

DHK ASSOCIATES
MANAGEMENT CONSULTING
355 N. SAN ANTONIO ROAD
LOS ALTOS, CA 94022

Donald H. Korn, CFA
Principal

Tel./Fax 650-941-0355

To: Director of Major Projects--File Reference No. 1102-100
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116
VIA email to director@fasb.org

Date: June 7, 2004

Letter of Comment No: 3092
File Reference: 1102-100

Attn: Suzanne Bielstein

Re: FASB Exposure Draft, Proposed Statement of Financial Accounting Standards
on Share-Based Payment, an amendment of FASB Statements No.123 and 95

Dear Ms. Bielstein:

I am pleased to submit for consideration this letter including preliminary comments and tentative positions regarding the above-referenced ED on the Proposed Statement of Financial Accounting Standards on Share-Based Payment. The remarks herein are made in advance of the forthcoming roundtable meetings and may be revised somewhat by the June 30, 2004 deadline.

INTRODUCTION AND BACKGROUND

As a Chartered Financial Analyst (CFA) and management consultant with experience as a senior financial executive, much of my work has involved investment valuation, asset management, and utilization of the U.S. financial accounting and reporting system. I am an active, continuous "User" of financial statements. I testified at the March, 1994 FASB Hearings on Accounting for Stock-based Compensation, and was then also acting in the capacity of a "preparer" of financial statements. I was one of the very few individuals in "Silicon Valley" to testify in support of FASB's position that (to paraphrase) stock options "granted" as compensation for services had value and that option value should be expensed.

In 1995, after further research, I wrote to FASB Member and AIMR liaison Anthony T. "Tony" Cope expressing my theory that the vehement opposition then from "high tech" companies was probably based on executives' fears that the proposed accounting might produce adverse personal income tax consequences, due to certain wording in the Internal Revenue Code.

Specifically, the notion was that recognizing and measuring the value of employee stock options for publicly owned companies would likely lead to the creation of databases that might indicate a readily ascertainable fair market value for such options. This perceived likely outcome could conceivably become a tax problem vis-`a-vis the application of the "readily ascertainable fair market value" criteria specified in the Internal Revenue Code. (See for example Section 83. A "Section 83 election" under stipulated conditions can allow recipients of employee stock options or share awards favorable income tax treatment.) Executives' tax planning could be upset if

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option valuations led to adverse changes in the tax treatment of share-based payment arrangements, either from the direct impact of the "readily ascertainable fair market value" criteria, or from changes in tax policy and Tax Court decisions in light of new data. I included elaboration on this point in a 1996 talk on Stock Option Accounting under SFAS-123, at Stanford University's Center for Economic Policy Research.

Since then, the information that has come to light about corporate behavior and executive compensation, and my experience (albeit limited) in valuing various types of options (using both the Black-Scholes model and other methods), suggest additional factors that might explain the logic behind opposition to expensing employee stock options. Note that most of the opposition is spearheaded by corporate insiders who receive stock options, rather than outside users of the corporations' financial statements who are trying to estimate their value. While I believe my understanding of the basis for the opposition has increased, I have found no persuasive reason based on accounting theory for constituents to now oppose expensing.

COMMENTS ON THE SPECIFIC ISSUES

I strongly support the Board's conclusions 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. Such compensation cost should be recognized in the financial statements. This treatment makes the statements more relevant and representationally faithful in determining the entity's net income (Issue 1).

Moreover, I agree that pro forma disclosures are not an appropriate substitute for such recognition (Issue 2). Public companies should measure the compensation cost based on the grant-date fair value of the equity instruments (Issue 3). In the absence of observable market prices of identical or similar equity or liability instruments, the fair value measurement of most, if not all, share options issued to employees would be obtained using an option-pricing model.

I think that a lattice model is probably the best current approach for estimating the fair value, but it should not be a required approach at this time. The Black-Scholes-Merton and similar closed-form models often produce results very close to those produced using a binomial or lattice method. See "How to Value Employee Stock Options," John Hull and Alan White, *Financial Analysts Journal*, Jan,-Feb, 2004. {Issue 4(a),(b)}.

With respect to estimating expected volatility, which is a *key* input into the valuation models, more discussion is warranted. The upcoming roundtable meetings and further deliberations by the Board and staff on comments received in response to the instant ED should be utilized to conclude on the recommended approach and language in the final Standard (Issue 4c). Similarly, with respect to taking into account the special or unique characteristics of employee share options, **further discussion of the methodology regarding vesting, forfeiture risk, dilution, and tax effects should be useful.**

The recent, likely-to-be-controversial paper by Jeremy Bulow and John Shoven of Stanford University is provocative in this regard. See "Accounting and Stock Options," SIEPR

Discussion Paper No. 03-07, Stanford Institute for Economic Policy Research, April 2, 2004.

This paper would treat most employee stock options as effectively 90-day securities that are thus relatively easy to value, but the methodology would tend to understate option expense (perhaps materially). Significant attention is paid to dilution and tax effects. Also, the paper argues that some aspects of FASB's approach in the proposed Statement are not consistent with a modern financial economics view of the alignment of accounting and economic substance, or of the "implied labor contract" between the entity and employee(s). (Issue 4d).

Turning now to another issue, I find it hard to accept the notion that options would be granted under circumstances where it is not possible to reasonably estimate the fair value of the equity instrument given as compensation in exchange for some specific employee(s)' services. I thus don't agree presently that using the intrinsic value method with remeasurement is an appropriate treatment (Issue 5).

