June 21, 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation
Director of Major Projects
File Reference No. 1102-100
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Share-Based Payment Exposure Draft

Dear Sirs and Madams:

We applaud the Financial Accounting Standard Board’s (FASB) for its extensive deliberations and due process with respect to improving the financial reporting and disclosures of equity-based compensation. Seldom has Congress, regulators or an accounting standard setter deliberated a project as publicly and as extensively as the FASB has. In summary, we believe the Board’s proposal that all forms of equity-based compensation, including stock options, represent an expense that should be reported in the basic financial statements, is representationally faithful with respect to the underlying economics.

Glass, Lewis & Co., LLC is an independent proxy and financial research firm that provides research to institutional investors that manage over $5 trillion. In that regard, we rely on audited financial statements and disclosures that public companies provide to investors and the capital markets. Our staff has many years of experience as financial analysts, as senior executives and preparers of financial statements, corporate board members and as independent auditors. From our perspective it is vitally important to restore the confidence of the investors in the financial statements and disclosures that they receive. We believe the numbers therein should reflect the economics of the underlying events, provide sufficient transparency to make informed decisions, and have a high degree of reliability and integrity.

General Comments

Our general comments on the proposed standard are as follows:

1. Services provided by employees in exchange for any form of equity-based compensation, including stock options, represent compensation expense to the company and should be expensed in the income statement.

2. Pro forma or other forms of disclosures are not an appropriate substitute for recording the value received by employees and officers as compensation expense. Disclosure never should be permitted to disguise and mislead
investors as to the real economics of transactions in the basic financial statements.

3. We believe the amount of the compensation to the employee is the amount of the difference between what they must pay to exercise the option and the value of the stock at the vesting date. As such, we believe compensation expense is more representationally faithful to the underlying economics, is more reliable and verifiable if it is measured using a mark-to-market model. We believe this would also result in a much-simplified means of measurement with greatly enhanced comparability and consistency, as well as reducing complexity. The amount of compensation expense each quarter, over the vesting period, is the difference between the exercise price and market price. Each quarter as the price fluctuates the value the employee is going to get also fluctuates. Accordingly, each quarter the amount of compensation is trued up and amortized over the vesting period.

4. Based on our experience in analyzing financial statements of companies, we believe that under the proposed standard using the valuation models and guidance proposed, there will be a decline in the level of comparability and consistency in reporting of the amount of stock option expense. We believe these methodologies will result in more than just a few companies "inappropriately managing" key assumptions that directly affect the amount of reported compensation cost of equity-based plans. However the proposed methodology is still a vast improvement over the current accounting for stock options.

5. Based on our experience as executives in negotiating equity-based compensation plans, we disagree that the grant date is the date the exchange occurs between the company and employee. We believe the exchange occurs as the employee provides the services in exchange for the future right to vest in the reward. Accordingly, we believe that the exchange and measurement date should occur over the vesting period of the stock award. We believe the exchange and final measurement is completed once the employee has the full rights to obtain the underlying equity and associated benefits. We believe that occurs at the vesting date, not the earlier grant or later exercise date.

6. In theory, income tax benefits related to the vesting period should be included in earnings and those that increase or decrease after the vesting period should be reflected in additional paid in capital. However, we believe it may be more relevant for investors if the entire benefit was included in earnings.

7. Stock purchase plans provided to employees that are more favorable than stock purchase plans provided to all holders of the same class of shares should be recognized as compensation expense.
8. The effective date and measurement methodology should be the same for all entities. Creating exceptions to the general rule creates additional complexity for users of financial statements. We believe that when a particular class of business is granted an exception or waiver to the basic principles or objectives in a standard, it deviates from an objectives based accounting standard setting process that we support. In addition, when as a result of those exceptions or exemptions, a company provides numbers that lack representational faithfulness or transparency, as financial analysts we must provide them with a lower grade for the quality of their financial reporting, a higher risk assessment for investing, and in essence create a second class citizen.

