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Letter of Comment No: 169File Reference: 1102-001 Date Received: 1-3/-03

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Response to FASB's Invitation to Comment on Stock Option Accounting -- File Reference No. 1102-001

January 31, 2003

The Business Roundtable is pleased to respond on behalf of our members to FASB's Invitation to Comment (No. 1102-001), issued on November 18, 2002. FASB has asked for comments on the specific differences between Statement 123 and IASB's Exposure Draft on Share-based Payments (issued November 7, 2002) with respect to valuation and recognition issues of employee stock options and other equity-based grants to employees. In addition, the Board is also "interested in receiving suggestions on how application of option-pricing models and the consistent use of key assumptions might be improved to provide better estimates of compensation expense."

The Business Roundtable is a member organization of CEOs from 150 companies. Some of our members have adopted SFAS 123 while others have not. As a group, however, we are unanimous in believing that the Black-Scholes and other binomial option-pricing models, as proposed to be used by the FASB and IASB, overstate the value of employee stock options. Thus, we will focus our response on ways to improve the reasonableness, reliability and consistency in valuing employee stock options and the resulting comparability between companies, leaving to our member companies and other experts to provide detailed comments on the specific differences between Statement 123 and the IASB's Exposure Draft.

As a preface to our response, we wish to state that, despite the diversity of our membership, a majority of our member companies questions the premise that a mandated expense for the "fair value" of employee stock options at grant is appropriate; they also question whether it would result in a fairer and more comparable representation of operating performance between companies. Our majority believes that "fair value" expensing does not accurately reflect the true financial impact on companies and risks degrading the value of financial statements to investors using them to understand a company's financial performance.

We also believe that, since the cost of options to shareholders is already fully and fairly accounted for in diluted EPS, additional accounting on the income statement is inappropriate unless it can be determined that the company has, in fact, incurred a cost. We do not dismiss the notion that such a case could be made, but none of the proposed accounting schemes we have seen to date addresses that possibility in an intellectually coherent way.

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However, we recognize that the FASB may well undertake a new project leading to mandatory expense recognition for employee stock option grant values. Consequently, these comments will focus on ways in which the measurement of the value of options can be improved and made more reliable, consistent and comparable across companies in the event that the decision is made to mandate a charge to income for employee stock options.

Black-Scholes Overestimates the "Fair Value" of Employee Options

We, and many others in the business community, believe that option-pricing models, even with adjustments for expected rather than maximum term, overestimate the value of employee stock options. The FASB defines "fair value" as "[T]he amount at which an asset could be bought or sold in a current transaction between willing parties..." Both the FASB and the IASB propose that "fair value" at grant be the measurement method for equity transactions with employees. For equity grants such as restricted stock this presents no problem. However, most equity grants to employee are stock options, which are nontransferable. There is no trading market for employee options; nor is one likely to develop. Hence, there is no verifiable "fair value" for employee stock options.

We acknowledge that expense recognized for compensation should reflect the cost to the company, not the perception of value to the employee. With employee stock options, however, there is no determinable "cost" to the company. So statement 123 determines expense by the "fair value" of the option measured by option-pricing models. Thus, expense is the amount of cash forgone by granting the options to employees rather than selling them into the market. (It should be noted that, if a company were to sell its stock in the market, the proceeds would not be taken into the income statement; they would be a balance sheet entry.) However, options with the characteristics of employee options would be worth less to investors than options without those characteristics. Therefore, employees' perceptions of option value *are relevant* to the question of expense determination since this determines the amount of cash or other compensation saved by granting options to employees instead of something else.

In the absence of a trading market, the FASB allows adjustments to pure option-pricing values to help companies estimate the "fair value" for employee options. Statement 123 allows use of "expected" option term, instead of maximum term and offers guidance on how to estimate future volatility. But no proof is offered, nor have any tests been performed to determine whether the resulting estimates reasonably approximate the "fair value" of employee options.

Our members and many others in the business community believe that, even with these adjustments proposed by the IASB and the FASB, option-pricing models overestimate the value of employee options. And this is even more pronounced with respect to non-dividend-paying stocks with high volatility, such as technology stocks. We do not believe that the allowed use of an option's "expected term" rather than its maximum term adequately discounts the "fair value" of employee options for nontransferability. It does not adequately account for the loss of remaining time value of the option caused by early exercise, measured at the point of exercise. And, it has disparate effects on high-volatility stocks than for those with low volatility.

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Further, the adjusted "fair value" methodology does not recognize the following characteristics of employee options, all of which further reduce their value: (1) non-exercisability before vesting, (2) truncated term if employment terminates after vesting but before exercise, (3) inability of employees to hedge their option position or use their options as collateral, (4) ordinary income taxation of gains at exercise, and (5) for some companies' grants, black-out periods, holding periods, ownership requirements, non-compete provisions and "claw-back" provisions.

Several recent academic studies have concluded that Black-Scholes and other option-pricing models applicable to publicly traded options overstate the value of long-lived employee stock options, and have proposed alternative valuation methods.^{*} Among the reasons cited by these studies for overvaluation are that existing market-based models fail to consider employees' aversion to risk, over-concentration in a single security, illiquidity and inability to hedge these risks. These studies should be considered by the FASB as part of its effort to determine whether the "fair value" of a stock option with the characteristics of employee to do so.

If, as we believe, adjusted option-pricing models overestimate the value of employee stock options, then requiring expense recognition for the option's "fair value" at grant will create a bias *against* stock options, especially for high-growth companies with highly volatile stocks, because their perceived value will be less than their accounting cost.

