Letter of Comment No: 5511 File Reference: 1102-100



VIA EMAIL

June 29, 2004

Ms. Suzanne Bielstein Director of Major Projects Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: Proposed SFAS - File Reference No. 1102-100

Dear Ms. Bielstein:

On behalf of the members of The Technology Network ("TechNet"), thank you for the opportunity to submit comments in response to the Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95.* We appreciate the opportunity to offer our views on this important matter.

TechNet is a national network of 200 chief executive officers and senior partners of the nation's leading companies in the fields of information technology, biotechnology, venture

capital, investment banking and law. We are proud of the role that our industries have played in the growth of the U.S. economy, due in large part to the use of broad-based stock option and other equity-based incentive plans to attract and retain talented employees. Many TechNet members maintain broad-based employee stock option programs. By giving employees at all levels a chance to share in their company's financial success through equity ownership, broad-based stock option plans boost productivity and are essential to America's competitiveness and economic growth.

For reasons discussed in this letter, TechNet has serious concerns with the Board's proposal to require mandatory expensing of employee stock options. We believe that the Board's proposal would result in financial statements that substantially overstate the value of employee stock options, providing less clarity and comparability to investors. Because of this substantial overvaluation, the proposal would make it prohibitive to offer broad-based stock option plans, encouraging companies to concentrate share ownership in the hands of senior executives.

The following addresses specific issues on which the Board seeks comment.

### I. Recognition of Compensation Cost

Employee stock options do not constitute an expense.

We fundamentally disagree with the Board's premise that employee stock options constitute a corporate expense. The issuance of stock options does not result in a corporate level cost that impacts net income.

Employee stock options do not represent payment for goods or services received. Rather, employee stock options represent an opportunity for employees to share ownership in the enterprise for the purpose of increasing shareholder value. They are an employee-retention device, granted with a prospective view of future employment. A promise to issue employee stock options in return for a promise to provide services in the future in no way meets the definition of a liability. The issuance of an employee stock option results in:

- No outflow or consumption of corporate assets;
- No decline in the value of corporate assets;
- No creation of a liability representing actual or expected cash outflows;

Employee stock options have a contingent or hypothetical value to the employee who receives them. However, this value is not realizable at the time of grant and employee stock options cannot be converted into cash by either the employee or the corporation. In fact, in many cases, this potential value is never realized. Further, in any event, employee stock options will never result in the expenditure of cash by the company but, in fact, have the potential to provide cash flow to the company. Just as revenues or gains are not recognized until they are realized or realizable, the grant of an employee stock option that has no realizable cost should not be considered an expense to the corporation.

We further believe that requiring a fictional income statement impact for a transaction that takes place wholly within the balance sheet is insupportable. Unlike a fixed asset, the cost of which is an expense that is recognized over its useful life, employee stock options do not generate an expense that should be recognized either immediately or over time in the income statement. In fact, employee stock options cannot be converted into cash and to the extent

employee stock options are ultimately exercised, corporate assets are increased by the amount of cash that the employee must pay to exercise the option.

Expensing stock options will also result in balance sheet entries that give a grossly distorted view of a company's capital structure. When employee stock options are expensed, the value of those options increases a company's paid-in capital in the equity section of the balance sheet by a phantom number. The company's capital structure appears altered although no money has changed hands and no stock has actually been issued, or may ever be issued. Further, because the increased expense has impacted the company's net income and therefore its retained earnings, the balance sheet is further distorted. The equity section of a balance sheet should represent real dollars invested in the equity of the company. Expensing will not only corrupt income statements, it will serve to distort already complex balance sheets, to the detriment of investors.

Recent studies of employee stock options and compensation at a comprehensive sampling of companies provides further evidence that stock options are not compensation in that they are generally not viewed by the employee or employer as compensation for labor performed and are not granted in lieu of salary compensation. In their book, *In the Company of Owners: The Truth About Stock Options And Why Every Employee Should Have Them*, Rutgers University Professors Joseph Blasi and Douglas Kruse found that, in the companies examined, average employees who held options were paid competitive wages and benefits irrespective of any options held. Options instead represent "capital income" that workers receive for sharing the risk of ownership in the corporation.