9. Today, many small companies already find themselves in such a situation as they are unable to gain analyst coverage and attract sufficient liquidity in their stock. We do not believe the FASB should engage in standard setting that only further contributes to this problem. As a company who issues financial reports on companies, we would provide a lower grade on the quality of financial statements and disclosures that are prepared using exceptions or waivers to the general rule. This includes reports issued on small businesses.

10. The statement should be written in plain English that allows preparers and users to understand the implications of each general principle. We do not believe the Exposure Draft as currently written achieves that objective.

We have expanded on our overall general comments in the attachment. We would be pleased to respond to any questions you might have after considering our comment letter. Please contact Mike Lofing at 303-532-2416.

Sincerely,

Lynn E. Turner
Managing Director of Research
Glass, Lewis & Co., LLC

Michael Lofing
Senior Research Analyst
Glass, Lewis & Co., LLC
Specific Comments

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 agree with the Board's conclusion that services provided by employees in exchange for stock options represent compensation. Cash paid to employees is clearly viewed as compensation and in many cases vested options will become another form of cash compensation when exercised.

Today almost 600 companies have voluntarily chosen to adopt expensing of stock options. This group of companies cut across many industries and include many well known household names. We believe the choice they have exercised is consistent with the conclusions that stock option awards do represent a cost to the company that should be reported in the income statement.

When a company issues equity, including stock options, it dilutes the value of the shares held by existing shareholders. More importantly, it results in the company forgoing an asset (cash) it would otherwise be entitled to if it sold that stock in the public markets and received the cash proceeds. As a result, we do believe there is a cost to companies of equity-based awards.

We also note many companies who have equity-based award programs have also engaged in stock buy back or repurchase programs to avoid further dilution in the value of the stock price. As a result, companies who have expended cash on such programs have had to forgo an asset, cash, in order to continue to make these awards to employees. In these instances, it is nonsensical to argue that there is no cost to the company. In order to avoid the dilutive effects of stock option programs some companies establish ongoing share repurchase programs. We found the following example of others that agree there is a real cash cost related to stock option plans.

"Indeed, in such cases the difference between the proceeds from employee option exercises and the cost of reacquiring an equivalent number of shares in the open market is the real cash cost of the option compensation. The upshot of this is that credit analysts may want to
consider reclassifying net repurchase cost to operating cash flows, presuming sufficient information exists to make these adjustments.¹

"On a related issue, about 75% of our companies repurchased shares. Of those that did, on average, the amount repurchased was equivalent to 62% of op exp in '03."²

"In the five years ending in 2003, Intel employees received 465 million of the company's shares through the exercise of employee stock options, annual reports show. But because Intel bought back 709 million shares of its common stock during that period, spending $8.1 billion to do it, its share count fell."³

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:

The fundamental premise of high quality financial reporting should be that the end product provided to investors reflects the underlying economics of the transactions being reported in a timely, comparable, consistent and reliable fashion. Putting the wrong numbers in the basic financial statements used by investors and analysts, and the right numbers in a footnote, is akin to a high technology company shipping a piece of hardware or software with glitches; then informing customers when they figure out they have a problem that the company will ship a patch to fix it. The markets will sooner or later appropriately turn such products into an endangered or extinct species.

Accordingly, we agree pro forma disclosures are not an appropriate substitute for recording the value received by employees and officers as compensation expense by the company. Our opinion is consistent with that of the following analyst:

"Anyone who's spent time analyzing financial statements knows that it's hard enough to make logical comparisons among companies when you're working in the published income statements; forcing oneself to bring numbers to the forefront from footnotes only makes the whole process

¹ Fitch Ratings, Accounting for Stock Options: Should Bondholders Care?, April 20, 2004
even more imperfect. Not everyone cared either: in the last eight years, did you ever see a consensus EPS figure that included stock option expense? Of course you didn't. Quarterly earnings estimates drive the market; there's no reliable way to build quarterly estimates of option compensation into earnings models, not without a lot of "help" from firms.\textsuperscript{4}

