ADDENDUM TO COMMENT LETTER FROM KIP HAGOPIAN, DATED MARCH 29, 2004 ON THE FASB EXPOSURE DRAFT REGARDING SHARE-BASED PAYMENT

Who Bears the Economic Cost of an Employee Stock Option?

Employee stock options ("ESOs") do have economic value to the employees that receive them. It is understandable, therefore, to expect there to be an economic cost somewhere on the other side of the transaction, since almost all transactions have approximate if not perfect accounting symmetry.

ESOs have an economic value to the recipient based on their *potential* for gain in intrinsic value. Likewise, ESOs have a corresponding economic cost to the *shareholders* of the issuing entity based on their *potential* for dilution to shareholder ownership. But are ESOs also a cost to the entity that grants them? This is the central issue in the debate over employee stock option expensing.

The Economic Cost to Shareholders

Before considering whether ESOs are a cost to the granting entity, it is important to be clear on what an ESO's real economic cost is to the shareholders. This requires an agreement on how the treasury stock method ("TSM") of accounting really works and how it affects the shareholders' accounts.

The Treasury Stock Method is Mark-to-Market Exercise-Date Accounting.

The TSM is effectively a *mark-to-market version of exercise-date accounting done at the shareholder level rather than the company level. As such, it results in the full option spread at time of exercise being charged to shareholders in the form of a transfer of value from shareholders to employees.* This point is illustrated in Exhibit A, which is a table representing, hypothetically, the amount of value transferred from the shareholders of "Acme Electronics" to Acme's employees. (See pages four, five, ten

and eleven of the author's original submittal to the FASB. For convenience, this entire submittal is attached as Exhibit B.) What this table shows is that at each period end the full economic cost to shareholders can be measured quite accurately by calculating the dilution percentage (which is determined by the TSM), then translating this dilution into dollars of value transferred to employees. The value transfer is shown for the current period and cumulatively. Since the dilution, and hence the value transfer, is driven by the stock price, this cost to the shareholders will fluctuate up or down as the stock price fluctuates. The greater the spread, the greater will be the value transferred from the shareholders to the employees.

A key figure in the table is the $9 million that appears in the box on line nine in the last column (2004). This is the cumulative value transferred from shareholders to employees resulting from dilution. Note that the gain to the employees ($15 million pre-tax and $9 million after tax, assuming the employees had a combined tax rate of 40%), mirrors exactly the cost to the shareholders ($9 million in value transfer assuming the same 40% tax rate), providing perfect accounting symmetry. Thus, the TSM results in exercise-date accounting for the shareholder account.

The $9 million in shareholder cost is exactly the same amount that the granting entity would incur as a cost if it used exercise-date accounting to record option expense on its income statement. (Proof: Assume all one million Acme ESOs were exercised in 2004 at the $10 strike price when the market price was $25. The spread would then be $15. This would produce a $15 million gain to the employee and a $15 million deduction for the company, making the after-tax cost to the company, $9 million, again assuming a 40% combined state and federal tax rate.)

Should an Additional Charge be Made to the Granting Entity?

The option expensing debate centers on whether, on top of the cost to the shareholders, there should be an *additional* charge made to the entity owned by those

same shareholders. The FASB proposes to do just that by expensing the purely hypothetical and *not realizable* call premium of the option.

Opportunity Cost.

Since the granting of an ESO does not involve the incurrence of a liability, or *an outlay of cash or any other asset that is convertible into cash*, or the using up of an asset, it is hard to see how there has been a decrement to the assets of the entity. The only possible justification for an expense is that the entity has incurred an opportunity cost. The FASB makes a passing reference to this notion in paragraph C17 of the Exposure Draft ("ED") in explaining why minimum value is not an adequate measure of fair value: "....minimum value does not result in a measure of the amount of cash an entity forgoes by granting share options to employees rather than issuing similar options to third parties, that is, the fair value of the options."