Some have argued that a corporation incurs an opportunity cost in issuing employee stock options, but generally accepted accounting principles have not required the recognition of opportunity costs. Reliable calculation of the opportunity cost associated with the issuance of stock options would clearly be impossible. And, indeed, to do so would lead to confusing results.

If employee stock options are considered an expense on the basis of opportunity costs, then companies should be able to account for the economic benefits that result from employee ownership. Amending GAAP to incorporate such costs or benefits into the financial statement would clearly lead to distortions, inaccuracies and investor confusion.

Any cost that may exist with respect to shares or options issued to employees results from the potential dilution of each investor's share of company ownership, which may increase when options are granted. This cost is already reflected in the income statement in the earnings per share (EPS) calculation. Reducing net income when employee stock options are granted will result in an inaccurate "double charge" in the financial statements.

Because the potential "cost" of issuing employee stock options is borne by existing shareholders in the form of potential dilution, we believe that the most appropriate way to reflect the so-called "cost" of employee stock options is through consistent and extensive disclosures of data regarding shareholder dilution.

The Board has suggested that financial statements include a range of subjective estimates and that the estimated valuation of employee stock options is no different. We firmly disagree with this view. The subjective nature of the inputs into the Board's proposed option valuation formulas, the unpredictable nature of factors related to employee stock options and the resulting challenges in arriving at an accurate valuation are unique to employee stock options.

Admittedly, there are uncertainties involved in measurement of other items included in financial statements including depreciation, pension and other retirement benefits and even stock options granted to third parties as compensation for prior work performed. All of these examples, however, involve costs that can be valued and assigned a definite out-of-pocket expense; or are subject to later truing up. Depreciation estimates, for example, merely represent timing issues; the cost of equipment purchased is a readily determined number. Work performed by third parties can also be assigned a market value. In the case of pension costs, companies are required to estimate total cost, but these estimates are trued up to reflect actual costs.

In contrast, there is no reliable way to estimate the value of employee stock options and the Board's proposal does not provide an opportunity to correct results to the extent they prove wrong.

The longstanding approach embodied in FASB Statement No. 123 is an appropriate method of accounting for stock options.

We believe that the approach embodied in Statement 123 is an appropriate method of accounting for stock options. Statement 123 recognizes that there is not consensus on whether

employee stock options constitute an expense. For all investors, Statement 123 provides relevant information and supports the public policy goal of fostering broad-based stock option plans.

Investors and accounting experts have expressed considerable doubt about the accuracy of existing valuation methods include those proposed by the Board. Mandating that a distorted charge be incorporated into financial statements will result in significantly less clarity, consistency and reliability in financial statements. The established approach required by Statement 123 enables investors who consider the "compensation cost" a meaningful number to easily discern a hypothetical compensation charge and its impact on the financial statement. Those who consider the "compensation cost" meaningless may ignore that cost.

## II. Measurement Attribute and Measurement Date

The grant date of the option is the appropriate date for public companies to measure the compensation cost of employee stock options

Current stock option accounting rules require that if employee stock options are expensed, they must be expensed at the date they are granted to the employee. Notwithstanding our position that employee stock options do not represent an expense, grant date is the correct valuation date because it is when the employer and the employee agree to the terms of the stock option award.

Exercise date accounting permits reliance on an actual value, rather than estimates.

However, it would produce substantial swings in net income based on volatility of the underlying

June 30, 2004

stock. In addition, it would have the perverse result of creating a higher expense when the stock performs well. If employee stock options were expensed at exercise, the better a company is at increasing shareholder value, the worse its reported earnings would be.

The Board previously considered and rejected expensing employee stock options at the date they are exercised. FASB also rejected the view that if employee stock options were expensed at exercise, the "cost" of the option would be the difference between the market price of the stock and the amount paid by the employee on the date the option is exercised. More recently, the International Accounting Standards Board concluded that employee stock options that are expensed, must be expensed on the grant date.

