VERITAS

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Letter of Comment No: 388
File Reference: 1102-100

VIA E-MAIL: director@fasb.org

June 29, 2004

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

Re: Exposure Draft – Share-Based Payment:
An Amendment of FASB Statements No. 123 and 95

Dear Sir or Madam:

VERITAS Software Corporation is a global developer and supplier of storage and infrastructure software and services for use by large enterprises in managing their data. VERITAS has annual revenue of approximately $2 billion and approximately 6,500 employees worldwide. VERITAS offers employee stock options to almost of all of its employees worldwide. VERITAS also offers an employee stock purchase plan in which approximately 70% of VERITAS' employees worldwide participate.

We have reviewed the Proposed Statement of Financial Accounting Standards on "Share-Based Payment", an amendment of FASB Statements No. 123 and 95 (the "Proposed Statement"). In response to the particular issues on which the Board has requested comment (see pages (i) through (vii) of the Exposure Draft), we have the following recommendations to improve and enhance the Proposed Statement:

Issue 4(b): Do you agree with the board's conclusion that the fair value of employee share options can be measured with sufficient reliability?

In general, we believe that the Proposed Statement presents an improvement over the existing FASB Statements No. 123 and 95 in measuring the value of employee stock options, and appreciate the time and efforts the FASB has expended in developing it. We agree that a lattice model can incorporate the unique characteristics of an employee option better than any closed-form model, such as Black-Scholes-Merton. As a result, the customized lattice models are likely to produce more reasonable estimates of the fair value of the employee options and thus more accurately estimate the compensation costs reflected in the financial statements.

However, the lattice model was developed to determine the value of the call option of transferable options that are freely tradable in the market. A call option is the contractual right but not the obligation to purchase the underlying stock at some predetermined contractual exercise price within a specified time and a put option is the contractual right but not the obligation to sell the underlying stock at some predetermined contractual price within a specified time.

Given the lack of marketability of an employee option, the holder of an employee stock option has in effect given up his or her rights to sell the option. Although the lattice model does account for this lack of marketability to some extent by considering the "suboptimal" exercise behavior of the employee, we believe that there are additional transferability limitations which are not accounted for by the model in the Proposed Statement. As a result, the lattice model will overstate the value of the employee option, unless the option's non-marketability is taken into account. While the value of an employee option as determined based on a lattice model could be discounted to reflect the option's non-marketability, we believe it would be more accurate to reduce the value of the option by the value of a put option on the stock, computed using the same lattice model and the same variables that are used for the valuation of the option.

Recommendation:

We recommend that the FASB modify the valuation methodology in the Proposed Statement to adjust the valuation for the non-marketability of the option, preferably by requiring a reduction equal to the value of the put option.

Issue 4(d): 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?

The increased accuracy of a lattice model compared to a closed-form model results from the fact that a lattice model can be designed to incorporate certain characteristics of employee options; e.g. a lattice model can accommodate changes in volatility over the option's contractual term as well as estimates of expected option exercise patterns during the option's contractual term and black-out periods. While a closed-form model does allow for the inclusion of certain option characteristics, they take the form of weighted-average assumptions that cannot be changed over time, resulting in less accuracy of the valuation. In addition, the lattice models have mathematically proven that any interactions among the various inputs are non-linear. The non-linearity appears to approximate real life scenarios of employee options. Thus, by including <u>all</u> variables <u>inside</u> the lattice model, the interactions among the variables are properly taken into account when determining the fair value of the employee option.

If the forfeiture rate is not included in the lattice model, but instead applied outside the lattice, we believe the accuracy of the model will be negatively impacted. First, by applying the rate outside the lattice it will no longer be possible to apply a changing rate over the option's contractual term. Secondly, by using the rate outside the lattice the nonlinear interactive behavior among the variables in the lattice will be lost. Consequently, we believe that by putting the forfeiture rate outside the model, the resulting valuation will be less indicative of a "real life" situation of an employee option than if it were included inside the lattice. For example, when used inside the lattice, the forfeiture rate can be used to condition the calculation to zero if the employee is terminated or leaves during the vesting period. In addition, post-vesting, the forfeiture rate can be used to condition the lattice to execute the option if it is in-the-money or allowed to expire worthless, when the employee leaves.

Recommendation:

We recommend that the option valuation methodology under the Proposed Statement allow for the inclusion of that the forfeiture rate inside the customized lattice model, and that this rate can be allowed to change over time to more closely reflect actual experience.

Issue 6: For reasons described in paragraph C75 (in the Proposed Statement), 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 shares. Do you agree with that principle?

Most companies have an Employee Stock Purchase Plan ("ESPP") in accordance with Section 423 of the Internal Revenue Code, thus requiring that the individual is an employee at enrollment in the ESPP as well as within three months of the purchase date under the ESPP. During the purchase periods the employee has a certain amount deducted from their paychecks and at the end of the purchase period the company will purchase stock on behalf of the employee at a certain discount. While the employees usually can withdraw from the plan at any time during the purchase period, they often can change the amount of their deductions only a limited number of times during the purchase period.