Proforma disclosure doesn't provide enough information to allow the investor to determine the impact on the operating results of a company including the various measurements of performance including margins. One respected analyst has noted, "As stock options are a form of compensation, expensing them will increase cost of goods sold (COGS); selling, general, and administrative (SG&A) expenses; research and development (R&D); or any other line item in the income statement where a company reports labor costs."\textsuperscript{5}

Arguments have been made that sophisticated users of financial statement have access to the information they need through proforma disclosure. But we must ask, when the actual cost of stock options in the semiconductor industry is 42\% to 91\% of earnings per share, why hide it in the footnote?\textsuperscript{6} Financial statements should be useful to investors. They should not be a compilation of numbers that must be remodeled and adjusted at additional cost, to be used, especially when the "real" numbers are to be found in the footnotes. This greatly complicates the cost of financial analysis, if not makes it exceedingly difficult, for the 90 million Americans that are invested in the U.S. capital markets. We wholeheartedly agree that:

"Recognizing the fair value of the employee stock options that firms grant would enable analysts and investors to more easily assess firms' compensation expenses and how those expenses affected firms' profits. That improved transparency would also aid corporate committees that approve managers' compensation packages. In fact, if recognition of that expense better informs investors about firms' profitability than disclosure does, capital will be allocated more efficiently, and the economy will be more productive."\textsuperscript{7}

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

\textsuperscript{4} The Analyst Accounting Observer, May 14, 2004
\textsuperscript{7} A CBO Paper, April 2004, Accounting for Employee Stock Options.
with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

Response:

We strongly believe the grant date is not the appropriate measurement date for the cost of options. The appropriate measurement date is the date the exchange actually occurs, as the employee provides the services over the vesting period. The final measurement date with respect to the expense becomes the vesting date as that is when the employee has fulfilled his or her obligation and the reward is deemed to be earned. At the offer date the employee has not fulfilled his obligation and as such the transaction is not complete. A major international credit rating agency has appropriately noted, "Expensing of options under the proposal results in a point-in-time estimate of compensation expense that may have little or no relationship with the actual future cost." The approach we propose would make the measurement method consistent and comparable for all companies that offer stock options to their employee and officers. We also believe it provides the most relevant information to investors.

We believe a mark-to-market model would be more appropriate and less complicated. The number of vested options multiplied by the market value of the common stock less the exercise price is the market value of the compensation earned. Ultimately, the compensation cost is the difference between the exercise price and the market price. That value is paid in return for services over the vesting period. As a result, we believe a company should charge to expense each quarter, over the vesting period, the difference between the exercise price and market price. Each quarter as the price fluctuates the value the employee is going to get also fluctuates. Accordingly, each quarter the amount of compensation is trued up and amortized over the vesting period, just like it has been for years for Stock Appreciation Rights (SARs).

Most companies have established broker/dealer cashless exercise arrangements for those employees who participate in their stock option plans. Glass Lewis has reviewed 727 stock option plans of which 590 or 81% have cashless exercise provisions. Today in the majority of the option plans, an employee seldom actually pays any money to acquire the stock. Rather cashless exercises are arranged by the employer whereby within a day or so, or even in just a few short hours, an employee "borrows" enough money from a brokerage firm to exercise the options and sells enough shares to pay for the purchase, taxes, and broker commissions. Essentially, just as with any stock appreciation right program, the employee receives just the net proceeds between the sales proceeds from the stock and the price of the stock paid to the company. Since such cashless exercise plans are substantively and economically the same as a stock appreciation rights plan (SAR), we believe they should be accounted for in a similar fashion.

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* Fitch Ratings. *Accounting for Stock Options: Should Bondholders Care?* April 20, 2004
For publicly traded companies, the measure of expense using the mark-to-market approach can easily be determined and manipulation and unnecessary costs avoided. We believe the mark-to-market mode will also contribute to more consistent and comparable financial reporting, thereby increasing the quality of the product investors receive.