We believe that this issue has been thoroughly examined and that the Financial Accounting Standards Board and International Accounting Standards Board reached the appropriate conclusion in determining that employee stock options should be valued at grant date.

Nevertheless, as discussed below, we believe the Board's current proposal is unworkable on any basis including a grant-date basis.

#### III. Fair Value Measurement

Use of the Black-Scholes, lattice or binomial option pricing models will not result in accurate, reliable or consistent measurement of the fair value of employee stock options.

We concur with the Board's view that the fair value measurement should be based on observable market prices of identical or similar instruments in active markets. We do not believe, however, that estimates of fair value arrived at using existing option pricing models will be accurate and reliable. We also do not believe the Board has provided sufficient guidance to "ensure that the fair value measurement objective is applied with reasonable consistency".

Current option pricing models, including the Black-Scholes model and the lattice or binomial models, do not "reflect[] any and all substantive characteristics" of an employee stock option. Each of these models was created to value market-traded options. Specifically, these models do not factor in the lack of transferability of employee stock options, as discussed below in the response to the Board's proposal relative to expected life. As a result, both option pricing models result in substantial over-inflation of the value of employee stock options. The result is a material distortion of financial statements and a negative impact on the quality of financial reporting.

The Black-Scholes model, in particular, has been widely discredited as a reliable method of valuing employee stock options. The Black-Scholes model was designed to value short-term, freely tradable stock options, which have very different characteristics than employee options. Many of the unique features of employee stock options are not accounted for by the Black-Scholes model. As a result, companies that utilize this model must factor a wide range of subjective judgments and assumptions into a complex valuation formula. Predictions of a range of variables, including interest rates, stock volatility, and employee exercise behavior will determine the outcome of these calculations, resulting in widely divergent results depending on

the subjective assumptions a company makes. The results will be unreliable and will defy comparability.

We commend the Board's apparent recognition that the Black-Scholes model has limitations when valuing employee stock options, reflected in the Board's preference for binomial models. However, binomial models do not address the shortcomings of the Black-Scholes method. While the Black-Scholes method is designed to value traded options and has known limitations with respect to valuation of employee stock options, other existing valuation models have similar deficiencies. The Black-Scholes and binomial models essentially rely on the same variables: stock price, exercise price, time to exercise, risk-free rate of return and expected volatility of the underlying stock. As with the Black-Scholes model, volatility is the key input and is difficult to predict.

In addition, these existing option valuation models were designed to value freely transferable options, yet there are significant restrictions on the transferability of employee stock options. Employee stock options cannot be bought, sold or pledged. The Black-Scholes and binomial models do not incorporate a lack of marketability discount to address such restrictions.

Further, the Black-Scholes and binomial models were designed for options that are exercisable only upon expiration. Employee stock options, in contrast, typically have long vesting requirements of up to 10 years and are then exercisable for a period of time, but are worthless if the employee terminates employment prior to vesting. The Board's proposed option pricing models do not accurately account for these factors.

The Board's proposal also does not take into account restrictions that exist during the vesting period, on the basis that only instruments that vest are ultimately expensed. Again, however, a failure to discount for vesting restrictions overstates the potential value of an employee stock

option.

Any potential value of employee stock options is also significantly reduced -- and made

difficult to estimate -- by the imposition of blackout periods or trading restrictions on employees.

Many companies prevent trading of employee stock options based on events such as product

breakthroughs or major announcements. These blackout periods vary by individual company

and by individual employee, restricting options exercise and trading opportunities for significant

periods of the year. As a result, the potential value of employee stock options is reduced and

made substantially more difficult to estimate.

In short, although the binomial models may have theoretical advantages over the Black-

Scholes method, in practice, they suffer from similar shortcomings. Binomial models contain a

complex series of subjective inputs, and values calculated are greatly influenced by the many

assumptions and choices made. Investors and other users of financial statements will have no

way to understand the complex process of arriving at employee stock option valuations, nor will

they be able to interpret or compare the resulting financial statements.

11

Volatility estimates have a material negative impact on financial statements that do not accurately reflect a company's actual financial performance.

