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March 6, 2003

Ms. Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Invitation to Comment – ED 2 Share-Based Payment

Dear Ms. Crook:

We appreciate the opportunity to provide comments on the International Accounting Standards Board (IASB) exposure draft, "ED2 Share-Based Payment" (ED2). We believe that the impact of changes in the accounting requirements for share-based compensation will have a profound impact on companies and their employees and may produce financial reporting results that are not in the best interest of preparers and users of financial statements alike. Specifically, we wish to address three areas of particular interest to us.

1. We do not believe that stock options should be reflected as an expense in the income statement.

   We realize that the IASB has heard and considered the following arguments against expensing employee stock options. However, we feel it is important to state our belief that these arguments form a convincing case against expensing employee stock options. In summary, with respect to the appropriateness of expensing employee stock options, we believe the following:

   a. The granting and exercising of employee stock options never translates into outflows of cash from the company, only inflows. We believe that adopting accounting standards which introduce permanent differences between actual real world cash flows and reported income are counter productive to improving the relevancy of financial statements.

   b. Flaws in methodologies currently used to value employee stock options (which we discuss in detail below) consistently overstate the theoretical value of employee stock options. Treating an incorrect and misleading number as an expense in the income statement will decrease financial statement reliability and transparency.

   c. Methodologies to value employee stock options required by the FASB and proposed by the IASB rely on the use of extremely subjective assumptions that are subject to a high degree of judgment, variability, and manipulation. Use of such methodologies damages the comparability of financial statements.

   d. The dilutive impact of options is already reflected in earnings per share and properly reflects the dilutive impact of outstanding stock options on existing shareholders. Expensing employee stock options without adjusting the calculation of earnings per share will result in reflecting the impact of such options on earnings per share twice.

2. We do not believe it is appropriate to utilize existing option-pricing models to value employee stock options.

Inadequacies of Existing Option-Pricing Models

We do not believe that any of the current valuation methodologies utilizing option-pricing models proposed by the IASB or required by the Financial Accounting Standard Board (FASB) are adequate. When the FASB adopted Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation,” in 1995, the FASB believed that current option pricing models were an adequate way to value employee stock options. However, data accumulated since the adoption of SFAS No. 123 indicates that while FASB may have believed current pricing models were adequate, they are not. These are essentially the same methodologies proposed by the IASB in ED2. We wish to make several points regarding the rationale for utilizing existing option-pricing models to value employee stock options.

Many of the unique aspects of employee stock options which are substantially different from market traded options are not accounted for in existing option-pricing models including restrictions on transferability, vesting provisions, contractual lives, and trading blackout periods. The markets for traded options for which existing option-pricing models were developed do not rely solely on blind adherence to the results of complex mathematical models as suggested by the IASB and FASB standards. Rather, option pricing in a real market reflects a broad range of subjective factors that are subject to constant change. While some have suggested that the imprecision associated with using option-pricing models would not necessarily be greater than the imprecision inherent in other complex accruals required by accounting standards, we believe that if share-based compensation is to be subjected to a fair value approach, then such an approach must truly and with confidence reflect the fair value of the underlying transactions.

We believe that the assumptions required when using existing option-pricing models are subject to a high degree of judgment and variability making the output of such models inconsistent and subject to manipulation. In particular, assessing the expected life of options and the expected volatility over that life is virtually impossible to do with any degree of certainty. Therefore, when the expected future volatility and expected life assumptions used to value options are subsequently compared against actual results, significant variations are common.

We have also observed wide variations in practice among U.S. companies currently valuing employee stock options for purposes of applying the pro forma disclosure provisions of SFAS No. 123. For example, while some companies only consider their stock’s historical volatility in determining their expected volatility assumption, others employ a variety of methods to subjectively adjust downwards the expected volatility assumption from their stock’s historical volatility. The most common method we have seen is for expected volatility to be adjusted to reflect the volatility implied by actual traded options. This approach is usually highly subjective because most companies utilizing it do not have traded options with the same life as the expected life of their employee stock options. Therefore, some highly subjective analysis is needed to reconcile the volatility of the traded options with the volatility assumption used to value employee options.

On several occasions, we have sought informal valuation of our employee stock options by investment banks that regularly work in active options markets. In every case, the informal valuations we received from these investment banks were substantially less than those obtained by applying the Black-Scholes option-pricing model. In the real world, such valuations are not based exclusively on complex mathematical models, but reflect numerous subjective adjustments to arrive at the true value of the options. It has been our experience that markets never value options based on historical volatility. There is always a discount that increases with the life of the option. Not only was each investment bank’s valuation significantly below those results generated by application of the Black-Scholes model, but the valuations have been extremely consistent between the various investment banks from which we have received quotes. To us this indicates that we are getting reasonable quotes from the bankers that the Black-Scholes model is consistently overstating the theoretical value of our employee stock options. Our anecdotal observations are consistent with recent academic studies that indicate the Black-Scholes and other existing models consistently and significantly overstates the value of employee stock options.