Members of Glass Lewis have participated in the process whereby a private company puts a value on its stock as a result of recording the cost of the options granted as an expense in the financial statements. We have not observed where that process negatively impacted the business, its ability to explain its financial statements to investors or creditors, or to attract capital. We believe private companies can measure the expense without undue cost or burden and using a consistent measurement approach we feel is most appropriate.

If the FASB, after further deliberations decides not to adopt an approach measuring expense over the vesting period, then we believe the FASB should adopt a similar approach measuring the expense through the exercise date using a mark-to-market approach. The least desirable approach is the proposed grant date accounting measurement. Of course a continuation of not expensing the cost of equity-based plans is unacceptable and simply the answer furthest from reality.

**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:

Based on our previous experience as business executives and preparers of financial statements, we note that to “guess” at what the life of an option will be, what the expected volatility will be and other characteristics such as the expected number of options that will be exercised, one needs a crystal ball. Recent history has shown vividly that U.S. and global economies are not constant, but very cyclical. Likewise, businesses often see the success of their business fluctuate with the local and global economies with their share prices also moving up and down. A good example is the stock prices of many technology companies whose stock rose as the Nasdaq exceed 5200 in early 2000, only to fall below 1200 and then rebound to current levels. It would have been impossible for most preparers of financial statements to foresee such events at the end of 1999.

Likewise, it is fundamentally wrong for the FASB to expect an otherwise very busy preparer to make such wildly speculative guesses at what the future might hold for the success of a company and its stock price, and how those will ultimately impact the average life of an option, the volatility of stock price, and the number of options that will or will not be exercised. While there are many judgments that go into the preparation of financial statements, they do not require this level of speculation about such a broad range of uncertain future events totally outside the control of the Company.

Furthermore, we do not believe numbers requiring the inputs described in the proposal can ever be verified in a reliable fashion. We are in agreement with the recommendation made to the Board by The Public Oversight Board Panel on Audit Effectiveness.

"Establish a protocol with the ASB to assess the auditability of proposed standards before they are issued, including evaluations of the auditability when proposed standards are field tested."

We do not believe the approach defined by the Board will achieve the objectives of comparability or consistency. The keystone of high quality financial reporting is comparable, consistent reporting that is representationally faithful to the economics of the transaction. This high quality information is necessary in order for investors to be able to analyze and compare one company to others, when deciding where to allocate her or his capital.

The approach proposed in the Exposure Draft requires a minimum of six separate inputs. Only two of those inputs are factually verifiable at the grant date, the exercise price and the current price. The other four inputs require assumptions to be made by the Company based on their ability to predict the future. Comparability will be very difficult to achieve given it is unlikely any two people will make the same exact predictions about the future.

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9 The Panel on Audit Effectiveness Report and Recommendations, Public Oversight Board, August 31, 2000, p 55.
10 Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, paragraphs 63 to 80 and 111 to 122.
Consultants evaluating the proposed standard also cannot agree on the potential outcome. Craig Schneider, CFO.com, March 15, 2004, *Less Ado about Options*, states; "On one side is the Boston-based Analysis Group, whose recent study concluded that the Black-Scholes method can overestimate the value of employee options by anywhere from 28 percent to 56 percent. On the other side is Mercer Consulting. Mercer's study of 350 major companies with broad-based stock-option plans found that in 75 percent of the cases, the two formulas produced a cost differential of less than 5 percent." We also note that the misuse of pricing models can result in very disastrous effects as we experienced in the Long Term Capital Management debacle.

The assumptions required in an option-pricing model are subject to manipulation in order to achieve a desired outcome. Our review of public company filings has identified companies that we believe have manipulated their pro forma expense by inappropriately reducing their volatility assumptions. A study by The Analyst Accounting Observer of stock compensation of the Fortune 500 found the following:

"Just as there were firms that routinely lowered their expected life assumptions, there were 22 firms that routinely dropped their volatility assumptions in each of the last three years. 53 companies that dropped both volatility and expected life assumptions in 2003."

