Karen Salmansohn

From: Director - FASB
Sent: Monday, February 03, 2003 11:39
To: Karen Salmansohn
Subject: FW: File Reference No. 1102-001

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-----Original Message-----
From: Alfred M. King [mailto:alfredking@erols.com]
Sent: Friday, January 31, 2003 6:15 PM
To: Director - FASB
Subject: File Reference No. 1102-001

Ladies and Gentlemen:

The attached submission from the Appraisal Issues Task Force ("AITF") represents the collective views, on a unanimous basis, of some 30 representatives from the major apprasial and valuation firms. AITF was formed to provide input to accounting regulators on the many valuation issues involved in accounting and financial reporting. As the world moves closer to a "FairValue" Accounting model, it is imperative that the best thinking of valuation specialists be available to accounting regulators. For the time being you can consider me as a point of contact with AITF. If you decide to hold hearings, AITF would like to be represented.

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Report of AITF Sub-Committee on Stock Option Valuations

Introduction

The Appraisal Issues Task Force (AITF) at its meeting in Philadelphia on October 3, 2002 appointed a Sub-committee to provide input to the FASB and the SEC on the valuation of stock options for financial reporting purposes. The Sub-committee has solicited input from its members on this topic and this is the report of its findings and recommendations. The AITF believes that FASB should issue any Standards dealing with the determination of Fair Value on a "principles-based" approach, rather than a "rules-based" approach. It is almost impossible to anticipate, and therefore specify in advance, just how to make Fair Value determinations given the wide variety of business situations and conditions in actual practice. The Committee recommends, therefore, that FASB avoid specifying specific valuation methodology. Instead the Board should provide suggestions either for the minimum characteristics that must be considered in a determination of Fair Value or for representative characteristics that can be considered. Professional valuation specialists should be encouraged to utilize their professional expertise. Now that SAS 101 has been issued the profession has provided guidance to auditors in reviewing the work of valuation specialists.

Procedures

The committee has reviewed FASB Statement #123, *Accounting for Stock-Based Compensation* and its related interpretations. The committee has also reviewed FASB's Invitation to Comment #1102-001, which is a comparison of FASB Statement #123 and the IASB Proposed IFRS, *Share-Based Payment*. This report is being furnished by the AITF to the FASB as a response to its Invitation to Comment.

In its Invitation to Comment, the FASB identified 17 issues relating to what it termed "Primary Similarities and Differences" between FASB Statement #123 and the corresponding IASB Standard. In addition, ten issues (identified as A-1 through A-10) were identified as "Secondary Similarities and Differences". Our comments and recommendations are focused on Primary Issues 2 and 9.

The Sub-committee did not consider or treat accounting issues related to the measurement of stock-based compensation expense, such as selection of the valuation date, the treatment of vesting and forfeitures, the timing of compensation cost recognition, and the like.

Recommendations

Issue #2

A. Issue #2 from the FASB Invitation to Comment, relates to the use of a six factor option pricing model. Under this heading, additional Issues (2a-2e) are discussed. In response, we note that the value of stock options can be determined within reasonable limits. FAS 123 (par. 19) requires, in the valuation of public companies, that an option pricing model be used which takes into account six factors; (exercise price of option, expected life of option, current price of stock, expected volatility of stock, expected dividends on stock and the risk-free interest rate). Black-Scholes is the best known example of such a model. However, both the economic terms of incentive stock options and the methods of measuring the value of stock options are evolving. Therefore, accounting pronouncements should not specify a limited number of approaches to valuation, but should permit any standard methodology generally accepted in the financial community. An accounting standard should not mandate the use of any particular option pricing model for measurement purposes (see Issue 2a). Other methods, such as market-based approaches, are available that might be more accurate in certain circumstances. As the Invitation to Comment states, alternative models at times are more accurate than the Black-Scholes Model. The FASB's and IFRS's focus on the Black Scholes and similar models fails to recognize that Employee Stock Options are more like warrants than options entered into by disinterested third parties in that the exercise of a warrant or employee stock option results in a cash infusion or some other benefit to the issuing corporation. Therefore, practitioners should not be confined to using these specific types of option pricing models.

We are particularly concerned with the FASB's view that the appropriate adjustment for the non-transferability of an option is simply reducing the life of the option from its contractual life to its expected life. Currently, directors are considering restricting the transferability not only of an employee's stock options but also of all or part of the stock received through the exercise of the option until a period of time after the employee ceases to work for the corporation.[1] This transfer restriction reduces the option's value to the employee and its cost to the corporation's shareholders. As both the options and the shares obtainable with the options are restricted for transferability, employees are less able either to hedge the option by directly or indirectly shorting the company's stock, or capitalizing on market swings at the expense of other shareholders of the corporation. Employees have little incentive to exercise all their options prior to expiration. Yet, under current GAAP, the reported expense for granting these restricted options is greater than for granting unrestricted options because the average life of the former is longer than the average life of the latter. At a minimum, in addition to the six listed factors, the valuation of employee stock options should consider whether the employee can either directly or indirectly create the hedge portfolio assumed in the standard models, and the related costs.

Disclosure pertaining to the methodology employed and inputs utilized in arriving at option value will improve financial statement users' ability to compare the reporting of financial results of different enterprises and is therefore desirable (see Issue 2c).

B. The problem of valuing stock options on the stock of companies whose stock is not publicly traded is particularly resistant to the application of an option valuation model that has been

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[1] For example, the employment contract for Michael D. Capellas as CEO of WorldCom, Inc. was heavily negotiated and renegotiated. The terms of and conditions of employment were reported to the United States Bankruptcy Court in a document dated December 9, 2002. The relevant language is below:

(c) Stock Options. . . . After providing for sales in amounts necessary to pay income tax on option-related income, 50 percent of the shares acquired by MDC upon exercise of options shall not be sold until the date that is 12 months following the date MDC's employment with the Company ceases unless the board of directors shall set a different requirement.

developed to value options of freely-traded stock. Valuing options of private companies requires analysis and may require adjustments that take into account market liquidity issues attaching both to the underlying stock and to the option itself, including the ability to directly or indirectly create a hedge portfolio. Practitioners should be permitted to consider these liquidity issues. (see Issue 2d).

Issue #9

Issue #9 relates to the measurement of the expected volatility factor in connection with option pricing models and non-public entities. Generally, the use of volatility factors of zero in the Black-Scholes Model will result in under-valuation relative to fair value. By imputing an estimated volatility factor, the IASB approach does not have this problem. However, over-valuation is likely, to the extent that the IASB approach does not account for the real problems and the costs the holders of small company and non-public entity options have in constructing a hedge position. In addressing the issue, it is necessary to consider the probability of a price decline and the cost of constructing a hedge.

While the current FASB and IASB approaches may be appropriate in some situations, one standard may produce more reliable results in some circumstances. Either approach can also lead to inaccurate valuations, as can be the case in the application of option pricing models generally. The best estimate of volatility requires therefore a reasoned application of appropriate valuation principles and does not lend itself to a one size fits all kind of methodology.

January 31, 2002