With due respect to the FASB, this statement does not take into account the unique features of an ESO. First, an ESO, by its terms, may only be issued to employees (or company directors and consultants); thus, issuing "similar options to third parties" would be contrary to its purpose and, in any event, is prohibited. And if a company were to offer on the open market, options with the same terms as ESOs, it is hard to imagine there would be any "willing buyers" for such options. This is because an ESO is non-transferable (therefore, only the intrinsic value of the option, if any, can be realized) and is cancelable at the will of the company (in the case of an ESO by terminating the employee before or after vesting). Would anyone buy an option that is certain to be cancelled before the vesting date if it has gone into the money? Likewise, would anyone buy an option that, if vested and *not* in the money, is certain to be cancelled the moment it goes into the money? Selling ESOs to the employees for cash is not an alternative either. An ESOs' sole purpose is to provide an incentive to employees to increase shareholder value; ergo, any price charged to employees would erode and ultimately nullify the incentive, thereby negating the value of the ESO to the entity. The combination of these two very important features—non-transferability and cancellation

at will—eliminates opportunity cost as a consideration. If there is no decrement to the assets of the entity and no opportunity cost, there can be no expense.

Loss of Transactional Symmetry.

Tacking on a charge to the entity's income statement that is over and above the economic cost that is incurred by the shareholders of that entity creates a conundrum. If there is to be a charge to the entity, what is the other side of the transaction? What is the corresponding value received and who receives it? Are we to believe that the employee, in addition to receiving the full spread upon exercise of the ESO, also has received at grant date something of value in addition to that spread?

Over Counting

Inasmuch as dilution results in a charge to the shareholders' account that is equal to full exercise-date accounting (which is the most punitive method of accounting for stock options), it hard to comprehend how an additional expense to the entity laid on top of this charge could be justified.

Stated simply, a call premium on a stock option is the discounted present value of the expected future intrinsic value, or spread, in the option during its expected term. Whether the gain results from volatility, or from the performance of the company during its term, really makes no difference. In a short-term option (three to nine months), such as the type Black-Scholes and the binomial models were designed to value, volatility plays the largest part; in a long-term option (one to ten years), projected company performance dominates.

This is where over counting comes into play. The call premium the FASB proposes to expense is the discounted present value of the *very same spread* that has already been effectively charged to the shareholder account in the form of a value transfer. Thus, we have two charges for exactly the same thing, one to the entity and one to the people that own the entity. It seems clear that one of these charges has to be eliminated.

Since the value transfer is a given as long as there are outstanding ESOs that are in the money, it seems clear that the charge to the entity is inappropriate.

ESOs are Conceptually Equivalent to Bonuses

Conceptually, an ESO most resembles a bonus and should be accounted for in a similar manner. When an employee is made eligible for a bonus, the employee rightly perceives he or she has received something of real economic value, namely the possibility of significant cash gain if the conditions of the bonus are met. Likewise, the entity has entered into an arrangement that may result in an economic cost. The accepted method of accounting for this type of arrangement is to accrue the bonus if, as and when it appears that it has a reasonable probability of being earned. If the bonus ends up being more or less than what was accrued, the amount of expense, if any, is trued up.

If bonuses were accounted for in the same way as is proposed for ESOs, a discounted present value estimate of the bonus for each employee would be made and that amount would be expensed ratably over the bonus period. This expense would be charged whether in fact it was ever incurred (as is proposed for ESOs). Presumably, this accounting treatment is not used because of its likelihood of resulting in over or under charges. Rather, a sort of "pay as you go" method is used instead. This has the benefit of being relatively accurate during the period the expense is occurring and precisely accurate when the period ends and the expense gets trued up.

Why shouldn't ESOs be accounted for similarly? That is, why isn't the current method of accounting sufficient? As indicated above, the TSM is a calculation of the economic cost of an ESO as it is incurred. But it is even more accurate than bonus accounting because the cost measured by the TSM is not an accrual followed by a truing up for misestimates. Instead, it is a precisely accurate measurement throughout the period the ESO is outstanding, which reflects the full economic cost of the transaction at each reporting date.

Conclusion

If the ED is implemented it will be the most radical change in accounting practice in several decades, dramatically affecting the earnings of a countless number of high-growth companies. This change should only be made if the rationale for doing so is so compelling that it is beyond any reasonable doubt. But this is not the case. There is considerable doubt as to the accounting merits of the FASB's proposal.