Independent research has also indicated the volatility assumption are subject to manipulation.

"I hypothesize and find that expensing firms have significantly lower unexpected volatility assumptions than non-expensing firms, suggesting that expensing firms manipulate the volatility assumption downward (relative to non-expensing firms) to reduce the amount of stock option expense. However, I find no evidence that expensing firms manage stock option expense by manipulating the dividend yield and risk-free interest rate assumptions." 

The assumptions made on the grant date will never be the same as the actual value received by the employee and paid by the company through the issuance of additional shares of common stock. It is almost impossible to "model" day one because to do so you have to forecast: (1) how the global and US economies will do, (2) how the industry sector will do, and (3) how the company and its products will fare compared to the competition today and in the future. Only by knowing the data can one reasonable forecast what the price of the stock will do, and

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12 The Analyst Accounting Observer, Jack T. Ciesielski, CPA, CFA

13 Managing Stock Option Expense: The Manipulation of Option-Pricing Model Assumptions, Derek Johnston-Wilson, Assistant Professor, Colorado State University
when considering the exercise price what actions employees will take when it comes to exercising or not exercising the options. We believe the board should clearly demonstrate through field tests how this can be done within a reasonable degree of accuracy if they proceed with their current proposal. See our response to Issue 3.

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 £1) 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:

See response to Issue 4(a).

If the Board issues a final standard that is based on the modeling techniques as proposed, we believe the Board should provide the general principles required to make the calculations comparable and consistent and be accurately measured. Furthermore, we believe that disclosure should then be required, for each year for which an income statement is presented, of each assumption that could have a material impact on the calculation. We also believe that companies should disclose the impact of the expense of a plus or minus one percent change in the volatility assumption as this tends to be where companies have "managed" the numbers. Experience has clearly demonstrated that requiring companies to disclose assumptions and methodologies supporting estimates used in financial statements, along with comparisons of how the estimate varied from actual results reduces inappropriate earnings management as the market becomes a disciplinary force.

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.

We believe a single method would enhance comparability. In addition, if the expected volatility used is not consistent with historical experience that variance should be disclosed along with an explanation as to why the expected volatility used is more appropriate. In addition, any changes in volatility assumptions should be clearly explained. The proposal identifies factors to be considered. Disclosure of how those factors were applied to a Company's specific calculation would be helpful in the assessment of the quality of the calculation.

Volatility is a key concern of investors because the proposal does not provide for a true-up based on actual experience. The proposal very aptly identifies instances in financial statement preparation where uncertainties are inherent in estimates of fair value, such as loan loss reserves and valuation allowances.

The difference between those types of estimates and the estimate required by the Board's proposal is a true up of the original estimate. Every uncertainty described in the proposal is recorded at the actual amount when that amount is known. This proposal does not true up the estimate when the amount is known. The lack of a true-up mechanism leaves investors to do their own calculation after the fact to determine the accuracy of the original estimate, which is years later.

In fact, one of the developers of the binomial method has the following sentiments about volatility and the true up of initial assumptions:

"Rubinstein himself recommends that the board simply require companies to calculate the present value of options based on the stock's price at the time of the grant, and then adjust that as the price changes. That way, a company would have to "true up" any difference between the value of the option estimated at the time it was granted and the actual value when exercised."

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 non-transferability 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 agree that options that never vest, and as a result are never exercised, do not ultimately result in any benefit to an employee or a cost to the company. (See our answer to issue 4(c).) However, for reasons previously expressed, we do not believe a reliable estimate can be made of the factors that affect the numbers of options that will be vested and exercised. For example, we analyzed the forfeiture rates for four public companies Microsoft, Intel, Cisco, and Pfizer for 1998 through 2003. The forfeitures were as follows:16

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Source: GLC, Company Reports

We find it difficult to believe that a chief financial officer of any of these companies could have predicted with any degree of accuracy the level of forfeitures that would occur in the 2001 to 2003 time period as a result of global, national, and industry economic changes.