The Board seeks comment on whether a specific method for estimating volatility should be used and if so, what method should be used and why. We believe that current option pricing models, including those proposed by the Board, favor companies in non-volatile industries and penalize companies in highly volatile industries. In addition, these models do not produce reliable and comparable results in large part because they require assumptions of expected volatility.

The Black-Scholes and binomial valuation models create a disadvantage for companies in volatile industries. Assuming stock price and other terms are the same, if the stock price is declining in the volatile market and staying constant in the non-volatile market, the option value will be significantly higher for the company in the volatile market, under the Black-Scholes formula.

In addition to creating a disadvantage for companies in volatile industries, the Board's proposal requires estimates of long-term volatility, inherently unreliable figures. The volatility of the underlying stock expected over the life of the option, up to ten years, is perhaps the most significant prediction that must be incorporated into option pricing models. Volatility estimates have the potential to result in substantial swings in stock option valuation yet corporate estimates of future stock volatility truly represent efforts to predict the future.

June 30, 2004

Rather than rely on historical volatility, the Exposure Draft requires companies in most instances to consider the extent to which "future experience is reasonably expected to differ from historical experience." Companies are further required to estimate future volatility over the life of the option, up to 10 years in the future.

Wide shifts in volatility are a unique feature of technology and high-growth companies, in contrast to many other sectors of the economy with more predictable performance characteristics. The high technology and biotechnology industries are subject to significant swings in volatility due to patterns of scientific breakthrough and innovation that uniquely characterize these industries. Furthermore, these technological and scientific breakthroughs or setbacks by a company – or by its competitors – are impossible to predict.

These unpredictable events also have an unpredictable impact on volatility. Experience illustrates that positive events, including strong test results, regulatory approvals and technology breakthroughs, can but do not always increase volatility. In addition, macroeconomic variables and general market conditions also positively or negatively impact volatility. Finally, the start and end dates or time period used to calculate volatility as well as the number of data points used can significantly impact the resulting volatility estimate. In short, events and their impact on volatility are not possible to predict and positive or negative events can instantly make obsolete any valuation assumptions made at grant date.

Incorrectly estimating the impact of volatility can cause option valuation and expenses to fluctuate significantly. For example, using the Black-Scholes formula and making reasonable

assumptions about stock price, option life, risk free rate of return and number of option grants per year, an estimated volatility of 60 percent yields an estimated options expense number that is almost 100 percent greater than the expense number that results from a 40 percent estimated volatility. Changes in volatility estimates have a dramatic, material change in employee stock options expense, reported earnings and potentially to stock price.

Without a consistent or standardized method of estimating expected volatilities, similar companies can generate significantly different expense results. Estimates or predictions of volatility based on events a decade in the future and any valuation based thereon will clearly be unreliable, except in the case of companies that grant stock options sparingly (any expense number would be immaterial for companies with limited option programs). We urge the Board not to adopt a proposal that will create an unequal playing field by penalizing industries that experience high stock volatility.

Employee exercise behavior is another significant factor that cannot be accurately estimated.

The Board's proposal permits use of expected option term rather than maximum term as a means of addressing the absence of a market for employee stock options. The Board's proposal, however, would require companies to forecast employee exercise behavior. Many variables impact employee decisions to exercise stock options, including vesting horizon, option term, magnitude of in-the-money position, and the portfolio of options that the employee can exercise in the near and long-terms. In addition, employee exercise behavior differs based on job classification levels, gender and age, restrictions on trading due to blackout periods and closed

trading windows, and a range of other factors. Personal decision-making based on individual expectations and needs is virtually impossible to predict, yet the Board's proposal would require

such estimates.

The unique attributes of employee stock options are not taken into account by the Board's proposal resulting in overstatement of the value of employee stock option grants.

The Board's proposed valuation models do not provide a sufficient discount for the unique features of employee stock options. Shortening the life of an option by adjusting the contractual terms for expected early exercise and post-vesting employment behavior does not adequately

account for the non-transferability attribute and other unique features of employee stock options,

resulting in overstatement of the value of employee stock options.

