June 16, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: Exposure Draft of a Proposed Statement of Financial Accounting Standards, Share-Based Payment (File Reference No. 1102-100)

Dear Ms. Bielstein:

Siebel Systems, Inc. appreciates the opportunity to provide the Financial Accounting Standards Board ("FASB") with a summary of our initial views on its Exposure Draft of a Proposed Statement of Financial Accounting Standards "Share-Based Payment" (the "ED"). As requested in the ED, our comments are discussed below under each "Issue" identified in the ED.

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13-C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

Response: We do not agree with the FASB's conclusion. Specifically, we do not believe that expensing employee stock options is consistent with the current conceptual framework established by the FASB. Specifically, the conceptual framework defines an expense in paragraph 80 of Concept No. 6 "Elements of Financial Statements" as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."

The grant of an employee stock option does not result in the creation of a liability, which we believe the FASB clearly acknowledged in the ED by treating employee stock options as an equity transaction rather than the incurrence of a liability. Similarly, the grant of an employee stock option does not result in the creation of an asset that is subsequently "used up." While some could make a theoretical argument that an employee's service is a "future economic benefit" that meets the definition of an asset and that asset is then immediately "used up" as the employee performs services, we do not believe that this argument meets the definition of an asset within the FASB's conceptual framework (e.g., employee services are "at will").

More importantly, in our opinion the ED will not meet the expectations or needs of the "users" of financial statements. Specifically, if the FASB determines that the exchange of an employee stock option is consistent with the definition of an expense in the conceptual framework, we believe that the understandability and usability of the income statement may be significantly impaired. Further, we believe that the complexities of the ED and the resulting financial impact may be counterintuitive to the average investor, shareholder advocacy groups, financial press, and even many institutional investors and investment advisors. We encourage the FASB to reconsider whether the provisions of the ED faithfully represent the needs of the users of financial statements. We believe that even those users that believe that stock options are an expense may find that the very reasons they desired to have stock options reflected as an expense are not met. For example, as explained further below stock option expense often will have an inverse relationship to: (i) the value realized by the employee, (ii) the potential dilution to shareholders, and (iii) cost to the company. Unfortunately, we believe the ED places undue weight on the theoretical accounting merits of the standard and little to no weight on usability. For example, we believe it is very...
telling that the question we believe is the most important (i.e., whether the ED is understandable) is not asked until
last in the ED.

We encourage the FASB to consider not only the theoretical merits of the arguments for expensing, but what the
users of financial statements need and what is otherwise intuitive to the majority of users of the financial statements.
It has been our experience that the majority of the users of financial statements measure the "value" of stock options
by subtracting the exercise price of the stock option from the current market price of a company's common stock,
and would expect that, if the company were to account for a stock option as an expense, that the expense would
approximate the "value" received at vest versus the hypothetical fair value required under the ED.

As the FASB is fully aware, stock options granted "at-the-money" that have a low exercise price relative to the
market price of common stock at vest, and therefore the most economic value, will carry the least amount of expense
in the financial statements under the ED. Conversely, stock options that have a high exercise price relative to the
market price of common stock (i.e., they are "out-of-the-money"), and therefore no value or the least potential value,
will carry the largest expense in the financial statements. This is counterintuitive and perhaps even misleading. The
expense recognized under the ED does not (i) reflect the value that an employee will ultimately receive, (ii)
represent the dilution to shareholders or (iii) represent the cost to the company.

To provide the FASB with several examples of the counterintuitive nature of the accounting proposed in the ED and
to support our arguments that the ED does not measure the value transferred to the employee, the dilution to
shareholders, or the cost to the company, we provide the following examples from our financial statements.

Value to the Employee

In 2000, we granted stock options with weighted-average exercise prices of $62.42 per share. Employees have
realized $8.8 million in value on these stock options; however, if the ED had been effective at the time of these
grants, we would have recognized nearly $1.6 billion of expense in our financial statements. In other words, under
the ED we would be required to recognize a compensation expense that was over 180 times the economic value
actually received by our employees.

We believe that the exact opposite may occur in a strong bull market similar to the bull market experienced in the
late 1990's. Specifically, we believe that the appreciation of a company's common stock may far outpace that of the
expense that company would be required to recognize related to its stock options under the ED. As we noted above,
we believe the majority of the users of financial statements currently expect that the expense from an employee
stock option would approximate the intrinsic value at the vest or exercise date. Because this expectation would not
be met under the ED (i.e., the expense would likely be understated), companies could be subject to increased
lawsuits as plaintiff attorneys utilize hindsight to second guess the assumptions utilized to value the stock options at
the grant date.

Further compounding this problem, we believe that the requirements of Regulation G/Item 10 of Regulation S-K
may preclude companies from providing to users in a timely manner the information that would allow users to
reconcile the mismatch between their expectations and the expense recognized in the financial statements.

