

**Comment Letter to FASB and IASB  
on the  
Employee Stock Options Valuation Issue**

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By E-Mail

Robert Herz  
Chair, FASB  
401 Merritt7  
P.O.Box 5116  
Norwalk, Conn. 06856-5116  
director@fasb.org

Re: Employee Stock Option Valuation Request for Comment Letters Regarding Exposure Draft of FAS 123 Stock Based Compensation and IFRS Shared-Based Payors

Dear Mr. Herz,

While reasonable people can differ whether it is more appropriate to reflect stock based compensation on the income statement or directly on the balance sheet or simply by disclosure, it is very clear from several recent studies on the Black-Scholes model as well as from research that we have just completed that ESOs fair value (using any of the manifestations of the Black-Scholes model currently in use or the binomial model) at grant date can *not* be estimated with sufficient reliability and therefore should not be the basis for reflecting a company's cost of stock based compensation.

The values derived from these option methodologies yields inaccurate and unreliable economic results for several reasons. Besides the issue of applying these models to non-publicly traded stock where deriving volatility is near impossible and at best guess-work, the fact that subsequent events like declaring dividends are not taken into account (witness Microsoft's recent announcement to pay dividends, which would change the value of ESOs for previously granted options), and the fact that transaction costs are ignored in the B-S models specification, etc., the most glaring omission from these models is employee turnover rates. Employees leave the companies voluntarily or involuntarily, for all sorts of reasons. Unfortunately, Reduction in Force (RIFs) have been very common over the last several years and this factor is not reflected in the valuation models that derive compensation expense relative to compensatory stock. We will call this factor the 'jump rate', which is caused by exogenous or endogenous factors that result in the employees sudden and unexpected exiting from the firm.

Our research shows that when the jump rate factor is added to the Black-Scholes model specifications you get very different option valuation results that make the use of this model unreliable. For example, the higher the turnover rate the higher the option valuation that is derived from the B-S model. This is counter-intuitive and just one of the reasons that this model does not reflect reality and should not be used to value stock options. The turnover rate is something that is either company specific or potentially derived from a specific industry's experience rate.

Therefore, we recommend that if the intrinsic method is unacceptable that the implementation of the FAS 123 standard be postponed a year or two until the new model can be tested and proven to be reliable by reflecting the reality of the jump rate as well as other factors that make the B-S model inappropriate for ESOs. We propose modifying the Jennergren & Naslund (1993) model in order to obtain fair and robust values for employee stock options. We plan on extending the analysis by using a trinomial procedure and forward stock option models. The reason the trinomial model needs to be utilized is that the binomial model currently in use is not robust enough since it does not reflect that the stock price may stay relatively flat.

Thank you in advance for reviewing these comments and if you have any questions, do not hesitate to contact us.

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