Exhibit C contains a list of just a few esteemed individuals that strongly oppose the expensing of ESOs as proposed in the ED. In each case, these individuals are opposed to expensing on the grounds that expensing is inappropriate accounting that would impair the usefulness of financial statements. In addition to being very qualified to opine on the subject, these people have arrived at their views through careful thought and analysis. Six of them have written or testified on the issue. None of them could be considered to be acting out of self-interest. The list includes two former Secretaries of the Treasury, and two former or existing chairs of the accounting departments at major universities. Eight of the people on the list are highly respected economists, including one former Chair of the Council of Economic Advisors. Several are business professors. Two are Deans of major business schools. Almost all are PhDs.

Exhibit D contains excerpts from the comment letters from the six largest accounting firms in the U.S., commenting on the FASB Exposure Draft for FAS 123 in 1993. All of these firms, speaking for thousands of certified public accountants, vigorously opposed expensing of ESOs then. Moreover, their reasons for doing so were forceful, comprehensive and trenchant. Since then nothing has changed in accounting concepts or theories that should call their earlier arguments into question. Nonetheless, currently the four largest firms favor expensing. Were they right then or are they right now. Whichever it is, the arguments these firms expressed ten years ago should be heard because individually and collectively they cast serious doubt on the merits of the FASB's proposal.

The full economic value of ESOs to employees and the full economic cost of ESOs to shareholders is reflected in the form of a value transfer from shareholders to employees. Given this fact, the FASB should explain why there should be an additional charge levied on the entity for essentially the same cost that is reflected in the shareholder account. The FASB should also explain what the other side of this added transaction is: to wit, what is the corresponding benefit in such a transaction and who is the recipient of that benefit.

Kip Hagopian

June 30, 2004

Acme Electronics, Inc.
Impact of Stockholder Equity Dilution
Arising from Employee Stock Options

Shares outstanding = 10,000,000; ESOs outstanding = 1,000,000 shares; exercise price = $10 per share

	Year	1999	2000	2001	2002	2003	2004
(1.)	Average Stock Price in the period	$10.00	$11.98	$14.38	$17.27	$20.80	$25.00
(2.)	Fully Diluted Shares Outstanding (000's)	10,000	10,100	10,183	10,253	10,310	10,360
(3.)	**Market Value at year end (000's) ((1)x (2))**	**$100,000**	**$121,000**	**$146,400**	**$177,100**	**$214,400**	**$259,000**
(4.)	Basic Earnings per share	$0.40	$0.48	$0.58	$0.69	$0.84	$1.00
(5.)	**Shareholder Dilution**	**-0-**	**.99%**	**1.8%**	**2.47%**	**3.0%**	**3.47%**
(6.)	Diluted Earnings per share	$0.40	$0.476	$0.57	$0.673	$0.815	$0.965
(7.)	Increase in market value during period (000's)	-0-	$21,000	$25,400	$30,700	$37,300	$44,600
(8.)	**Value Transferred from Shareholders to Employees during period (000's)**	**-0-**	**$1,200**	**$1,435**	**$1,740**	**$2,055**	**$2,570**
(9.)	Net Increase in Shareholder Market Value in period (000's) ((8) – (9))	-0-	$19,800	$23,965	$28,960	$35,245	$42,030
(10.)	**Cumulative Value transferred to employees (000's)**	**-0-**	**$1,200**	**$2,635**	**$4,375**	**$6,430**	**$9,000**
(11.)	Cumulative Gain to Preexisting Shareholders	-0-	$19,800	$43,765	$72,725	$107,970	$150,000
(12.)	Preexisting Shareholder Market Value (000's) ((7) – (11))	$100,000	$119,800	$143,765	$172,725	$207,970	$250,000

B. KIPLING HAGOPIAN

B. Kipling ("Kip") Hagopian co-founded Brentwood Associates, a high-technology venture capital and private equities firm in 1972, and for several years headed its high technology investment group. Brentwood and its successor firms, Brentwood Associates Private Equity, Redpoint Ventures and Versant Ventures, are some of the largest private equity firms in their respective fields. Since 1990, Mr. Hagopian has gradually reduced his commitment to venture capital in order to pursue other interests. Presently, he is affiliated with Brentwood Venture Capital in the capacity of Special Limited Partner of several Brentwood funds, and with Redpoint Ventures I as a Special Advisory Partner.

