

Letter of Comment No: 6377
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VIA email: director@fasb.org

Director of Major Projects – File Reference No. 1102-100
Financial Accounting Standards Board
P. O. Box 5116
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Dear Sir/Madam:

I thank you in advance for reading this letter. I was part of a small group that met with Board Members Crooch and Schipper last week in Palo Alto, not at the Roundtable, but at the earlier discussion on the evening of June 23 sponsored by the AeA and held at the regional offices of the NYSE. I mention this because I think my arguments will be more meaningful if you can put them together with a face and voice. I am writing this letter on my behalf and not as a spokesperson for my employer, but I have been the CFO of my present employer for nine years. We are a high, albeit volatile, growth company, and very profitable – our net income (GAAP basis, of course) is greater than 20% of sales. We have limited capital requirements, in fact have negative net-working capital requirements, and hence generate extraordinary amounts of cash which we use to repurchase our shares. We have a market capitalization that accompanies these characteristics: we are a component of both the S&P 500 and Nasdaq 100. Approximately 85% of our shares are held by institutions. I spend a great deal of time with portfolio managers and equity analysts and have had extensive discussions with them on the subject of expensing options.

I feel strongly that your exposure draft on accounting for equity-based compensation is a step in the wrong direction, and is the latest in a long series of such steps. Fair value accounting will destroy the integrity of GAAP financial statements. I passionately believe that financial statements should be meaningful and accurate descriptions of business activities and financial position. I am proud of our capital markets, our systems of financial reporting, and even the regulatory structures and enforcement mechanisms that ensure compliance. And I see the notion of expensing options as a serious threat to all of the above.

The Board has studied this issue long and hard enough to correctly conclude that employee stock options have value, and are an equity instrument. More precisely, you understand that what employees are receiving are contingent claims on the equity of their employer. The exposure draft reads to me as a series of apologies for violating the fundamental principles of accounting --- principles which I expect you to uphold, not to erode. My argument is about basics and fundamentals, and I can think of no better illustration of the basics than that which Professor Bill Bruns, of Harvard Graduate School of Business, gave in his introductory course on Financial Reporting and Management Accounting. He described the practice of accounting at its origin, when syndicated trading ships plied the waters of the

Mediterranean. I can still see the ship's accountant standing at the top of the gangplank ("FOB: top of gangplank") with his ledger recording the goods passing to and fro, and enquiring of the captain about the particulars of each trade.

Let me add a new chapter to his story. Pretend I am a capitalist attending to my various businesses in Venice when a courier delivers latest word from a particular voyage in which I am a 40% investor. The captain describes a navigation error that led to the ship being washed onto the rocks; destruction of the vessel was imminent. By chance another ship happens by. The commander of the passing ship offers to intercede but notes that his offer entails risk to his ship and crew. Accordingly he wants to be compensated. My captain negotiates a deal that amounts to surrendering a ten percent equity stake in the voyage for the Good Samaritan's aid, if the ship is freed. Fortunately, it was. Accompanying my captain's letter is the accountant's ledger showing the books on a voyage-to-date basis. It reflects a reduction in the ship's trading stores of 10% at the time of the "mishap", i.e., one tenth of every item (oils, precious metals, perfumes, dyes, etc.) is subtracted from inventory at the time of the mishap and charged off as an extraordinary event: "ship-grounding". I'm somewhat confused and of course there is no way to reach my captain. But I do resolve that upon his return I will chastise him for his poor navigational skills and commend him for his superlative negotiation. Ten weeks later the ship returns to Venice and the ship's accountant, proud of his association with a daring and successful venture immediately reports to my office with his ledger. I encourage him to freshen up while I study the books. I find them perfectly comprehensible up to the point of the mishap. From that point forward, they are confusing. I observe that somehow trading costs seem to be overstated, that is, I have given up more in trade than I had in inventory. I notice that after the ship sails from every port-of-call there is a series of entries that further credit trading stores and charge ship-grounding. Moreover, upon the ship's return to Venice there are additional entries both debiting and crediting ending inventory with the offsets charged to the cost of the mishap. You see, the ship's accountant treated the redistribution of equity as an expense, and from there the books become irreconcilable with reality.