In the Proposed Statement the FASB concludes that an ESPP is compensatory if the employee is entitled to purchase shares on terms that are more favorable than those available to all holders of the same class of shares. We believe that it is inappropriate to compare ESPP purchases to purchases in the open market by regular shareholders due to the following:

- Under an ESPP the employee has a certain amount deducted from their paycheck throughout the purchase period, usually 6 months. Thus the employee "prepays" the share purchase over several months, whereas a regular shareholder who purchases shares on the open market receives the shares within a few days of payment.
- While an employee can usually withdraw from the ESPP at any time during the purchase period, the plan often sets limitations on the number of changes an employee can make to their deduction amounts throughout the period. In addition, the timing of share purchases is governed by the mechanics of the ESPP, such that purchases are made on a predetermined date regardless of market conditions. A regular shareholder, on the contrary, is free to decide the amount and timing of his or her share purchase without any limitations.
- The employee must be employed within three months of the ESPP purchase date, whereas there is no such obligation for a regular shareholder.

Given that an employee is subject to significant additional limitations under the ESPP compared to an individual who purchases shares in the open market, we believe it is inappropriate to require the discount offered to employees to be equal to the discount available to regular shareholders in order for the ESPP to be considered not compensatory. It seems reasonable to us that an ESPP discount of up to 15% is reflective of the fact that the employee does not have the use of their funds during the purchase period, is limited to a finite number of changes in their deductions, cannot determine the timing of their shares purchase and is required to provide services to the company in order to be able to participate in the ESPP. In addition, the Company usually does not incur the same registration, offering and administrative costs of issuing shares under its ESPP as it would in an issuance of shares to the public. Part of the rationale of allowing for a discount of up to 15% under Section 423 not to be treated as taxable to the employee for U.S. federal income tax purposes is that the Company had avoided certain issuance costs under the ESPP and in effect was receiving the same "net" amount as it would have in a public issuance.

In addition, if ESPP is considered compensatory, we believe that an accurate pre-purchase valuation will be difficult. The customized lattice models address most unique characteristics of employee options. However, the lattice models do not address certain characteristics specific to ESPP, such as the relative short purchase periods (ranging from six months to 24 months) and the fact that the ESPP exercises only occur a few times per year at predetermined purchase dates. If a company's stock is highly volatile, it is especially difficult to accurately value the ESPP given these unique characteristics. In addition, in order to value ESPP shares a company must estimate the total payroll deductions during the purchase period. The size of deductions is difficult to determine due to the fact that it is dependent on employee turnover, the company's stock performance and the overall economic climate. To the extent that the payroll deduction estimate is incorrect, it further reduces the accuracy of the ESPP valuation expense.

If the ESPP is treated as compensatory, as currently provided in the Proposed Statement, we believe that many companies will consider reducing their ESPP look-back and discount features or eliminating the ESPP altogether. In particular, if the actual benefit provided to employees (in the form of discounts realized) is substantially lower than the accounting charge, it would not make sense for a Company to incur this expense for an ESPP in its current form. Unfortunately that would reduce or eliminate the main equity program available to a significant portion of our employee population. If VERITAS eliminated the ESPP, approximately 70% of our global workforce (or approximately 4,000 employees) and approximately 80% of our US workforce would be negatively impacted.

Recommendation:

We recommend that the FASB provide that an ESPP in accordance with Section 423 of the Internal Revenue Code should not be considered compensatory due to (1) the limitations of ESPP on the employee compared to regular shareholders, (2) the lower costs of issuing capital under the ESPP and (3) the difficulty in estimating the ESPP valuation due to the unique characteristics of ESPP.

Issue 9: 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?

The Proposed Statement requires that compensation cost recognized for an award of share-based compensation shall be based on the number of instruments for which the requisite service is rendered. As the Proposed Statement allows companies to estimate forfeitures, any share-based compensation expense related to instruments that are estimated to be forfeited would therefore be properly excluded from the expense. However, by considering an award with a graded vesting schedule to be in substance separate awards, each with a different requisite service period, we believe the compensation expense would be inconsistent with the concept of matching the expense with the requisite service period, and with the actual compensation delivered to employees.

For example, a grant which allows for monthly vesting over one year would result in a significantly higher expense in the first six months than a grant which allows for a one-year cliff vest. However, the total valuation of both grants is the same and the employee did not provide more services in the first six months under the monthly-vested grant versus the cliff-vested grant. In addition, if the employee were to terminate his or her employment in the sixth month, the expense under the monthly-vested grant would be significantly higher than if the employee had received a cliff-vested option and terminated in month six (even considering an estimated forfeiture rate).