Dilution to Shareholders

To further illustrate the inconsistencies within both Statement 123 and the ED with those of the expectations of the
users of financial statements, we note that the ED would require companies to recognize an expense at the time
stock options are reconveyed (i.e., returned for no consideration) to the issuer of the stock options. To our
knowledge, the accounting afforded these types of transactions is the only instance in which a corporation receives
something of value (i.e., if one accepts the FASB's argument that stock options have value) for no consideration and
in agreeing to accept that value reports an expense. Regardless of any theoretical accounting argument that can be
made as to why this is "technically pure accounting," it defies common sense. Not only is it difficult for
shareholders to grasp this concept, it is equally difficult to explain.

The following example illustrates these concerns. If we had followed the provisions of the ED in 2001 to 2003, our
financial statements would have reflected an expense of over $760 million related to stock options issued and
subsequently cancelled for no consideration (i.e., options returned by our former CEO for no consideration and
vested options cancelled upon termination of employees). The stock options reconveyed represented potential
dilution to our shareholders of over 10%. We did not utilize any assets to obtain these stock options nor did we incur any liabilities. Further, the issuance and subsequent cancellation resulted in no net change in options outstanding and all other equity accounts remained unchanged. Yet, for financial reporting purposes, we would have had to disclose that we received a capital contribution and incurred an expense to obtain that contribution. Compounding this counterintuitive result, we believe that Regulation G may prohibit us from excluding these charges in our filings with the Securities and Exchange Commission ("SEC"), as they would be "Non-GAAP" financial measures.

These limitations, coupled with the requirements of the ED, have resulted and in the future may result, in the users of our financial statements incorrectly assuming that our financial results were deteriorating and that our shareholders were continuing to be diluted, when in fact these transactions had no impact on our financial condition and actually reduced the potential dilution to shareholders. In fact, we have been made aware of several instances where members of the financial community have incorrectly included one-time expenses associated with stock options reconveyed (e.g., by our former CEO) in forecasting our future stock option expense. The fact that a return of stock options resulted in such a large expense in our footnote disclosure for Statement 123 was not intuitive, and most likely would not be intuitive under the ED either, to even the most sophisticated users of our financial statements.

Cost to the Company

We believe the following example illustrates that the fair value of a stock option as calculated in accordance with the provisions of the ED has little relationship to the cost actually incurred by us. In September 2002 we repurchased 28.1 million stock options for total consideration of $52 million, which we reflected as an expense in our income statement. If we had followed the provisions of the ED, we would have been required to reflect an additional $595.3 million of compensation expense in our financial statements in 2002. This would have been in addition to the approximately $400 million that would have been expensed in accordance with the ED in 1999 to 2001 related to these same stock options. In other words, our financial statements would reflect an aggregate "cost" to us in excess of $1 billion, when in reality we repurchased all of these stock options at a cost of only $52 million.

We ask the FASB to consider which is more reflective of the "asset used up" as defined by Concept No. 6 the actual $52 million repurchase price of the stock options, which was paid in cash and stock, or the over $1 billion of expense that would have been reflected in the income statement. Regardless of any theoretical accounting argument, we do not believe anyone in good conscience would argue that our employees were compensated $1 billion rather than $52 million, or that the repurchase actually cost $1 billion. Moreover, absent a firm understanding of the ED, we believe the vast majority of users would believe that reporting the compensation at $1 billion rather than $52 million would be a great misrepresentation. Accordingly, we believe the current accounting allowed under Statement 123 (i.e., disclosure in footnotes only) is preferred and better reflects the economic substance of the transaction.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25’s intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

Response: While we do not agree with all of the conclusions reached in Statement 123, we believe the pro forma disclosures strike a reasonable balance between those who believe that an employee stock option gives rise to an expense and those who believe that it does not. Specifically, in response to the ED, numerous investment advisors have developed models to value companies in a variety of different ways, ranging from models that include all of the stock option expense to those that exclude that expense and rely solely on the earnings prior to the charge. As discussed above under Issue 1, we believe that the ED, coupled with the interaction of Regulation G, would limit a company’s ability to provide the information to the very users who need it.

In contrast, Statement 123 provides companies with much greater latitude to provide the information requested to all users of financial statements. In the event that the FASB proceeds with the ED, we encourage the FASB to permit or even require that the expense related to stock options be reflected in one line item in the income statement, which we believe will allow users to more easily obtain the information required for their investment decision. In addition,
in order to provide investors with a clear understanding of the impact that this expense has on a company’s liquidity (i.e., no impact), we encourage the FASB to require a company to reconcile the earnings reported in accordance with the ED to the earnings excluding these charges. By doing so, the FASB would allow companies to meet the needs of all users of financial statements and not just those that agree with the FASB’s positions as stated in the ED.

Based on our response to Issues 1 and 2, we believe that the remaining Issues are not relevant. However, given that the FASB may proceed with a statement requiring the recognition of expense related to employee stock options, we have provided the following comments and suggestions, which we believe may improve the ED.