Before deciding whether to propose changes to U.S. accounting standards for employee stock options, we believe the FASB should determine whether the "fair value" of employee options, as measured by adjusted option-pricing models, reasonably estimates the foregone cash the company could have received from selling options *with the same terms* to the market.

Recommendation for a Market Test

We recommend the FASB develop and sponsor a comprehensive market test of the grant value of employee stock options. Specifically, a large number of investment banks and other institutions with sophisticated modeling techniques should be asked to provide bid and ask prices for at-the-money options to purchase stocks of a large number of diverse companies. The test should specify that (1) the options are not transferable (i.e., they can only be exercised, not transferred and once exercised, the option expires), (2) the options cannot be exercised until after a typical vesting period (e.g., three years), and (3) the investment bank or other purchaser may not hedge the option position by, for example, borrowing stock and shorting it against the option. In addition, such a test could be refined to reflect specific features of individual options plans (i.e., ownership holding periods; claw-back provisions; black-out periods) so that plans that incorporated desirable governance features would benefit from a lower charge. While such a test likely cannot deal with issues of employee risk aversion or concentration risk, we believe it still would show a substantial valuation discount from the results obtained by applying the Black-Scholes or other option-pricing models to tradable stock options for the same securities, even after adjusting for expected term.

^{* &}quot;Stock Options for Undiversified Executives" by Brian J. Hall and Kevin J. Murphy as published in the Journal of Accounting and Economics 33 (2002), pp. 3-42; "Non-Traded Asset Valuation with Portfolio Constraints: A Binomial Approach" by Jerome Detemple and Suresh Sundaresan published in CIRANO Scientific Series 995-08 (1999); "On the Accounting Valuation of Employee Stock Options" by Mark Rubinstein as published in the Journal of Derivatives (Fall 1995); and "How to Value Employee Stock Options" by John Hall and Alan White as presented in a August 2002 report to the Ontario Teachers' Pension Plan

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Criteria for Improving Employee Stock Option Valuation Consistency and Comparability

If it is decided that there should be an earnings charge for the "fair value" of employee stock options at grant, then the business community (including established companies, high-growth companies and startups), investors, the accounting profession, and American citizens who depend on a vibrant economy to maintain a high standard of living deserve an option valuation method that meets the following four criteria:

- 1. <u>Reasonable</u> -- that is, produces significantly lower values than option-pricing formulas for traded options,
- 2. Transparent -- simple and understandable to investors,
- 3. Reflects real economic values and costs, and
- Fair across various industry sectors -- dampens the gross effects of differing volatility estimates on valuation outcomes.

"Fair Value" Measurement Alternatives

We believe the FASB has four choices if it decides to undertake a project to require expense recognition for the value of employee stock options at grant:

- 1. Sponsor and support the development of a new option-pricing model that will reasonably estimate the "fair value" of employee stock options taking into account their special characteristics and the acknowledged problems with option-pricing models,
- 2. Allow predetermined adjustments to market option-pricing model results to further reduce the "fair value" estimates to a level more likely representative of "employee value" estimates by capping volatility for individual stocks at industry norms and allowing a 40% haircut on "fair values" for maximum term to recognize the value-reducing effects on employee options of nontransferability, employment restrictions, and issues of risk concentration with inability to hedge,
- 3. Adopt the Interest Cost Method ("ICM"), instead of the "fair value" method, to determine an expense for employee stock options,
 - --- The ICM approaches option expense from the perspective of cost to company of buying back shares to fund option exercises, not from the value to participants or the amount such an option could be sold for in the market
 - Expense would be the risk-adjusted interest costs of borrowing the stock's fair market value at grant, accrued over the option's maximum term or to the point of exercise if sooner
 - -- If the option's exercise price is at a premium or discount to market value at grant, the amount on which ICM interest costs are computed would be adjusted accordingly

- The ICM would involve compensation expense regardless of whether the company actually repurchases shares or not, and whether or not the option is exercised
- If the company actually commits to repurchase shares at the option grant date with borrowed funds, the ICM expense would be the actual interest costs incurred. If it did not, the ICM expense would be a deemed interest expense at its current borrowing rate, as if it had done so,
- 4. Adopt the Employee Value Method ("EVM"), instead of the "fair value" method, to determine an expense for employee stock options at grant
 - The EVM is based on the premise that the real value of an option to an employee is the ability to defer payment of the option's exercise price, risk free
 - Under EVM, the value of the option is the fair market value of the stock at grant, less the sum of the present value of (1) the option exercise price discounted at the risk-free rate from the maximum option term, plus (2) the present value of forgone dividends, if any, during the option period. The EVM value of an at-the-money option with a ten-year term on a non-dividend bearing stock at a 5% risk-free discount rate is 38.6% of the market value of the underlying stock at grant. While not "fair value," EVM meets all four of the criteria identified earlier: reasonableness, transparency, reflects real economic values and fair across various industry sectors. We believe it is a worthy alternative to "fair value" that could garner substantial support if it is decided there should be a mandated expense for employee stock options.

Thank you for inviting and reviewing our comments. Leaders of The Business Roundtable would be pleased to meet with the FASB to present our viewpoints in person and to answer your questions.

Respectfully submitted,

Steve Sango

Stephen W. Sanger Chairman & CEO General Mills, Inc. On behalf of The Business Roundtable