We believe that there is a better matching of the exchange of employee services for equity instruments if the Proposed Statement permits the compensation cost to be recognized on a straight-line basis over the vesting period. If the Statement does not allow expense recognition on a straight-line basis, we believe that many companies may consider revising the vesting schedule of its option grants from graded-vesting to cliff-vesting. This practice would result in a further mismatching of employee service and employee reward.

Recommendation:

We recommend that the Proposed Statement permits the compensation cost to be recognized on a straight-line basis, provided that the amount of compensation cost recognized at any date at least equals the fair value of the vested portion of the award at that date.

Issue 11: Do you agree with the methods of accounting for income taxes established by this Proposed Statement?

We believe that the methods of accounting for income taxes related to equity compensation are consistent with the principles of FAS 109 and company practice. However we believe that there are two areas in which the proposed standard may lead to inappropriate results in the company's financial statements.

(a) Deferred Tax Assets related to Certain Options

Under the Proposed Statement, a company will generally recognize a deferred tax asset for the future tax benefit of an option grant, by applying its tax rate to the fair value recognized for financial statement purposes. Paragraph 15 of the Exposure Draft provides that if the deductible compensation cost is less than the cumulative compensation cost recognized for financial reporting purposes, then the write-off of any portion of the deferred tax asset related to that deficiency be recognized in the income statement. In contrast, if the tax deduction exceeds the compensation cost recognized for financial reporting purposes, the so-called "excess tax benefit" is credited to additional paid-in capital.

In certain situations, the option may be granted by a U.S. employer and charged to non-U.S. affiliates in jurisdictions with different tax rates. Furthermore, the timing of the recognition of the expense and deferred tax benefit may be different from the timing of the related intercompany charge. For example, current income tax regulations issued by U.S. Treasury Department require that stock compensation expense be included in cost-sharing arrangements between a U.S. company and its non-U.S. affiliates for tax purposes. The regulations permit the charge to be made based upon the amount realized by the employee upon exercise of the option even though the related financial statement expense is recognized upon vesting. A literal application of the rules as outlined in the proposed standard could require the company to record a deferred tax asset at a 35% U.S. tax rate when the expense is recognized for financial statement purposes, and later to write off a portion of the deferred tax asset to the income statement when an amount is charged to the non-U.S. affiliate upon exercise of the option.

Recommendation:

We recommend that the proposed standard (and any relevant sections of FAS 109) be appropriately modified to allow a company to consider the expected future tax benefit in determining the amount of the deferred tax asset to record upon vesting of the underlying option. Alternatively, if the tax benefit is determined in a different period (for example, upon exercise), we recommend that any reduction of the original deferred tax asset be netted against any credit for the excess tax benefit to additional paid-in capital as a result of the exercise of the option.

(b) Transition Rules

Under paragraph 21 of the Exposure Draft, companies are required to use a modified prospective method of adoption of FAS 123. Under this method, the fair value (in most cases, as determined under the Black Scholes model) attributable to unvested options as of the date of adoption must be charged against the income statement over the remaining vesting period. Paragraph 21 further requires that deferred tax assets for options granted prior to the adoption of the proposed standard be accounted for prospectively under Statement 123, as amended, resulting in the recording of a deferred tax asset for expense attributable to such unvested options. Paragraph 15 of the Exposure Draft provides that if the deductible compensation cost is less than the cumulative compensation cost recognized for financial reporting purposes, then the write-off of any portion of the deferred tax asset related to that deficiency be recognized in the income statement. Such write-off would occur in the period the option is exercised, forfeited or cancelled.

Many companies granted stock options to employees during the last several years when the fair market value of the shares was substantially higher than it is today. As a result, there is still substantial unvested compensation cost attributable to options whose exercise prices are in excess of current value. In many cases these options will never be exercised. However the application of the transition rules in the exposure draft would require companies to record a deferred tax asset for the Black Scholes value of these options as the remaining options vest, even if it is a virtual certainty that this tax benefit will never be realized and there will be a "tax benefit shortfall".

FAS 123, paragraph 44 permitted a company to net the "tax benefit shortfall" against cumulative prior credits to additional paid-in capital, so that there was usually no charge to the income statement. This approach was commonly known as a "portfolio approach." The current exposure draft adopts a different approach under which, on an option by option basis, where the earnings charge for options exceeds the amount ultimately deductible, the incremental deficit flows through the income statement, but in the reverse situation the incremental positive bypasses the income statement and is a direct credit to capital surplus.

There appears to be little benefit in forcing companies to record a deferred tax asset with respect to a deduction which is not expected to be realized because the options are expected to expire unexercised.

Recommendation:

We recommend that the FASB modify the proposed statement to adopt one of two alternative approaches in applying the transition rules:

- Allow companies to consider whether the tax benefit of options granted prior to adoption will more likely than not be realized, or

- Allow companies to continue use of the "portfolio approach" with respect to options granted prior to the date of adoption.

Respectfully submitted,

VERITAS Software Corporation

By:_______________________________
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Executive Vice President and Chief Financial Officer