Mr. Hagopian is currently a Managing Partner of Apple Oaks Partners, LLC a private investment company he co-founded to manage his family's assets as well as the family assets of his co-founder.

During his venture capital career, Mr. Hagopian served in several industry leadership positions. For several years, he was a member of the Board of Directors of the National Venture Capital Association ("NVCA"), ultimately serving as President and Board Chairman. Mr. Hagopian also served several years on the Board of the Western Association of Venture Capitalists ("WAVC").

Mr. Hagopian has been involved in a variety of civic activities. In 1980, he was a member of presidential-candidate Ronald Reagan's "Business Advisory Panel" serving as Chairman of the Panel's Committee on "Capital Formation, Innovation and Productivity." In this capacity, he wrote the Committee's final position paper and recommendations which were submitted to President Reagan upon his election. In 1983 and 1984, Mr. Hagopian served on President Reagan's Commission on Industrial Competitiveness, which was comprised of 30 persons from business, labor, government and academia.

Mr. Hagopian currently serves on the Board of Directors of Maxim Integrated Products, a large publicly held semiconductor company, and is on the Board of Advisors of Thomas Weisel Partners, an investment banking firm. Mr. Hagopian's not-for-profit affiliations include memberships on the Board of Governors of the Pardee RAND Graduate School of Public Policy and the Board of Visitors and Executive Committee of the John Anderson Graduate School of Management at the University of California, Los Angeles. Past affiliations include several corporate board memberships as well as participation on the Executive Committee for Los Angeles Mayor Richard Riordan (1993-2001).

Mr. Hagopian has been a witness at several Congressional and executive branch hearings on tax policy, venture capital and securities law, and is an occasional lecturer at the UCLA business and law schools.

Mr. Hagopian holds a Bachelor of Arts degree in Industrial Design and a Master of Business Administration, both from the University of California, Los Angeles.

Stock Option Expensing Opponents

The following individuals oppose the FASB's Employee Stock Option Expensing Proposal on the grounds that it would improperly account for options, resulting in the impairment of the usefulness of financial statements.

Prof. Joseph Blasi, Ph.D.
Rutgers Professor of Human Resource Management, co-author of a comprehensive study on the impact of broad-based option plans on company productivity

Prof. Emeritus John Buckley, Ph.D.
Professor Emeritus at the Anderson School of Management at UCLA, and formerly Chairman of the Department of Accounting and Director of Research in Accounting and Information Systems at Anderson. Currently founder and partner of Buckley & Associates, specializing in theoretical and applied accounting and economic analyses.

Prof. Tom Campbell, Ph.D., J.D.
Dean of the Haas School of Business, University of California at Berkeley, former professor of law at Stanford University, and former Congressman representing the Silicon Valley area of California in Congress. Prof. Campbell holds his bachelor's, master's and Ph.D. degrees in economics at the University of Chicago, and his law degree from Harvard.

Prof. Bud Fennema, Ph.D.
Chairman, Department of Accounting, Florida State University

James K. Glassman
Resident fellow at the American Enterprise Institute where he specializes in issues involving economics and financial markets.

Kevin A. Hassett, Ph.D.
Director of Economic Policy Studies at the American Enterprise Institute

Prof. R. Glenn Hubbard, Ph.D.
Dean, Columbia University's Graduate School of Business, Business School. Russell L. Carson Professor of Finance and Economics, and Former Chairman Council of Economic Advisors under President George W. Bush.

Prof. Edward Leamer, Ph.D.
Professor of Global Economics and Management and Director of the UCLA Anderson Economic Forecast.