We believe that the inadequacies of the option-pricing models in valuing employee stock options can be manifested in numerous ways. For example, when using an option-pricing model like Black-Scholes to value an employee stock option, a shorter vesting period will generally lower the calculated fair value of an option because it will shorten the estimated life of the option. However, from the employee's perspective, a shorter vesting period makes the option more valuable because employees perceive value in being able to exercise the option earlier.

In summary, it is our position that the inadequacies inherent in available option-pricing models, including Black-Scholes, with respect to valuing employee stock options are so great that they should not be used for measurement of employee stock options. We believe that the Black-Scholes option-pricing model overstates the value of employee stock options by a factor of two to three times. Reflecting these inflated values in either pro forma disclosures or as a recognized expense in the income statement has an inappropriate impact on financial statements. Use of Black-Scholes and similar option-pricing models impairs the transparency of reported financial information and make comparisons between companies and across multiple periods difficult for investors and others to comprehend.

Alternative Valuation Approaches

We do not have a definitive answer to the question "what other approaches would provide more consistent and reliable estimates of the fair value of employee stock options granted?" In general, we believe it may be extremely difficult to develop a method of valuing employee stock options that produces reasonable and consistent results. However, we do recommend that the IASB reconsider the use of option-pricing models and/or reconsider how such models are required to be applied in valuing employee stock options. In seems reasonable to expect that such reconsideration could be done jointly with the FASB to further the goal of establishing a global standard.

Some suggestions with respect to employee stock option valuation methodologies include:

- Consider sponsoring the development of a new valuation model to be used solely for the purpose valuing employee stock options. Such a model must consider the unique nature of employee options and value them accordingly.

- For the volatility assumption, consider use of the volatility implied by actual traded options even if the life of such traded options differs from the expected life of employee stock options. Also consider the use of quotes from independent and qualified investment banks to value employee stock options.

- Consider placing a "cap" on the volatility assumption based on industry or exchange norms or some other reasonable metric.

- Consider allowing changes to be made to the assumptions used to value options on a prospective basis as time passes and actual data becomes available.

- Because many companies provide no insights into how they actually develop the values for the assumptions used to value employee stock options, consider requiring much more detailed financial statement disclosure concerning the methodology employed to derive assumption values. Specifically, such disclosures should identify all factors considered in developing assumption estimates and indicate in detail how each factor was used in arriving at the related estimate. This will provide users with a better assessment as to the reasonableness of the option expense calculated and drive more uniformity in application by preparers.

- Mandate an "inflexible approach" for selecting valuation model assumptions that does not allow for any subjective adjustment to the input assumptions. For example, require that the expected life of an option be based solely on the assumption that it will be exercised immediately upon vesting. For expected volatility, require that composite historical volatility of the stock exchange on which the company's common stock is traded (or likely to be traded) over a time frame equal to the expected life of the option be used. While we do not necessarily agree with this approach over others we have mentioned, such an approach will generate more consistent results than current practice.

3. We believe that adoption of the existing requirements of ED2 without serious consideration and changes, particularly with respect to option valuation methodologies, could seriously limit the ability of responsible parties to establish a set of global accounting standards.

   Developing one set of global accounting standards is a valid and worthy goal and is an objective we fully support. Based on our actual experience in the United States, existing FASB standards on share-based compensation and ED2 proposed by the IASB are inadequate and potentially damaging to the development of relevant, transparent, and consistent financial statements. While we believe that reasonable people can disagree on the appropriateness of expensing employee stock options, we do not believe it is reasonable to assert that existing valuation models are adequate to value such options. Appropriate alternatives to existing methodologies need to be developed before inclusion of an expense in financial statements can be considered or mandated.

   If the IASB fails to address these matters in a deliberate and serious manner, we fear it may do permanent damage to its ability to move forward on development of global accounting standards. Based on the public comments of some IASB members, including its Chairman, it appears that some members may have made up their minds on these issues long before ED2 was even issued. We hope that is not the case and that the IASB will take seriously the legitimate concerns of many of its constituents on important technical aspects of ED2. Failure to do so will undermine the IASB's credibility and hamper its ability to play a leading role in the challenging task of developing global accounting standards.

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We again wish to thank you for this opportunity to comment on these matters which we believe are of extreme importance to issuers and users of financial statements.

Yours truly,

---/s/---

Fred D. Anderson
Executive Vice President
and Chief Financial Officer
Apple Computer, Inc.