We believe the contractual term is the most appropriate measurement date for estimating fair value. The contractual term is the period of time during which the exchange between the company and employee occurs and the obligations of both are fulfilled. At the end of the contractual term the employee is in a position similar to all other stockholders; they can choose to sell their shares (i.e., through a cashless exercise) or hold them

16 Form 10-K disclosure for Intel, Microsoft, Cisco, and Pfizer.
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 previously noted, we believe the value of all equity awards, including stock options, should be determined using a consistent methodology. The method we have proposed provides a consistent method for all Companies. That method is less complex and we believe less costly to apply and therefore, exceptions to the general rule do not have to be built into a final standard. We believe similar transactions entered into by companies, regardless of their size, should be accounted for in a consistent and comparable manner. There should be no exceptions to the general rule. We recommend that the Board focus on an objectives based approach that avoids exceptions.

Our previous experience has proven to us that a reasonable value can be determined for stock options issued by private companies to their employees. Accordingly, we do not accept the ill-conceived notion that the fair value of equity in a private company cannot be valued. We believe executives who are capable of doing their jobs, do in fact look at the value of each of the types of compensation paid to employees including the base cash pay, perks and equity awards. Successful managers do so to ensure their overall compensation is competitive in the marketplace. Such analysis is also important as some companies may chose to pay higher or lower base pay and adjust equity awards for the differential.

We believe the Board has inappropriately rejected the most appropriate measurement date by making the following statement in paragraph C67, which states, “the Board is not aware of instances in which estimating fair value at a date between grant and settlement will be significantly easier than estimating fair value at the grant date.” The fair value of the difference between the option exercise price and the value of the underlying equity is known with certainty as of the vesting date. For public companies the fair value is simply the quoted market price of the common stock less the option price. For private companies with a stock buyback arrangement it is the redemption price of the common stock at the vesting date less the option price. We note many private companies have such terms in their equity plans.

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:

We agree with the approach included in the exposure draft with respect to employee stock purchase plans. Stock purchase plans provided to employees that are more favorable than stock purchase plans provided to all holders of the same class of shares should be recognized as compensation expense. The difference between the purchase prices available to employees versus all other shareholders should be recorded as compensation expense on the date of the stock purchase, unless the employee is required to provide future services such as with a vesting period. In that instance the associated expense should be recorded over the necessary service period required to earn the stock.

**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:

Compensation expense should be recognized in the income statement over the period the employee provides a service to the company in exchange for the equity award.

Ultimately compensation expense should be based on the difference between the exercise price and the fair market value of the common stock on the vesting date. After the vesting date, changes in the value of the stock options should no longer be charged to expense as all compensation has been earned at that date for the portion of options that have vested.

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:

The vesting period should be based on the estimated service period required to meet the terms and conditions of the option award. For awards that contain market conditions or performance conditions in order to be earned, the estimate should be based on the
probable vesting period consistent with the definition of probable in Financial Accounting Standard No. 5, Accounting for Contingencies. Every time financial statements are issued the probability and timing of vesting should be updated. Changes in estimated vesting timing should be reflected as a cumulative catch up adjustment that adjusts estimated life to date option awards earned based on current share market prices. The key assumptions affecting the determination of the estimated service period that is not fixed but rather subject to performance or market conditions should be disclosed. Changes in those estimates should be disclosed in the financial statements along with the reason for the change.

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 agree with the graded vesting approach proposed by the Board. In addition, providing one method for awards with a graded vesting schedule simplifies the standard and improves comparability.