The proposed Statement's treatment of Attribution of Compensation Cost and Modifications and Settlements (Issues 7-10) seem fine. Income tax treatment, on the other hand, deserves more discussion; especially, in my opinion, in light of the effort to achieve convergence with IFRS 2 (Issues 11 and 17).

On Disclosures, I am in favor of the maximum to allow the user of the financial statements to fully understand how fair value was determined, and to replicate the estimate and/or test its sensitivity by substituting his or her own estimates for the variables used in the calculations. The combination of recognition and measurement in the financial statements with sufficiently rich disclosures meets **the need for transparency, relevance, and comparability of information about share-based payment arrangements** (Issue 12).

The Transition provisions involve tradeoffs between relevance and comparability. I have not concluded anything on this issue yet, and am eager to hear more discussion, e.g., about the pros and cons of retrospective application (Issue 13).

Nonpublic Entities (Issue 14) comprise, I believe, mostly firms smaller than the typical public company, and firms that do not usually issue stock options to employees. Thus, they will see little if any impact from the proposed Statement. Those that do issue stock options are most likely hoping or preparing to "go public" in the foreseeable future, to raise capital and/or to take advantage of the chance for dramatic stock price appreciation that an IPO might bring. See also, remarks of Jack Ciesielski in Attachment 5, page 2 of Testimony of Robert Herz, Chairman, and George Batavick, Board Member, FASB, before the Capital Markets, Insurance and GSE Subcommittee of the Committee on Financial Services, U.S. House of representatives, May 4, 2004 (re H.R. 3574); and Bulow and Shoven, op. cit.

I am not persuaded that it is a good idea to give nonpublic entities special accounting treatment in this matter. This is because in the presumed relatively small percentage of such firms that would even be affected, the result would be to eliminate comparability and/or impose a burden on preparers or users of the financial statements, as the firms transition to publicly owned companies.

I feel more strongly that "small business issuers" that are already public companies should be treated the same here as other public companies (Issue 15). This is based in part on my participating in early research on the "Big GAAP-Small GAAP" question. See "Small Public Companies: Do They Have Different Reporting Needs?" Donald H. Korn, *Financial Executive*, August 1984.

The treatment of Cash Flows (Issue 16) as set forth in the proposed Statement is helpful in understanding the entity's transactions.

Achieving Convergence with IFRS 2 (Issue 17) is a desirable and high priority goal. However, the benefit of a preferred accounting approach, if different, must be considered along with the benefit of convergence, and the latter is desired as long as equally good, or better, accounting is the result.

The proposed Statement, taken as a whole, in my opinion, meets the objective of understandability (Issue 18)--but only with the proviso of "a willingness to study the Standard

with reasonable diligence." The illustrations in Appendix B are helpful. However, the body of knowledge and number of issues embraced by the proposed Statement, and the sheer magnitude of supporting material and references, require an interested party to invest considerable time and effort before understanding the issues and the implementation guidance. That is the "nature of the beast."

A comment may be in order at this point on the efforts of lobbying groups, particularly those representing so-called technology companies, to get Congress to intervene in FASB's efforts to finalize a Standard on Share-Based Payment. Many technology companies based in or affiliated with "Silicon Valley" are among the largest issuers of employee stock options. (Cf. "Employee Stock Option Expense," *Accounting Issues*, Pat McConnell and Janet Pegg, Bear Stearns, July 2002.) The opposition of some of these firms and others to expensing the value of stock options "granted" to employees is reflected in H.R. 3574, "The Stock Option Accounting Reform Act," as well as some earlier legislative proposals.

In contrast to such political intervention, this writer strongly supports the independence and due process of FASB in developing and setting financial accounting standards for U.S. GAAP. I agree with the Association for Investment Management and Research (now the CFA Institute) that "politics and financial-reporting standards don't mix." (AIMR quote on page 1, Attachment 2, supplied with Testimony of R. Herz and G. Batavick, op. cit.)

CONCLUDING REMARKS

In my opinion, most of the current arguments in opposition to the proposed Statement either have no significant merit, and/or they may be better explained in terms of perceived impact on executive compensation than by accounting theory. Recent work on agency costs and on corporate earnings restatements seems consistent with this view. (See "Agency Costs of Overvalued Equity," Michael Jensen; Negotiation, Organization and Markets, Harvard University, Working Paper No. 04-26, April 2004; and "Why do corporate managers misstate

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financial statements? The role of option compensation, corporate governance, and other factors," J. Efendi, A. Srivastava, and E. Swanson, Texas A&M University, May 17, 2004.) As for the arguments about dire consequences for the U.S. economy and competitiveness should the proposed Statement be adopted, I am prepared to rebut them! (The recent FASB Congressional testimony presented by Messrs. Herz and Batavick covered some of this ground.)

Director of Major Projects
File Reference 1102-100

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I would thus appreciate the opportunity to participate in the Roundtable on June 24, 2004 in Palo Alto to discuss the issues with the Board and constituents, to have the opportunity to advance the case for improved financial accounting and reporting.

Should you have any questions on the above or wish additional information, please telephone me at 650-941-0355, or email to dhkorn@earthlink.net. Thank you very much for your attention and consideration.

Sincerely,

Donald H. Korn, CFA