Adjusting the "life" of the option from the contractual life may account in part for the fact

that employee stock options vest. However, this adjustment does not address the other

restrictions that exist including the fact that an option cannot be transferred, hedged, pledged, or

sold. As a result, many options expire unexercised because an employee left a company before

the options had vested or because the option price was above the price of the stock when the

options became exercisable. In short, the option pricing models proposed by the Board do not

address these features of employee stock options and thus will result in significant over-inflation

of the value of employee stock options.

As a result of these shortcomings, current option pricing models, including those proposed by

the Board, allow a corporation to come up with huge differences in the expense number

15

depending on the inputs that are used. By failing to account for the restrictions and other characteristics of employee stock options, current option pricing models produce unreliable and misleading results that overstate the value of employee stock option grants, particularly with respect to companies in volatile industries.

A recent study confirmed that the Black-Scholes model systematically overstates the value of employee stock option grants. In a detailed study of the leading valuation models applied to an actual set of employee stock option grants covering 403 million options granted by nine major U.S. companies, the Black-Scholes model consistently overstated the value of the option grants. The authors of the study cited the failure of the Black-Scholes model to consider the unique features of employee stock options.

The Board's proposal does not provide sufficient flexibility to permit the use of new option pricing models when and if developed.

The Exposure Draft indicates that the Board seeks to adopt a flexible standard that will permit the use of new option pricing models when, and if, developed. We are concerned, however, that the Board's proposed standard appears to preclude the use of any model that is not based on the Black-Scholes model or a lattice model. Not only must any model used rely on the Black-Scholes inputs, but the Board's proposal refers only to lattice and closed and models such as Black Scholes and there is no clear guidance on the use of alternative models once developed. We are concerned that, as a practical matter, new models could not be used unless they were derivations of Black-Scholes or binomial models.

<sup>&</sup>lt;sup>1</sup> "Valuing Employee Stock Options: A Comparison of Alternative Models," Analysis Group/Economics for Financial Executives Research Foundation.

We have significant concerns about the Board's proposal to require options that vest on a

graded schedule to be valued and accounted for separately.

In essence, the Board's proposal would require that where options vest on a "graded

schedule," that each set of options constitutes a separate award that must be valued separately

and accounted for separately. Additional issuances to, for example, new employees, also would

presumably have to be accounted for separately to the extent they were issued other than on a

company-wide grant date. The result would be multiple valuations for the same option grant and

unnecessary complexity resulting in major implementation costs and challenges.

In addition, this approach will result in inappropriate front-loading of the option expense.

Under the Board's proposal, the expense of new option grants is based on "graded vesting"

which accelerates the expense in the early years. Thus, there is likely to be a greater financial

statement impact, or front-loading of the expense, in the first few years as each year will carry a

ratable piece of the historical grants and an accelerated portion of the new grants. This would be

extremely difficult to administer and impact comparability of financial statements.

The Board's proposed transition rules would result in unreliable and incomparable

financial statements.

We are concerned that the Board's proposal will result in a significant lack of comparability

due to the inconsistent treatment of new option grants versus prior option grants. The Board's

proposal would require unvested options to be expensed based on the Black-Scholes value that

was contained in prior footnote disclosures. Newly issued options, in contrast, would be valued

17

based on the new standard. As a result, during the transition period, outstanding options would

be valued in radically different ways.

In addition, estimates of the value of grants made in prior years using the Black-Scholes

method will, under this proposal, impact financial statements going forward despite recognition

that these "values" are overstated. The result will be highly confusing for investors, particularly

in the case of companies that offer broad-based plans.

We believe that the Board's proposal will have a significant, negative impact on emerging

growth companies and other non-public entities.

We are particularly concerned about the impact of the Board's proposal on non-public

companies given the importance of employee stock options to the success of emerging growth

companies and the reliance of such companies on stock options to attract, retain and incentivize

employees. Further, we believe that the subjectivity and unpredictability of the estimates

required by the Board's proposal is exacerbated in the case of non-public companies.

All of the arguments outlined above apply to non-public companies. In fact, such companies

will face heightened challenges in estimating the volatility of the stock that underlies the

employee stock option and for which there is no market. There is no reliable data to measure

volatility for most non-public companies. Estimates based on market volatility will not be

reliable because company volatility is often not comparable to industry volatility. In addition,

venture-backed companies often establish new industries with unpredictable volatilities.