**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:

Modifications made to equity awards prior to vesting regardless of whether the modification affects option pricing, or early settlement provisions, should be incorporated into the calculation of the change in market value and timing of the earning of compensation. Modifications to unvested options, such as changes to the exercise price or changes to the vesting period should be accounted for as new options granted.
and accounted for as described in our response to Issue 3. Modifications to vested unexercised options that result in additional value given to employees between the vesting date and the settlement date should be recorded as additional compensation on the date of the modification. For example, a reduction in the exercise price after the vesting date should be recognized as additional compensation. After the vesting date the employee has earned the right to own those options and as such is subject to the changes in market value all shareholders experience. A reduction in the exercise price after vesting has given the option holder additional value by eliminating or reducing post vesting market risk and as such that reduction in market risk is additional compensation to the option holder.

**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 agree with the Board's proposal.

**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 have separated our response into two parts, the first addresses disclosure related to the Board's approach described in this exposure draft and our approach, the second addresses disclosure related to the Board's approach only.
We agree with the items the Board is proposing be disclosed. We strongly disagree with
the Board eliminating some of the key and significant disclosures currently required. We
believe investors and analysts need information necessary to understand how
compensation expense is being calculated and reported. Equally important to investors
is information that allows them to determine and assess the impact on earnings from the
likely dilution of options arising in the future. We do not believe the proposed disclosure
come anywhere close to providing the necessary level of transparency. In order for
investors to be able to make informed decisions and reasoned analysis of the financial
statements, we believe the following disclosures are required.

Additional disclosures we believe are necessary for investors to be able to analyze the
financial statements using the approach recommended above are:

a) Share based compensation expense reported for each reporting period and on
what lines it is recorded in the income statement.

b) Aggregate difference between the stock option exercise price and the value of
the stock that has not yet been expensed and the average period of time over
which that amount is expected to be amortized to expense.

c) The number and weighted-average exercise prices of options for each of the
following groups of options: (1) those outstanding at the beginning of the year, (2)
those outstanding at the end of the year, (3) those exercisable at the end of the
year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the
year.

d) The number and weighted-average fair value of equity instruments for which
expense has been recorded other than options, for example, shares of non
vested stock, granted during the year.

e) The terms of significant modifications of outstanding awards.

f) The key assumptions affecting the determination of the estimated service period
that is not fixed but rather subject to performance or market conditions. Changes
in those estimates should be disclosed along with the reason for the change.

Additional disclosure requirements we believe are essential if the grant date accounting
in the exposure draft is adopted:

a) Disclosure of significant assumptions that have a material effect on the
calculation of expense, for each year for which an income statement is issued.
These should include the following weighted-average information: (1) risk-free
interest rate, (2) expected life, (3) expected volatility, and (4) expected dividends.
b) Explanations for changes in assumptions and variances to actual historical experience including:
   a. Disclosure of the difference between the historical (1) volatility of the company's stock and (2) actual life of options exercised in the past two years, and that used in calculating expense for equity awards.
   b. Changes in volatility assumptions should be clearly explained. The proposal identifies factors to be considered. Disclosure of how those factors were applied to a Company's specific calculation would be helpful in the assessment of the quality of the calculation.

c) Disclosure of the impact of the expense of a plus or minus one percent change in the volatility assumption as this tends to be where companies have “managed” the numbers. In addition, disclosure of what a one year change in the life of the stock options would have on the expense reported.

d) The amount of share based compensation expense reported for each reporting period broken down as to the lines it is recorded in the income statement.

e) The number and weighted-average exercise prices of options for each of the following groups of options: (1) those outstanding at the beginning of the year, (2) those outstanding at the end of the year, (3) those exercisable at the end of the year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the year.

f) The weighted-average grant-date fair value of options granted during the year. If the exercise prices of some options differ from the market price of the stock on the grant date, weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price (1) equals, (2) exceeds, or (3) is less than the market price of the stock on the grant date.

g) The number and weighted-average grant-date fair value of equity instruments other than options, for example, shares of non vested stock, granted during the year.

h) The terms of significant modifications of outstanding awards.

i) The key assumptions affecting the determination of the estimated service period that is not fixed but rather subject to performance or market conditions. Changes in those estimates should be disclosed along with the reason for the change.