In my story, a 3rd party who provided services to the entity received a contingent transfer of equity from the existing shareholders. I of course could have concocted the story differently to read directly on-point to option expensing. But my argument is larger, and goes beyond just options. My argument is straight-forward and simple: a transfer of equity should not be confused with an expense, and as a corollary, the market value of equity has no place on a company's financial statements. The basic principle goes beyond equity-based compensation, to the whole set of transactions that involve a company trading in its "own" equity including companies entering into derivative contracts on their own shares, shares granted to third parties in exchange for consulting services, and acquisitions with stock. Interesting but true and very timely story: just this last Friday, June 25th, the price of our shares as traded on Nasdaq went up nearly 20% (and that is a lot of money) in the last eight seconds of trading due to trading anomalies on Nasdaq. Of course, eighty percent of that gain was eliminated before the markets opened on the following Monday. My point is simply this: market value comes and goes like the wind – there is no accounting for it.

When a company issues additional shares amounting to twenty-five percent of its ownership in exchange for a merger, that event is fundamentally different than the company issuing a like amount in cash – to treat them the same is just plain wrong. Investors and accountants see cash the same way: one dollar is worth one dollar to everyone at every time. The value of a percentage ownership in a publicly traded company is revalued dynamically and comprehends many sources of potential value creation and destruction that have no place in financial statements (from market size to innovation to potential competitive entry). I've been watching FASB tie itself in knots in this issue for two decades and you still haven't got it right. Look at the financial statements of companies that engaged in large merger transactions using their own very highly valued shares during the heyday. Look at the subsequent enormous write-offs and the market's non-reaction to the charges and ask yourself what value is being added to investors' comprehension by the accounting? The disconnect is too huge to ignore! Imputing market value of equity, or equity instruments onto the company's books takes the vagaries of the market as of a particular point in time and encumbers the financial statements with them for all times. And as you know, the single biggest determinant of the value of a call option is the market price of the underlying equity.

My observation of FASB over the years leads me to the following. You act as if the income statement is the only document investors pay attention to and consequently have a tendency to impact it for every behavior that could have impact on the value of the firm or shareholders' interests. You have thrown everything but the proverbial kitchen sink into the income statement. Meanwhile, I consider it an outrage that as a shareholder to get a clear understanding of the dilution I have experienced due to acquisitions and other share issuances, as well as dilution I will experience as a result of options issuance and especially the issuance of convertible securities is relegated to arcane, difficult to read, and at times arcane footnotes in the back of the filings. Pick up any issuers financials and look at the Consolidated Statements of Stockholders' Equity and ask yourself if this is clear and adequate disclosure in the context of its importance. Can you tell if management issued a large number of shares to a consultant at a bargain price? Pretend you are a "common man" and read the footnotes of filings on the treasury stock method – what a mess! As certainly as my ship owner's accountant failed him, you have failed us and your proposal is yet another step away from clarity and truth. My prescription for remedying the chaos the Board has created:

- 1) Let the income statement reflect increases or decreases in the value of the firm as measured by historical cost-based transactions. Rewrite the standards that account for equity issuance as an expense. All of them.
- 2) Require that a reconciliation of both basic and diluted shares outstanding be displayed with equal prominence to the income statement, in proximity to the other key financial statements: income statement, balance sheet, and cash flow. How have we, as a profession, allowed such an important consideration as shareholder dilution, to be relegated to the backwaters (right next to the FAS 123 footnote)?
- 3) Create standards for disclosures that anticipate and model future dilution under various scenarios.

I and almost every other investor can understand the principles that are implicit in this approach: 1) this is what the firm is worth (balance sheet) and this is how that value has

changed over a reporting period (income statement), and 2) this is how much you own and how that has changed over a reporting period (shares outstanding reconciliation – your next project).