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

Response: If the FASB determines that a company should reflect in its income statement an expense associated with a stock option, we reluctantly would support a fair value measurement at grant date. However, we strongly believe any such fair value must consider ALL of the unique characteristics of an employee stock option as discussed below under Issue 4. Further, we encourage the FASB to make it clear within the final pronouncement that companies are permitted and even encouraged to disclose that the expense recognized under a grant date fair value methodology will most likely have absolutely no relationship to the value realized by an employee, and often times may even have an inverse relationship as the examples provided above indicate.

We also encourage the FASB to consider whether the perceived benefits of expensing stock options are outweighed by a grant date fair value model that results in a measurement date and attribute that is overly complex, requires too high a degree of subjective judgment, allows the greatest opportunity for manipulation by management, creates undue legal exposure to the company estimating that fair value, and does not match the perceptions and needs of the average investor. Prior to implementing such a standard, we encourage the FASB to continue to explore other methodologies that would provide more objective and verifiable measures of compensation and at a cost much less than that of a fair value model. For instance, some respondents have suggested the use of an estimated volatility of 0%, which we would support.

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

Response: We believe that the FASB has done an outstanding job in providing guidance to ensure consistency in gathering historical data for the input assumptions and the various items to consider in adjusting those assumptions from the historical amounts. Despite these efforts, we believe that the FASB would be unable to provide enough guidance to compensate for the fact that these assumptions are inherently subjective, which will inevitably lead to inconsistent application from period to period and across companies resulting in the expense recognition being incomparable and inconsistent from period to period and across companies.
While the ED suggests that a company adjust historical lives and volatility for reasonable expectations of the future, we note that reasonable people can have vastly different reasonable “expectations.” For example, we believe many companies may justifiably conclude that the stock market bubble in the late 1990s, subsequent bear market, September 11, 2001 and the war in Iraq are all abnormal periods, and thus the mid 1990s and prior periods’ volatility is the mean to which volatilities will revert. Other companies may also justifiably conclude that these same periods are normal phenomena and leave historical volatilities unadjusted. While both companies made good faith estimates, the assumptions utilized would result in vastly different option valuations and therefore lack of comparability.

Further, we are aware that several of the large auditing firms are concerned whether an adjustment to historical volatilities and lives, even if the historical assumptions are known to be incorrect, are “supportable.” In a recent speech, Douglas Carmichael, the PCAOB Chief Auditor, expressed this same concern by stating, “When fair value cannot be measured by reference to matters that are directly observable, and if the measure represents little more than the measurer’s state of mind, neither the measurement nor the measurement method are verifiable. In those circumstances, the independent auditor has a scope limitation and should not express an unqualified opinion on financial statements that are materially affected by such a measurement.”

Many in the financial community believe that expected lives and volatility of employee stock options are not subject to reasonable estimation and do not believe that the guidance provided by the FASB will improve this reliability. To test this hypothesis we selected a sample of companies from the Dow Jones Industrial average, the NASDAQ 100, and a handful of financial institutions, which presumably would be more astute at estimating volatility, to review how accurate these companies were in estimating their future volatility. Companies evaluated were across a wide variety of industries and were among the largest and most sophisticated international companies, some of which included “stock option experts,” such as Warren Buffett, on their board of directors.

We evaluated these companies ability to estimate volatility over the stated “expected life” of their options (lives of typically three to six years) and their ability to estimate volatility over the life of the shares granted through their employee stock purchase plans (“ESPP”) (lives of typically 6 months or less). The results of our analysis were very concerning, especially if those results were reflected in the income statement and extrapolated to the entire population of publicly traded companies. We would be glad to discuss examples during the open forum on June 24, 2004.

Specifically, we found that on average these companies incorrectly estimated their “expected” volatility by 42% (differences ranged from 6% to nearly 150%). The ability to estimate relatively short-lived options (i.e., six month grants under an ESPP) was not much better, with the average actual volatility differing by 32% from the previously estimated “expected” volatility. We further analyzed the accuracy of early adopters of Statement 123 in estimating their volatility since adoption, noting an error rate on average of nearly 25%. To determine whether the “financial experts” were any better at estimating the “expected volatility”, we analyzed entities in the financial sector separately, as we believe this group would be a primary source of the expert services utilized by other companies to estimate the fair value of stock options. While the financial sector did perform better on average, we believe their actual volatility differed significantly enough from their original estimates that the results should not be acceptable (e.g., some of these entities incorrectly estimated volatility by as much as 30% and, collectively, since adoption of Statement 123, by on average over 20%).

Because volatility has such a dramatic impact on the expense recognized, an error rate as high as that noted in the preceding paragraph could lead to hundreds of millions of dollars of under or over recognition of expense in the typical high tech company’s financial statements (where volatility tends to be higher). While we recognize that none of the above samples are statistically determined, we do believe that these results highlight our belief that the fair value of an employee stock option cannot be reasonably determined with any degree of reliability. We encourage the FASB to perform their own review of the estimates made by public companies of expected volatility to determine if an option can be reliably valued at grant date prior to implementing a final standard.