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:

Upon adoption of this Statement the most useful presentation for investors would be comparative financial statements that show the effects of expensing stock options for all periods presented. The Board’s proposal should achieve the objective of comparability in the financial statements presented.

**Nonpublic Entities**

**Issue 14(a):** This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board’s conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

Response:

We believe all companies should account for similar equity-based awards using a consistent and comparable methodology. Companies that fail to provide sufficient transparency will be assigned a higher risk by users and a higher cost of funds. There should be no exceptions to the general rule. We do not believe the FASB should issue rules that say the economic impact of similar transactions should be different based on simply the size of the company. Such a standard will raise questions as to the FASB’s commitment to financial statements that are representationally faithful, that have the degree of integrity that warrants the trust of investors.

**Issue 14(b):** Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them
additional time me to study its requirements and plan for transition. Do you believe those
decisions are appropriate? If not, why not? Should other modifications of this proposed
Statement’s provisions be made for those entities?

Response:

The effective date and measurement methodology should be the same for all entities.
Creating exceptions to the general rule creates additional complexity for users and
auditors of financial statements. Additional costs and complexities are also created by
the measurement methodology and measurement date chosen by the Board. We do not
believe additional modifications would be in the best interest of users, preparers or
auditors. We noted a survey by Broadgate Consultants found the following, “An
overwhelming majority -- 90% -- of respondents said they are opposed to any
exemptions from the options expensing rule for “start-ups” or technology companies.
Only 6% of respondents said they favor such exemptions.”

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose
certain accounting alternatives for nonpublic entities should apply equally to small
business issuers, as defined by the Securities Act of 1933 and the Securities Exchange
Act of 1934. Do you believe that some or all of those alternatives should be extended to
those public entities?

Response:

The effective date and measurement methodology should be the same for all entities.
Creating exceptions to the general rule creates additional complexity for users and
auditors of financial statements. Additional costs and complexities are also created by
the measurement methodology and measurement date chosen by the Board. We do not
believe additional modifications would be in the best interest of users, preparers or
auditors. We noted a survey by Broadgate Consultants found the following, “An
overwhelming majority -- 90% -- of respondents said they are opposed to any
exemptions from the options expensing rule for “start-ups” or technology companies.
Only 6% of respondents said they favor such exemptions.”

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–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?

17 *Institutional Investors Support FASB Options Expensing Proposal, Broadgate Consultants, Inc. April 7, 2004
Response:

We agree with the Board’s proposal.

**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:

In general achieving convergence between US accounting standards and international accounting standards is desirable, provided it results in high quality, transparent financial statements that reflect the economic reality of the underlying transactions.

The accounting for all share base payment arrangements should be consistent whether the equity is received as payment to employees or non-employees. In the case of non-employees the measurement date should be the date goods or services are received, which is consistent with the vesting period for employees. See our response to Issue 3.

We agree with international standard setters with respect to a consistent measurement method for both public and non-public companies. See our response to Issues 14 and 15.

With respect to equity modifications, we believe international standard setters have added additional complexity to the standard unnecessarily by creating additional exceptions and rules for specific circumstances. See our response to Issue 10.

With respect to book and tax measurement basis for share options we believe both the US and international standard setters have added unnecessary complexity. See our response to Issues 11 and 16.

**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:

No. The statement should be written in plain English that allows preparers and users to understand the implications of each general principle. For example, paragraph B 25 identifies factors to consider and subparagraph d starts with the following, “The mean-reverting tendency volatilities.” Very few preparers or users understand what that phrase means, how to apply it to a given company’s financial statements, and whether it is comparable to other companies accounting policies and practices. Another example, can be found in paragraph B 20 in relation to the discussion of the expected term of employee stock options, “However, if an entity uses a lattice model that has been modified to take into account an option’s contractual term and employees’ expected exercise and post-vesting employment termination behavior, the expected term is estimated based on the resulting output of the lattice.” We would hope the FASB can do a better job than this in writing a standard for those preparers who must implement it.