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Letter of Comment No: 3197
File Reference: 1102-100

June 1, 2004

Ms. Stacey Sutay
FINANCIAL ACCOUNTING STANDARDS BOARD
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To Whom It May Concern:

I am opposed to the expensing of stock options for the following reasons:

1. The purpose of options was to incentivize employees. This should continue. Just because some people abused the process, should not necessitate a purging of the system. There are several ways to remedy those abuses without changing the system.

   I have already seen, as a director of a public company, how a change from options to restricted stock can create employee morale problems;

2. Expensing options is taking a relatively simple, uniform process, and creating a complicated, expensive, unequal system (e.g., valuation of options for expensing purposes);

3. The valuation process, to be used for expensing, is far too complex for investors. Not only will they do less analysis (which is the opposite of what should be encouraged), but there will not be a uniform system (see attached Houlihan Lokey article regarding valuation);

4. It is bad enough that Sarbanes Oxley has caused an enormous amount of additional expense for companies, as well as redirecting personnel away from operational aspects of the business, but now there would be another distraction, <u>bad for business</u>, and, therefore, investors.

I would be happy to meet and discuss this with you at any time.

Sincerely,

Gerald E. Wedren

GEW:red

Attachments

Implementing Option Expensing under FASB's Proposed Rules

By
Gary Brewster, MBA, Karen M. Miles, MBA, CPA, Terence Tchen, MBA
Houlihan Lokey Howard & Zukin

FASB's March 31, 2004, exposure draft, Share-Based Payment, an amendment of FASB Statements No. 123 and 95, clearly sets forth FASB's position that all public companies must expense employee stock options. It also provides companies with the potential to lower their stock option expense when compared to current FASB valuation guidelines.

While the requirement for expensing employee options was expected, the preferred method of valuing these options may come as a surprise. FASB proposed that, based upon the availability of certain information, public companies should use lattice models to value their employee options. Existing rules generally require public companies to use the Black-Scholes option pricing model to value their employee options for reporting in the footnotes and for companies that have already chosen to expense options. So how do the two types of option models stack up in terms of ease of use, and more importantly, resulting value?

First, let's start with the Black-Scholes model. Although the formula is somewhat complicated, it is nevertheless fairly easy to program in a spreadsheet and is routinely taught in finance courses. However, the Black-Scholes model generally assumes that the option will not be exercised or abandoned until the end of the option period, and that exercise decisions will be optimal. In reality, however, employees typically do not hold their options to term and frequently exercise their options early for a variety of reasons. While the Black-Scholes model itself does not capture such behavior, there may be ways to modify the Black-Scholes inputs to account for the impact of early exercise and forfeiture. These modifications would also require a company to analyze historical forfeiture and early exercise experience.

In comparison, a lattice model, such as a binomial model, provides much more flexibility at the cost of added complexity. A lattice model calculates possible future stock prices and exercise decisions at various time periods. For example, a 400-step binomial would calculate over 80,000 possible future stock prices.

With a stock price lattice, and with the help of computing power, one can identify what would happen at the various time periods. Based on an analysis of a company's experience, one could determine at what points in the lattice a person would exercise early because they will be leaving or because the price has reached a certain level. One can incorporate the typical exercise behavior of a company (or perhaps industry) and how it might change as a function of the stock price. One can incorporate how the dividend rate might change over time, and how the volatility of the company's stock is projected to change over time, or as the price of the stock changes. One can also determine the impact of vesting schedules and forfeiture rates on option value. These and other considerations could result in a substantial reduction in calculated option values when compared to Black-Scholes.

The following table provides a summary comparison of the Black-Scholes model to the binomial model:

	Black-Scholes	Binomial
Ease of Implementation	Easy	Hard
Flexible	Somewhat	Very
Handles Early Exercise	Requires changes to inputs	Yes
Handles Vesting	Requires adjustments	Yes
Handles Forfeitures	Requires adjustments	Yes
Relative Valuations	Higher Values	Lower Values

Let's take an example of a specific employee option grant and the resulting option expense under the two models. Assume the following details:

- Strike price of option = $50
- Volatility = 30% - 50%
- Length of option = 10 years
- Risk-free rate = 1.5% - 4.3%
- Annual forfeiture rate = 2.5 %
- Vesting period = 3-year cliff
- Employees have historically exercised options early when the stock price is 2 times the strike price

Using the basic Black-Scholes model, the value per option is approximately $29. However, under the binomial model, a value of approximately $22 per option is derived, which is nearly 25% less than the value from Black-Scholes. The value derived from the binomial model is lower than the value from the Black-Scholes model due to the binomial model's ability to model forfeitures, early exercise and vesting. Modeling expected

changes in dividend policy and volatility could cause further divergence in the resulting values.

It is clear that using the more complex binomial model in conjunction with historical company experience and forecasted data can produce dramatically different results in option expense. For companies with a history of granting employee options, the time and costs spent in gathering and analyzing past experience with forfeitures and early exercise may have a large payoff in terms of reducing option expense. Not only is this approach of benefit to a firm's EPS, but it is also preferred by FASB.

As the FASB suggests, different employee categories may have different experiences in terms of forfeitures and early exercise. and companies may consider valuing the options granted to different classes in separate tranches. Additionally, firms need to develop databases and statistical models to extrapolate past behaviors for use in a binomial model.

While the option expensing issue is still in the exposure draft stage, those companies expecting to see a material impact on their reported earnings should begin researching the alternative valuation models. For those companies that determine that a lattice model more accurately incorporates the parameters of their employee stock option program, they should begin developing a lattice model specific for their company, as well as the process of gathering and analyzing the historical data to provide a foundation for the upcoming valuations.

ABOUT THE AUTHORS

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