We did not perform a similar analysis of expected life, but based on a cursory review of the data available it appears that the vast majority of companies that granted stock options in the late 1990s and 2000 significantly underestimated the actual lives of their options (i.e., because of their high exercise prices, the options will most likely remain “out-of-the-money” and therefore will expire unexercised). We find it counterintuitive that if these companies had assumed at grant date that the stock price would drop, resulting in the option becoming and remaining “out-of-the-money” and thus expiring unexercised, these companies would be forced to use the
contractual life to value the options, resulting in an increase in the value versus decrease. Counterintuitive and potentially even misleading results such as these simply should not be acceptable.

While we acknowledge that the ED does not intend for a preparer of financial statements to estimate the future value of the stock option, we believe the FASB should consider that in order to value the option at the grant date a company must utilize estimates of the future volatility and either directly or indirectly the expected life. It troubles us that this ED may introduce significant imprecision and diversity in practice into financial statements. To our knowledge, the error rates noted above would not be acceptable for any other estimate in the financial statements and we do not believe it should be acceptable related to estimating fair value of an employee stock option. Further, we do not believe the accounting under the ED reflects the economic substance and, therefore, requiring companies to expense stock options would be a poor compromise that does not achieve the FASB’s stated goal of a financial reporting model that is reflective of the economic substance of the transaction.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board’s conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board’s conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

Response: Primarily for the reasons noted above under Issue 4(a), we do not believe that an employee stock option’s fair value can be measured with sufficient reliability, regardless of the model used. The models utilized today require too many subjective judgments, which as indicated above have often proved to be incorrect by a significant amount. Further, we do not believe that the majority of these assumptions are either objective or verifiable by a company’s auditors.

We believe that the FASB acknowledged the importance for the assumptions to be objective and verifiable in paragraph B7 of the ED: “assumptions made should not represent the biases of a particular party.” As noted above, we believe that the PCAOB Chief Auditor shares our concern and may require audit firms to issue a scope limitation on many entities as the auditors discover that estimates utilized in the past were significantly different than actual results.

Regarding the FASB’s preference for the binomial model over the Black-Scholes model, we believe that any additional benefits of flexibility are not justified by the cost. Using the binomial model will require companies to incur significant costs to reconfigure systems to obtain the data to support assumptions for the binomial model, require new capital expenditures for binomial option-pricing models, and require additional expertise that the majority of companies do not currently have.

Further, we are skeptical as to whether the additional flexibility will result in a better estimate than Black-Scholes. As we have shown above related to the analysis of the accuracy of just one assumption (volatility), companies have difficulty accurately estimating the relatively few assumptions utilized in Black-Scholes. We do not believe that it would be prudent to extend this error rate to the hundreds of additional assumptions required by many of the binomial models, the slightest incorrect estimate of which could change the estimated value of the stock option materially. After incurring the significant costs of analyzing historical and expected employee stock option exercise behavior, there is no indication that the more complex binomial option pricing model will produce a better estimate of value than that produced by the Black-Scholes model, with its single overarching estimate of expected life.

Specifically, as companies have begun to test the binomial model, we understand the difference in fair value calculated using a binomial model and Black-Scholes model is often insignificant. The use of a binomial model will almost certainly require the majority of companies to use costly outside experts, introduce a level of complexity into the financials that will be beyond the comprehension of the majority of accountants, much less the average user of
financial statements, and require the purchase of new financial systems and software to implement. We do not believe any perceived, yet unproven, benefits of a binomial model would justify these costs.

We also note that the FASB’s current deliberations on the proposed standard for “Fair Value Measurements” summarize its conclusions on the hierarchy of valuation techniques used to measure fair value, but the FASB has not indicated a preference for a specific valuation technique within a given level of the hierarchy. The proposed Fair Value Measurement standard would allow discretion in the selection of a valuation technique within a given level of the hierarchy. We believe that the flexibility regarding the selection of valuation techniques, among those generally accepted by the valuation community, is consistent with the FASB’s tentative conclusion in the proposed standard on “Fair Value Measurements” and should also be included in the final standard on Share-Based Payments.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Response: We are aware that many companies and members of Congress are advocating a volatility of 0%, which in their view would increase the objectivity of the estimate and consistency between companies. In a political and legal environment where corporate officers must certify the accuracy of their financial reports under the threat of possible fines or imprisonment if such certification is in error, and given that future results will inevitably indicate that the vast majority of option-related estimates were in fact incorrect, albeit ethically and judiciously selected, we would encourage the FASB to either mandate the use of a 0% volatility or some other specific method of arriving at expected volatility.