18

The Board's proposal states that, where it is impossible to estimate the fair value of employee stock options, companies be required to use an "intrinsic value" method where the value is adjusted each reporting period. Non-public entities may also elect this method. We have concerns regarding the Board's proposed use of an "intrinsic value" method in which the value of employee stock options is adjusted each reporting period.

This approach will, in effect, bring the stock price directly into the income statement. The expense associated with employee stock options will increase or decrease each quarter depending on changes in the price of the underlying stock. Under this approach, it is conceivable that the expense might even be negative in some cases.

In previous examinations of the expensing issue, the Board determined that measuring volatility would be too difficult, resulting in the current use of the minimum value method for non-public companies. We believe that estimating future volatility for new, non-public entities remains a significant challenge and we urge the Board not to require this approach.

A one-year extension of the effective date is not sufficient to address these concerns. The substantial compliance costs that would be imposed on non-public companies would far outweigh any possibly perceived benefits resulting from a mandatory expensing standard.

The Board should conduct extensive field-testing of proposed option pricing models prior to adoption of any final standard.

There are fundamental differences of opinion within the accounting community on the threshold issue of whether employee stock options constitute an expense. There is widespread agreement among accounting experts and in the business community, however, that current valuation models will not product accurate, reliable and consistent results. As a result, we strongly urge the Board to require field-testing of any proposed option pricing models prior to the adoption of any final standard.

Field-testing should be comprehensive and enable the financial officers and management of companies to make and test real-life assumptions to determine whether these models can produce reliable and comparable results. Further, we believe that the results arrived at through field-testing should be used to develop footnote disclosures until it can be determined that they provide accurate and reliable results. If, based on sufficient field-testing data, it is determined that the Board's proposed models provide credible, transparent, consistent, comparable and unbiased information, and that the footnote disclosure has not addressed investor needs, then the valuation of stock options on the face of the financial statements should be considered. There is ample precedent for field-testing in cases such as this, in which a long-standing method of accounting is replaced with a newer, untested approach.

The Exposure Draft and resulting standard will not increase clarity or comparability for companies or investors.

We support the Board's stated goal of issuing "financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence." We feel strongly, however, that the proposed Statement will not achieve this objective.

On the contrary, as detailed in this letter, we believe that the Board's proposal would establish a standard that significantly reduces the reliability, comparability and clarity of financial statements for companies and investors. We believe that the proposed standard would impose significant burdens on companies, particularly smaller companies, related to compliance and auditing. Further, we believe the standard is so complex and subjective as to produce financial statements that cannot readily be understood or compared across industries or over time by the average investor.

The Board's proposal will have a negative impact on the ability of companies to offer Employee Stock Purchase Plans.

The Board has taken the position that any Employee Stock Purchase Plan (ESPP) is compensatory, and an expense must be recognized, unless all holders of the same class of stock are entitled to purchase shares of stock on no less favorable terms than the employee. The proposal thus requires companies to treat as an expense the discount given to employees when they purchase shares under these plans.

Employee stock purchase plans are an important benefit to American workers. More than 15 million workers at 4,000 public companies across the United States participate in ESPPs. We are concerned that the likely result of the Board's proposal will be the reduction or elimination of one of the primary savings vehicles for millions of average American employees.

## IV. Economic Policy Implications of the Board's Proposal

# Mandatory expensing will threaten the trend toward broad-based employee ownership

Increasingly, employee stock options are being offered by companies in a range of industries and the clear national trend has been toward increased employee ownership particularly among non-managers. Data from the National Center for Employee Ownership and other sources over the last few years shows that the number of companies that offer options to all employees continues to grow. Currently, over 14 million American workers or 13 percent of the entire private sector workforce hold stock options, according to a recent national study by Professors Joseph Blasi and Douglas Kruse of Rutgers University's School of Management and Labor Relations and Professor Richard Freeman of Harvard University's Department of Economics. 94 percent of these employees consider themselves part of the middle class, working class or lower class, while only 15 percent identify themselves managers. Mandatory expensing will threaten this important trend.

