar transactions should be accounted for in the same manner.
- Compensation should be accounted for comparably without regard to whether the recipient is an employee or an outside contractor.
- Compensation should be accounted for comparably without regard to whether it is in the form of cash, goods in-kind or equity.
- Compensation costs should be measured based on fair value at grant date and recognized over the vesting period.
- Assumptions used to determine compensation costs should be fully disclosed.

As we have stated in earlier comment letters on this issue, we believe it is particularly important to the users of financial statements that all transactions undertaken by a company, regardless of the currency (cash, stock, real property, or stock options), be recognized in financial statements. To do otherwise has the potential to misstate corporate financial performance and results in a disservice to those who rely on the credibility of financial reports. Current U.S. reporting standards do not require appropriate financial reporting for all share-based payments. One type of payment – the fixed, at-the-money stock option – can result in zero expenses in financial statements, regardless of the number of options issued – a result that

implies that fixed options are “free.” Other types of options and payments in shares can result in recognized expenses, resulting in an uneven playing field across all forms of compensation.

This current accounting distinction makes no sense and is highly detrimental to shareholders. We have heard from companies and compensation consultants that they do not include variable options in compensation plan design because of the disparate and “punitive” accounting treatment. As a policy matter, economics – not accounting – should dictate appropriate business transactions, including compensation. However, under current accounting standards, the choice of option plans can have such a disparate effect on the income statement that companies believe that they are left with few alternatives.

We are greatly concerned that the lack of appropriate accounting has encouraged behavior that is counter to shareholder interests. Specifically, the uneven playing field may have resulted in a preference for U.S. companies to use, and in some cases to over-use, at-the-money fixed options in lieu of superior forms of option incentive compensation. In some instances, this has also resulted in excessive executive pay that is not adequately disclosed or accounted for in financial statements. If some cost were assigned to fixed options and that amount was required to be shown as expense, we believe shareholders would have a more complete picture of the company’s financial health, and a more rigorous cost-benefit analysis and evaluation of compensation plans would be possible.

From a shareholder’s perspective, outright grants of restricted stock and performance options might be more preferable forms of compensation. Stock grants result in employees experiencing some downside effects if share prices decline. Options have no downside, only possible upside potential. As a result, executives with large option holdings have an incentive to take large risks that may not be in the best interests of shareholders.

In arguing against expense accounting for options, some companies have cited potentially dire “economic consequences” of the proposed accounting rules. However, we believe the current accounting standards have economic consequences that are deleterious to shareholders and employees, alike. In addition to the previously described detrimental effects of an uneven playing field, we note the following:

- Reduction or slower growth of dividends paid to shareholders. Executives holding options have a clear incentive to avoid dividend payouts that would reduce stock prices.
- Reduction in pension plans being adopted or maintained. Again, the cost of a pension plan must be expensed whereas a fixed stock option need not be. We believe that the current financial reporting requirements have allowed companies to shift forms of compensation without thorough analysis of all the benefits to employees and costs to shareholders.
- Inadequate information on compensation costs reported to Board compensation committees. Executives who propose that directors adopt generous option plans may convey the impression that options have no value and therefore no cost. Boards and compensation committees should be analyzing various compensation alternatives and the

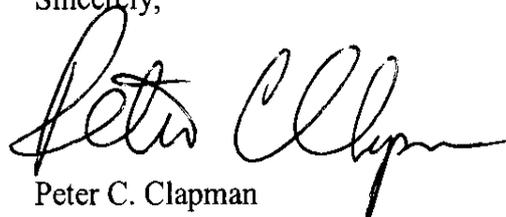
costs associated with them; accounting rules should not skew the decision-making process.

Many constituent groups and financial experts have endorsed expense accounting for stock options, including the major investment banks and accounting firms and about 600 companies that have voluntarily adopted expensing under the fair value method. Shareholders have also indicated their preference: in the 2004 proxy season to date, proposals to expense stock options have received majority support at nine companies. Moreover, we are encouraged by the Congressional Budget Office's April 2004 report, *Accounting for Employee Stock Options*, which advocates stock option expensing and concludes that expensing options is unlikely to have a significant effect on the economy, although it could make information more transparent to less-sophisticated investors.

For these reasons, we strongly support the proposed amendment of FASB Statements No. 123 and 95 to finally provide appropriate accounting treatment for the compensation cost of stock options. We applaud the FASB's commitment to improve the quality of accounting standards and financial reporting, and we appreciate the opportunity to comment on the proposal. Please do not hesitate to contact me with any questions you may have. I can be reached by letter at the above address, by e-mail at pclapman@tiaa-cref.org or by phone at 212-916-4232.

Thank you for your consideration.

Sincerely,

A handwritten signature in black ink, appearing to read "Peter Clapman". The signature is fluid and cursive, with a long horizontal stroke at the end.

Peter C. Clapman