As further discussed below in our response to Issue 4(d), utilizing a volatility of 0% to take into account the unique characteristics of an employee stock option, including the lack of liquidity, risk of forfeiture, vesting requirements and other restrictive features (e.g., black-out periods) may in fact result in a more reliable estimate of the fair value of that stock option. In addition, we do not believe the use of 0% volatility to take into account the unique characteristics of an employee stock option is any less arbitrary than the FASB’s assertion that the ED takes the unique characteristics into account by utilizing the expected term versus the contractual term coupled with the non-recognition provisions for options forfeited.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option’s contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option’s fair value? Please provide the basis for your position.

Response: We whole-heartedly agree that a company should only recognize an expense related to options that vest and, as suggested above, would encourage the FASB to consider whether a company should also reverse any previously recognized expense related to vested stock options that expire unexercised. This accounting would be consistent with that of similar monetary arrangements, such as pensions, bonuses, and commissions. From a common sense perspective, if the net impact on a company is zero (i.e., no change in assets, no change in liabilities, and no change in the number of equity instruments outstanding), we would find it misleading to record an expense and similar capital contribution for a hypothetical exchange that effectively had no economic consequence.
We are troubled that the ED would be the first accounting standard that results in the financial statements reflecting not what actually occurred but instead what was estimated to occur at the time the terms are initially negotiated. The vast majority of other financial standards issued by the FASB involving estimates (pensions, sales returns, environmental liabilities, warranties, etc.) require the financial statements to reflect what really happened, yet the ED would report only what could hypothetically occur. Because of the unique nature of a reconveyance, we encourage the FASB to reconsider the reconveyance provisions discussed in the initial deliberations of the ED and extend those provisions to options cancelled in accordance with the stock option’s terms (e.g., expire unexercised).

We appreciate the FASB’s acknowledgment that employee stock options have unique characteristics and that those characteristics result in an employee stock option having a lower fair value than a freely tradable stock option. Accordingly, we support the FASB’s effort to take into account the unique characteristics of employee stock options in determining the fair value at grant date. We encourage the FASB to take their existing efforts further to consider all of the unique characteristics of an employee stock option, including:

- Longer contractual terms;
- Subject to forfeiture and continued employment;
- Subject to black-out periods;
- Subject to vesting; and
- Lack of liquidity (i.e., are not freely tradable, non-transferable and non-hedgable).

We do not believe that the ED’s proposal to modify the contractual life to take into account suboptimal exercise patterns or the expected life adequately takes these characteristics into account in determining the fair value of an employee stock option. Specifically, the fact that an employee exercises an option prior to the end of the contractual term (e.g., suboptimal exercises) does not have any bearing on the actual value of that option at grant date. The fair value of the stock option, which is being used as a proxy to value the employee services rendered, should be based on the terms of that stock option and not a hypothetical instrument that was not issued.

We believe, as do many academics, that models can be developed to include adequate discounts for the unique characteristics of an employee stock option, such as the terms noted above. For example, Jonathon Mun, Ph.D., an expert in binomial option-pricing models, concluded in his response to the FASB that a binomial or other option-pricing model can appropriately apply a non-tradable and non-marketable discount to an employee stock option.

Regardless of which side of the technical accounting arguments for expensing employee stock options a person falls, intuitively the unique provisions of an employee stock option make it significantly less valuable than a freely tradable stock option. We also note that in our private discussions with several investment banks, national valuation firms, and even members of the accounting profession (both at the FASB, the SEC and within various national offices of the Big Four accounting firms), all acknowledge that an option with those terms would likely have no willing buyer other than an employee and/or would be valued at a significant discount to a freely tradable stock option.

We would suggest the FASB review a recent example supporting the above assertions involving a large technology company in which employee stock options were sold to an unrelated third party. In order to complete the transaction, the terms of the employee stock options had to be modified to remove several of the “unique terms” and even after modification the value of the transaction was at a price below that determined using the current valuation models suggested by the ED.

If the FASB is going to require that employee services be valued based on the “fair value” of an employee stock option, we would encourage the FASB to at least require that the derived value represent the value of the instrument actually issued versus a hypothetical freely-tradable instrument that was not issued. We are aware of several methodologies that take these characteristics into account and would recommend the FASB consider one of the following or combination of the following suggestions:

1. Include an appropriately applied non-tradable and non-marketable discount for each employee stock option. Among other alternatives such as models developed by valuation experts (e.g., Jonathon Mun, Ph.D., among others), we would recommend that the FASB explore similar proposals as put forth by Merck and Intel. Both Merck and Intel have proposed measuring this discount through some form of “put-on-call” approach where the value of a put on the underlying call option is calculated and deducted from the option value as a discount representative of the value of the selling privilege in a freely-tradable option.
2. Modify the interest rate assumption to present value the cash flow based on an appropriate risk premium that is consistent with what a willing party to the transaction (i.e., employee) would require.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

Response: As stated in our above responses, we do not believe there are any circumstances in which any company could honestly assert that their estimate of fair value is reasonable. We certainly believe that reasonable people will make honest, good-faith estimates of those assumptions, but they are just that, assumptions. As our test of just one assumption (estimated volatility) indicates, we do not believe the majority of companies will be even remotely accurate in estimating the "expected volatility," much less the numerous other assumptions required to estimate the fair value of a share-based payment.

