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Stephen P. Percoco
Lark Research, Inc.
P.O. Box 1131
Rahway, New Jersey 07065

Mr. Robert H. Herz
Chairman
The Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06586-5116

Dear Bob:

I am writing in response to the Board's proposal on Share-Based Payment. I apologize for sending this to you so late. Rather than respond to all of the questions that you raise in the Exposure Draft, however, I would like to offer a few thoughts on how I believe that analysts should consider share-based payment in their evaluations of companies.

The Board has taken the view that share-based payments are a form of compensation that should be reflected as an expense on the income statement. It is difficult to argue with that conclusion, since stock options have value and employees receive those options in exchange for the services that they provide. Yet, I believe that it might be possible to make a distinction based upon how the employees receiving the share-based payments treat them. It seems to me that if employees sell their stock soon after exercising their options, this clearly qualifies as compensation expense. On the other hand, if they hold on to their shares forever after exercising, it would not be inappropriate, in my view, to treat this as an issuance of equity. Of course, it may be quite difficult for analysts to find out what employees are doing with their shares. Furthermore, it would be difficult for the Board to come up with an accounting standard that covers the middle ground (i.e. when employees hold their shares for a few years before selling.) Consequently, it is probably prudent to treat all share-based payments as compensation expense.

It is also important to consider the effect on employee behavior of not treating share-based payments as compensation expense. Certainly, if the Board's proposal to expense share-based payments is thwarted by Congress, many people may conclude that the government is not concerned about proper accounting. Stock options, by their nature, encourage employees to take a short-term view on corporate financial performance. If the government does not care about proper and complete expense accounting, employees may determine that they need not care either.

Nevertheless, many analysts will choose to exclude the value of share-based payments in their assessment of earnings from continuing operations, primarily because this form of compensation typically does not require an outlay of cash. From my perspective, analysts should assess the degree to which a company uses share-based payment as an alternative to cash in order to provide fair, market-based wages to its employees. If cash-based compensation is below market levels and employees are unable to realize the expected value from their share-based payments, then companies may have to make up the difference.

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Admittedly, it may be difficult for most analysts to make such an assessment. Except for executive officer compensation, relative wage rate comparisons are either unavailable or hard to find, especially across an entire company. One way to make a quick assessment of the degree to which a company is relying upon share-based payment is to compare the total value of share-based compensation in a given year against total cash-based compensation. The higher the percentage of share-based compensation in the mix, the more likely it is that a company is paying below-market cash-based compensation. In addition, the trend in share-based payment and/or realized intrinsic value as a percent of total compensation expense may be significant. Accordingly, I request that you consider adding the total amount of cash-based compensation over a three-year period to your required disclosures.

A company's share repurchase policy may also help analysts assess whether a company is using share-based payment as a substitute for cash. Buying back shares in sufficient quantities to cover the extra dilution from exercised stock options is essentially the same as paying compensation directly to employees in cash. Under current accounting rules, this type of share repurchase scheme yields a more favorable accounting result. Consequently, analysts who might otherwise choose to adjust continuing earnings for non-cash share-based payments should at least include any exercised stock option share buybacks in compensation expense.

By and large, share-based payments represent a reallocation of a portion of the company's market value from shareholders to employees. However, most credit analysts do not care about measuring this reallocation. Rather, they are concerned primarily with the company's ability to service its debt. Accordingly, they will routinely seek to exclude the true (non-cash) value of share-based payment from compensation expense. In the future, the Board may want to consider including true share-based payment expense and other such reallocations in a separate section within the statement of comprehensive income (after operating earnings).

Although I have not reviewed the Share-Based Payment Exposure Draft in great detail, I believe that it has carefully considered the primary aspects and challenges on this issue. To me, given that different users will choose different ways of evaluating the impact of share-based payments on corporate financial performance, the disclosure provisions are especially important here. While it remains to be seen how companies will implement these disclosures, I believe that in concept at least, your proposal provides most, if not all, of the necessary disclosures.

Sincerely,



Stephen P. Percoco