Lawrence B. Lindsey, Ph.D.
Dr. Lindsey is President and Chief Executive Officer of The Lindsey Group; from Jan. 2001 to Jan. 2002 he was Assistant to the President and Director of the National Economic Council at the White House; served as a Governor of the Federal Reserve System from 1991 to 1997; Special Assistant to the President for Domestic Economic Policy during the first Bush Administration, and as Senior Staff Economist for Tax Policy at the Council of Economic Advisers during President Reagan's first term.

Francis J. O'Brien
Former Senior Partner and West Region Director of Accounting and Auditing of Ernst & Young.

Paul H. O'Neill
Former Secretary of the Treasury, former Chief Executive Officer of Alcoa Inc.

Alan Reynolds
Economist and senior fellow at the Cato Institute.

Prof. Emeritus George Shultz, Ph.D.
Jack Steele Parker Professor of International Economics at the Graduate School of Business, Stanford University; Former Secretary of Treasury and former Secretary of State.

Peter J. Wallison
Resident Fellow at the American Enterprise Institute for Public Policy Research and co-director of AEI's program on Financial Market Deregulation.

Prof. Charles Wolf, Jr., Ph.D.
Senior Economic Advisor and Corporate Fellow in International Economics at RAND Corp., Professor of Public Policy in the Pardee RAND Graduate School, Founding Dean of the RAND Graduate School of Public Policy (1970 to 1997), and Senior Research Fellow at the Hoover Institution.

Prof. Ed Zschau, Ph.D.
Currently a Visiting Lecturer at Princeton University and formerly Assistant Professor of Business at the Stanford Graduate School of Business and Professor of Management at the Harvard Business School. Professor Zschau was also a U.S. Congressman.

Why Expensing Employee Stock Options
Would Be Improper Accounting

In 1993 all of the six major accounting firms were vigorously opposed to expensing employee stock options ("ESOs"). They made their respective positions quite clear in letters of comment to the FASB on its Exposure Draft of FAS 123 ("Accounting for Stock Based Compensation"). Each firm based its opposition on two issues: first, they argued quite persuasively that expensing ESOs was simply bad accounting; and second, they argued that the Fair Value of ESOs could not be measured reliably and accurately.

The following are excerpts from the comment letters of the five major firms that are still extant either independently or as part of a merger. (Arthur Andersen's comments are not included.) These comments are organized into two categories: accounting merits and value measurement. All of the very same accounting firms that opposed expensing in 1993, are now on the record as supporting the FASB's expensing proposal. (This includes Price Waterhouse and Coopers & Lybrand, which have merged to become Price Waterhouse Coopers.) This raises the obvious question: What has changed? Clearly, there has been no change in the basic concepts or theory of accounting in this 10-year period.

Were they wrong then or are they wrong now? Which of their arguments in opposition to expensing do they no longer believe are valid and why? Surely their radical change in position cannot be based on a shift in the political winds. This would suggest that these firms have abdicated their fiduciary responsibility to produce accurate financial statements. These are questions each of these firms should be asked by both the FASB and by the SEC, which has the ultimate authority and responsibility to establish accounting rules for public companies.

ON THE ISSUE OF THE ACCOUNTING MERITS

"...the proposed changes in current accounting rules for stock options should not be adopted because they will not result in sufficiently reliable information; would not be a meaningful improvement over present practices; and, as you might expect, can severely impact the earnings and net worth of certain (especially high growth) companies."

Eugene M. Freedman
Chairman
Coopers & Lybrand
December 14, 1993

"In our November 5, 1993 letter, we once again expressed our concerns about the direction of this project and strongly recommended that the Board adopt a disclosure-based approach that retains current accounting standards. Everything we have learned since has only strengthened our conviction that the Board should not go forward with the current proposal."

J. Michael Cook
Chairman and
Chief Executive Officer
Deloitte & Touche
January 12, 1994

"...we have studied the Exposure Draft, analyzed the proposed accounting, and weighed its perceived benefits against the costs of compliance. Based on these procedures, we strongly oppose the proposal and believe that it would not enhance the overall usefulness or reliability of financial statements."