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Response:

For the same reasons noted above for employee stock options, we do not believe shares issued under an ESPP should be recognized as an expense. As to the specific provision requested in Issue 6, we concur with the position taken by the FASB in the basis of conclusion of Statement 123. Specifically, an ESPP that met the criteria of paragraph 236 of Statement 123 would receive non-compensatory treatment. We believe that a discount offered to employees in a broad-based ESPP is aimed at encouraging employees to become shareholders versus compensating the employee. We believe that the FASB should at a minimum include an exception for a small discount (i.e., 5%), which the FASB determined in Statement 123 was analogous to a stock issuance cost.

Attribution of Compensation Cost

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

Response: We agree that the service period is the appropriate basis for attribution; however, we would encourage the FASB to reconsider certain of its guidance as to when the service period begins. When an option is granted and approved prior to or simultaneously with commencement of service, we agree that commencement of service should be the applicable measurement date. Similarly, when an employee begins services but a particular term of the option, such as exercise price, is not fixed initially, we agree that commencement of service should be the applicable measurement date. However, when an employee begins providing services before the option is approved, the ED would require a company to account for a transaction that is not legally enforceable. The option could be approved or it could not, and the company would be required to account for it regardless. Further, if an employee begins providing service knowing that the option is subject to approval, which may or may not occur, then that employee is knowingly providing services for the approved compensation only. Accordingly, it is not until the option is approved and legally enforceable that the employee begins providing services in exchange for the additional compensation provided by the employee stock option. Therefore, in this instance, the appropriate measurement date should be the date the option is approved.

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37—
B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

Response: This guidance appears sufficient to determine the requisite service period as defined in the ED.

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

Response: We understand the logic of the FASB’s conclusion, but believe the FASB focused unduly on the vesting schedule of the option in determining the attribution of the value of that option. The ED attempts to value the employee services that give rise to compensation expense rather than the value of the option itself. An employee is providing services evenly over the vesting period regardless of whether the vesting is ratable or cliff. In other words, the employee is not providing more service or more valuable service in the early years of a stock option than the latter part of the option. Therefore, the cost should not be more heavily weighted towards one end, but recognized ratably over the term.

To illustrate, we provide the following example where an employer grants an option that vests 100% at the end of two years and a second option that vests 50% at the end of year 1 and 50% at the end of year 2. In both cases the employee is providing an equal amount of services, which are worth the same amount. We doubt anyone would assert that the first employee provided 75% of their services in the first year for the graded vested option and the second employee only provided 50% of their services in the first year for the cliff-vested option, yet the ED would require expense to effectively assert just that.

It is our belief that this provision would serve to only further confuse the average investor, a belief shared by many of the largest financial institutions (see Lehman Brothers response to the FASB dated June 7, 2004).

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

Response: In paragraph C99 the FASB argues that logically an employee would not agree to modify the terms of the original grant for a modified instrument that is worth less than the original instrument; therefore, the ED states that the value of the consideration exchanged (i.e., the modified award) must at least equal the value of the original award. Further, as proposed, if a modified award were issued, the ED would require that a company recognize not only the grant date fair value of the original award but also the difference between the fair value of the modified award and the then-current fair value of the original award.

We believe this accounting treatment does not reflect the fair value of the services provided by the employee. The basis of this conclusion has its roots in the precepts established to avoid abuse of the fixed accounting afforded under APB 25. In a fair value model of accounting for stock options, we believe the FASB should be consistent in its application. In other words, if the FASB argues that the option pricing models required under this standard and the guidance given is sufficient to allow a reliable measure of the value of an employee stock option, modifications of the terms of an option should be treated consistently with those principles.

In effect, a modification of a stock option is the cancellation of the previous terms of the option and a grant of a new instrument. As a result, the value of the employee services cannot exceed the value of the new (modified) instrument and no longer has any relation to the original instrument. Therefore, the value of the new instrument should be determined independently of the value of the original instrument. Take for example a union contract in
which the compensation to the union members is renegotiated. Would the FASB propose that the value of the
renegotiated compensation paid to the workers equal at a minimum the value of the original contract, or be
otherwise determined based on that value? We think not. The compensation would equal the value of the new
contract, determined based on the new contract alone, and regardless of whether compensation increased or
decreased from the levels in the original contract.

To further illustrate potential misleading results and the punitive aspects of the modification provisions of the ED
when compared to cash compensation, we provide the following example. Assume that an employee was granted a
stay-on bonus entitling the employee to receive a fixed amount of consideration paid in the employee’s local
currency and that currency was equivalent to $1 million (the functional currency of the employer). Also assume that
exchange rates declined such that the employee would now only receive the equivalent of $900,000. If the company
modified the terms of the original arrangement or even canceled the previous agreement, such that the employee
would now receive a total consideration equal to $1 million, the total compensation expense would be only $1
million. However, if the provisions of the ED were applied to this arrangement by analogy, the company would be
required to reflect $1.1 million of total compensation (the original value of $1 million plus the $100,000 difference
between the two arrangements) for a transaction that only cost the company $1 million.