In the high technology and biotechnology industries that TechNet represents, stock options and broad-based employee ownership have been an engine of growth, helping to build some of the nation's most innovative companies. TechNet member companies—including many of today's technology leaders as well as start-ups—have grown due in large part to the ability to use employee stock options to attract and retain skilled employees at all levels of the corporation.

A mandatory expensing standard is likely to result in the elimination of broad-based employee stock option plans. Professors Brian Hall of Harvard Business School and Kevin Murphy of the Marshall School of Business, University of Southern California, have conducted

research showing that the perceived value of stock options to executives at time of grant is typically one-half to two-thirds of the value under the Black-Scholes method, and may be as little as one-third.<sup>2</sup> A more recent study of over 640 employees at 300 publicly-traded companies suggests that employees place a 30 to 50 percent discount on the value of stock option grants they receive, relative to the Black-Scholes value of the options.<sup>3</sup> If forced to absorb a cost 50 to 200 percent greater than their perceived value, companies will face a major obstacle to offering options.

For companies that broadly issue employee stock options, the inaccuracies that result through application of existing option pricing models are more likely to have a material negative impact on financial statements, while companies that issue only a small number of options – usually to senior officers — will not be as significantly affected. Under a mandatory expensing standard, companies will be forced to restrict stock option grants rather than adding a significant expense, in accounting terms, to the financial statement. The result will be a decline in broad-based stock option plans.

In fact, recent studies and press reports confirm that companies will restrict option grants if a mandatory expensing standard is adopted. A 2002 survey of 117 U.S. companies showed that most of the companies surveyed would restrict option grants to rank-and-file employees if employee stock options were required to be expensed.<sup>4</sup> In fact, the study suggested that four of every five companies would grant fewer employee stock options. A number of corporations

<sup>&</sup>lt;sup>2</sup> The Journal of Accounting and Economics, April 2002.

<sup>&</sup>lt;sup>3</sup> How Do Employees Value Stock Options, Watson Wyatt Worldwide, March 2004.

<sup>&</sup>lt;sup>4</sup> "Survey: Firms Say Expensing Would Hurt Rank-and-File," San Jose Mercury News, describing a June 2002 study of 117 companies by iQuantic Buck.

June 30, 2004

have already announced plans to reduce option grants to non-executive employees in reaction to the Board's proposal.

The importance of broad-based stock options and their impact on economic growth is undisputed. Studies confirm that broad-based plans have a significant impact on productivity, innovation and economic activity. Companies that offer stock options to most or all employees have experienced significant increases in productivity.

Most recently, Professors Blasi and Kruse provide empirical evidence that companies with broad-based employee stock option plans receive a one-time, but permanent, boost to productivity of approximately 4 percent, compared to what their productivity would have been without employee ownership. Total shareholder returns increase by an average of approximately 2 percent.<sup>5</sup> Anecdotal evidence by employees and managers in a range of industries confirm the power of stock options to motivate employees through equity ownership.

#### V. Conclusion

TechNet strongly believes that the flexible approach set forth in Statement No.123 provides appropriate information to investors. We have serious concerns that an expensing standard utilizing existing valuation methods as proposed by the Board will result in inaccurate and inconsistent financial reporting.

<sup>&</sup>lt;sup>5</sup> Joseph Blasi, Douglas Kruse and Aaron Bernstein, In the Company of Owners: The Truth About Stock Options (and why every employee should have them), 2003.

June 30, 2004

Existing valuation models are not adequate for valuing employee stock options. We believe

that the Black-Scholes and binomial models proposed by the Board fail to adequately incorporate

factors unique to employee stock options. The need to make multiple subjective determinations

of the variables used in the Black-Scholes or binomial stock option valuation models will

threaten the comparability and consistency of financial reporting across companies and across

industries.

Thank you for the opportunity to comment on this important matter. Please contact me at

(650) 213-1160 for any further discussion of our comments.

Sincerely,

Rick White

President and CEO

Reb White