I thought we had a good discussion that evening in Palo Alto and I want to follow-up on a couple of the discussion points raised during the course of the meeting. You cited three reasons for the Board taking up again the project on share-based compensation. First, you cited the SEC's and other constituents' pressure for harmonization of international accounting standards. I think we can all agree that is a desirable outcome, but we should expense options because Sir Tweedy expenses options? It isn't the biggest deal in the world but America's high-technology industry is competing against Asian firms that give their employees restricted stock and charge their income statement for the par value of the stock. Would you consider adopting that approach in the interests of harmonization? Further, it is the responsibility of the SEC and all other U.S. governmental agencies to act in the best interest of the American people. Period. For this argument to have merit at least in my eyes, the argument of expensing needs to stand on its own.

You also commented that the Board was under similar pressures to move away from rules-based accounting and that the complexity of administering the existing body of rules and guidelines was burdensome and complex. You also noted the lack of question and comments on feasibility and implementation in the comment letters to this point, and indicated that the board was reading that silence as tacit acknowledgement that industry could implement this standard. That is a very dangerous assumption and one I would be quite willing to bet against. I had two years of calculus and one year of linear algebra as well as a host of classes in probability and statistics in my undergraduate studies, and, at the graduate level, I studied under professors now considered experts in options and derivatives. Do I understand Black-Sholes? Well, sort of. Binomial models? By extension, yes, but... Let's be honest. Accountants can do math. Calculus is a different matter. How many audit partners have ever taken any calculus? You are asking preparers of financial statements to book large and volatile entries using tools that we do not really understand. We've gotten away with it to this point, because FAS 123 footnotes have not gotten a whole lot of attention (and by the way, I think that's fine). When we embrace this animal, instead of combating it, it will get way complex and way difficult. Common sense should tell you that the incorporation of binomial models valuing long-lived equity options into the statement of operations is going to generate a whole lot of confusion and ongoing interpretation. I know the process the Board has gone through in addressing the valuation question – it wasn't easy for you and you had Nobel Prize winners at your disposal!

That evening, we also talked about giving employees donuts. In particular donuts that were free. Options are not free donuts. They are the possibility of a donut, or donuts, or perhaps no donuts. That is not the same as a donut. And yes, I understand the concept of expected value and do apply it in business decisions and even in preparing financial statements. But in the case of preparing financial statements, when I compute values using estimates, they eventually get trued-up. Ultimately we (and shareholders) get to the right answer. In the case of expensing options, the correct value is not and cannot be determined. Hypothetically, there could be two companies that issue options grants of equal

characteristics and for one company all of the options are exercised, but for the other none of the options are ever exercised. Under your proposal the charge for the options expense for the two companies would forever be the same. And for both companies it would be wrong – incorrectly characterizing potential dilution as expense. My favorite hypothetical firm under fair value accounting grows, satisfies all of its financial obligations and even pays a dividend without ever reporting a profit. Do you honestly think that the investing public is going to place credibility in the system of financial reporting you propose?

In that evening you also reflected back on the Board's fateful decision ten years ago to back off on expensing options in order to preserve the independence and vitality of the Board itself. You may well succeed in turning this draft into reality without running into Congressional wrath this time around. I suggest to you that the danger for the Board's own diminution is equally great. There is already a growing body of evidence to conclude that equity markets will look through the charge – for many good reasons I would argue. You can also reasonably conclude that issuers will in some way make it easy for investors to compute that charge, whether they pro-forma their full income statement or just disclose the charge in a note. In the end you will have widespread abandonment of GAAP, thus institutionalizing pro forma reporting. There can be no greater threat to the vitality of financial reporting, the financial markets, and even FASB than this outcome.

I strongly urge you to rethink not just this issue but all issues surrounding accounting for and reporting of equity-based transactions. In my estimation, you have a lot of work to do to get it right. Adoption of the exposure draft will only make the job of finally getting these issues resolved longer and more complicated.

Thank you for your time and indulgence. I know that your intentions are good and your efforts are sincere, but the steps you propose to take with employee stock options are not helpful or needed by the users of financial statements, and these new standards will damage your effectiveness as an accounting standard setting body.

Sincerely yours,



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