We encourage the FASB to remove provisions in the ED that result in more punitive accounting than that afforded
other forms of compensation and that are not otherwise intuitive to the users of financial statements.

Income Taxes

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement
123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income
tax effects and paragraphs C128–C138 describe the Board’s rationale. That method also differs from the one
required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the
method of accounting for income taxes established by this proposed Statement? If not, what method (including the
method established in IFRS 2) do you prefer, and why?

Response: We fail to understand the FASB assertion that a tax benefit results from an equity transaction, while a tax
shortfall is not. We believe that the FASB should require the compensation portion of the tax deduction be based
either on tax law or on the compensation cost for financial reporting purposes, versus the lesser of the two as
required in the ED. Once again we believe the ED results in the most punitive form of accounting and does not
address the substance of the actual transaction.

The FASB asserts that the grant of a stock option gives rise to compensation, yet a change in value of the underlying
stock is in one instance an equity transaction and in another an expense to a company, a conclusion we find illogical.
From a conceptual standpoint, using the grant date fair value model proposed under the ED, any change in the
underlying stock is not a compensatory event, but would be better characterized as an equity transaction. In fact, in
a speech at the December 2003 SEC conference, one of the FASB Board members explained the logic of the ED by
simply stating that risk and rewards of a stock option after the grant date were those of the employee and not the
issuing company. We find it unacceptable to require a company to bear the risk of an income tax shortfall with no
potential to realize a tax benefit. Accordingly, we believe movements in the stock after grant date should not impact
a company’s effective tax rate but instead should be treated as an equity transaction.

It is not clear to us why the FASB changed its conclusion from Statement 123. We continue to support the FASB’s
original conclusion in Statement 123 that both the tax benefit and deficiency should be recorded within equity.
While we support the concept of international convergence, we do not believe the FASB should converge to the
IASB standard just for the sake of convergence. We believe the FASB should strive for the right accounting and
converge only where the IASB has developed a better accounting standard.

If stock options are expensed as currently proposed in the ED, we believe that each employee stock option would be
composed of two events: (i) compensation expense attributable to the vesting period and (ii) an equity transaction at
exercise date. We believe that this concept is contained in the ED in paragraph C129, which states that tax
deductions pertain to two separate events:
• a transaction in which employees render services as consideration for an award of shares, share options, or other forms of share-based payment. Use of those services in the company’s operations results in compensation cost, which is an income statement item.

• an equity transaction, such as the exercise of share options. That equity transaction will be reflected by share price changes between the date an award of options is granted and the date the award is exercised or otherwise settled.

We believe this view is consistent with the intra-period allocation principle in Statement 109. Further, we believe that this treatment is consistent with the treatment of other equity transactions afforded in Statement 109 such as in paragraph 36(c). Specifically, this paragraph requires the tax effect of temporary differences caused by equity issuances to reduce or increase the associated equity proceeds versus impact income tax expense.

From a practical standpoint, to comply with the ED, a company will have to track option related deferred tax assets at the individual grant level. This complexity is compounded when considered in light of the FASB’s view that individual tranches within an option with graded vesting represent grants of individual options. Accordingly, a company would effectively need to account for and track the deferred tax assets for each individual tranche within an option with graded vesting. Not only is this requirement inconsistent with the ED requirement to initially value the employee stock option utilizing a portfolio approach, but invokes a level of cost and complexity that we believe clearly outweigh the benefits.

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191-B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

Response: We fully support complete and accurate disclosure and have already chosen to disclose in our filings with the SEC more than what is required under existing accounting literature. We believe that the FASB’s disclosure objectives are appropriate and relatively complete. To enhance these disclosures and in order to provide a better evaluation of a company’s liquidity and overall financial performance, we recommend that the FASB consider requiring a reconciliation of earnings including the stock-based compensation charge, which under the ED will be included in the income statement, to the earnings excluding that charge.

Transition

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board’s rationale for that decision is discussed in paragraphs C157-C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

Response: If the ED is issued as proposed, we would suggest that the FASB also allow a company, if it so chooses, to utilize either a modified retrospective restatement of financial statements or a complete retrospective restatement of prior financial statements in order to provide greater comparability and useful information.

Nonpublic Entities and Small Business Issuers

As we are a large, multi-national, publicly traded company, we have no comment on Issues 14(a), 14(b) and 15.
Cash Flows

Issue 16: For the reasons discussed in paragraphs CI39–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

Response: We do not support the FASB's conclusion. We believe that this accounting treatment would be inconsistent with the treatment afforded other operating cash flow impacts such as interest expense on outstanding debt. Further, we also are concerned that grossing up the cash flow statement for a "non-cash" transaction is inconsistent with the treatment afforded other non-cash transactions. Excess tax benefits are simply a reduction of taxes that would have otherwise been paid and not a financing activity.

Differences between This Proposed Statement and IFRS 2

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

Response: We support the concept of convergence with the IASB when that convergence results in a superior accounting standard, but disagree with convergence for the sake of convergence. As described in our response to Issue 11, we disagree with the convergence with the IASB regarding the accounting for income tax impacts of share-based compensation.

Understandability of This Proposed Statement

Issue 18: The Board’s objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

Response: We believe the FASB placed little weight on the usability of the ED and a disproportionately high weight on obtaining a theoretically pure accounting answer. We encourage the FASB to perform a cursory review of comments by financial advisors, the financial press, and shareholder advocacy groups on the expense under Statement 123, an arguably simpler pronouncement than the ED. We are confident that the FASB would find that the majority of these groups do not understand the provisions of Statement 123. The ED increases the complexities of Statement 123 exponentially, which we believe may result in company financial statements that are less transparent, more difficult to compare among companies - a result contrary to the FASB’s goal of creating more transparent and understandable financial statements. Further, as noted in our responses above, many of the provisions of the ED will result in counterintuitive results that will be difficult to explain to the investment community because of Regulation G, further contributing to confusion among investors.

It is our belief that the complexities of the ED will far exceed the knowledge base of the vast majority of accountants and preparers of financial statements. Inevitably, the preparers will have to use costly outside experts to help prepare the financial statements to comply with the ED. These experts are not subject to uniform professional standards or restricted in their determination of what constitutes a reasonable basis for determining valuation parameters that cannot be observed. If the preparers of financial statements and the majority of the auditors of those financial statements need the assistance of specialized experts, then the users, both the sophisticated user and the average user, most certainly will need similar assistance to interpret the impact of the ED on the financial statements. We believe that it is unreasonable to expect the average investor, especially the retail investor towards which many of the recent accounting pronouncements have been focused, to "study the standard with reasonable diligence," an exercise that we believe will be futile. It is not surprising that many of the financial institutions, valuation firms, and auditors are advocating the very complex valuation models and expense recognition provisions included in the ED that they ultimately will derive significant financial benefits from.
Effective Date

In addition to the above comments requested by the FASB, we also request the FASB reconsider the proposed effective date. We are very concerned that the proposed timing for the release of the final standard and the proposed effective date for calendar year-end public companies will result in poor implementations of the ED. We believe that the FASB should select an effective date that not only reflects the need to issue standards in a timely manner, but also allows preparers and their auditors sufficient time to ensure that the ED is implemented with high quality. Under the proposed timing for the release of the final standard, preparers will have only a limited time (a matter of days or weeks) to address the complex valuation issues arising from using a binomial model, develop the systems to record compensation cost and to individually track the tax effects of their option awards. This major undertaking will be conducted simultaneous with the significant efforts currently underway to comply with Section 404 of the Sarbanes-Oxley Act, the combination of which may overwhelm many companies.

We have inquired with several providers of software that would be utilized by companies to account for stock options in accordance with the ED. Based on our discussion with those providers, the providers indicated that their software would not be available for general release until the end of December 2004. In reviewing the specifics of the ED against the features of the software that would be available in December 2004, we noted that the anticipated December 2004 releases may not be fully compliant with the ED and that fully compliant versions would not be available until mid 2005. We encourage the FASB to consider two key issues, both of which could result in misreporting of the relevant financial metrics: (1) there will not be a fully compliant software tool available as of the proposed effective date (January 1, 2005) and (2) because even a partially compliant version of the software tool will not be available until late December 2004, companies will not be able to adequately test those aspects of the software prior to adopting the ED on January 1, 2005. We find this unacceptable, especially in an age where internal controls and high quality financial statements are critical and the CEO and CFO must certify the financial statements under threat of possible fines and imprisonment.

Further, the inability to utilize fully compliant software may limit a company’s ability to provide financial guidance in its 2004 year-end earnings calls. Because the software may not contain adequate modeling features, this problem will only be exacerbated for companies with a highly volatile stock. We encourage the FASB to consider whether the perceived benefits of the ED and the timing of its effectiveness exceed the “cost” to investors of not having adequate guidance as to a company’s future operating results. Especially, when the options expensing costs are already included in the company’s footnotes and periodic financial filings (both quarterly and annual filings).

We encourage the FASB to delay the effective date of the ED to January 1, 2006 or later, which would allow companies to ensure a high quality implementation of the ED.

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Thank you for the opportunity to comment on the ED and we look forward to participating in the FASB’s public roundtable of this issue in Palo Alto, California on June 24, 2004. Please do not hesitate to contact either me (650 477 6082) or Greg Rush, Senior Director External Reporting (919 287 0317) with any questions to our comments.

Very truly and respectfully yours,

Kenneth A. Goldman
Senior Vice President, Finance and Administration and Chief Financial Officer

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