Ernst & Young
December 6, 1993

"Many in the business community have expressed a concern about the potential adverse economic effects on the competitiveness of U.S. business that could result from adoption of the ED. While that concern should not be a principal factor driving the accounting standard, it is entirely legitimate to expect that those who would change present practice, possible adverse economic consequences notwithstanding, would do so only with great conviction that the new standard is the right one. If there is any doubt, the Board should not proceed."

Price Waterhouse
December 17, 1993

"There is no disagreement that stock options provide the employee with a benefit that is valuable. However, there is considerable disagreement as to whether any cost that might be associated with that benefit should be recorded in financial statements and, if so, whether there is any reliable means of measurement. APB Opinion No. 25 concluded that for fixed stock options, such cost is simply the options' intrinsic value at the grant date. We are not persuaded that a better and more reliable measure of the employer's cost is available at this time."

Coopers & Lybrand
December 29, 1993

"We do not believe accounting for stock-based compensation arrangements represents a major financial statement reporting concern. We do acknowledge that disclosure of such arrangements is an important component of a company's corporate governance and stewardship responsibilities. We believe that the executive compensation disclosures currently required by the SEC in proxy statements fundamentally satisfy those responsibilities."

KPMG Peat Marwick
December 28, 1993

"We believe it is in the best interests of the public, the financial community, and the FASB itself for the Board to address those issues that would have a significant impact on improving the relevance and usefulness of financial reporting. Accounting for stock-based compensation does not meet the test."

Arthur Andersen
December 23, 1993

"*The Present Accounting Model Should Not be Changed*

We remain unconvinced that the proposal is an improvement over present practice."

Ernst & Young
December 6, 1993

"We have given careful consideration to the many issues bearing on this project and have reached a conclusion that the road traveled by the Board has not borne fruit and is not likely to do so in the near term. We, therefore, urge the Board to withdraw the Exposure Draft."

Price Waterhouse
December 17, 1993

"The interests of all parties would be well served if the FASB does not

change its current standards regarding employee stock options. The FASB should shift its focus to issues where the need for improved standards is greater and the opportunities for developing those standards are more clear-cut."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"For reasons outlined above, we strongly urge the Board not to proceed with the proposal, and instead withdraw it in favor of a new project to develop improved disclosures of stock-based compensation plans."

Ernst & Young
December 6, 1993

"The intrinsic measurement method that is used in APB Opinion No. 25 (APB No. 25) should be retained."

KPMG Peat Marwick
December 28, 1993

"We trust it is clear that we oppose fundamental change in this area at this time, for the reasons previously stated."

Price Waterhouse
December 17, 1993

"The issue of executive compensation has become something of a political football in recent months, and I am troubled that the FASB may be letting political rather than accounting considerations set its agenda. The little concern about employee stock options that has been expressed by users of financial statements has largely been assuaged by recent SEC actions. The SEC's new proxy rules require very full disclosure of executive compensation, enabling interested parties to make their own determinations regarding the costs and values of any stock options that have been granted. Options are "common share equivalents", when they become likely to be exercised (because of the rise in stock price) and thus reduce earnings per share. In this way, they become reflected in a business' cost of capital. The FASB proposal would reflect, in effect, a double dip or double cost of capital."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"Any compensation for stock-based compensation arrangements, as for other noncash compensation such as health care benefits, company

cafeterias, and company athletic facilities, should be measured based on the *cost to the employer,* not the value received by the employee."

Arthur Andersen
December 23, 1993

"Thus, notwithstanding the Board's considerable efforts to develop a workable approach, we are convinced that in comparing the costs of compliance with the results attained, the proposed accounting provides a less satisfactory answer than current practice. Accordingly, we urge the Board not to proceed with a final standard."

Ernst & Young
December 6, 1993

"In summary, we believe the ED is predicated on a valuation methodology that is not sufficiently developed and on a largely imagined user demand for fundamental change. In light of this, and considering economic consequences, we believe the ED does not provide a platform from which the Board should proceed to a final standard.

Price Waterhouse
December 17, 1993

"Awards that call for settlement by issuing equity instruments are equity instruments and measurement of such awards should be made at grant date to the extent possible. Thus, the approach used in APB No. 25 for "fixed" plans should be continued."

KPMG Peat Marwick
December 28, 1993

"It has been a general tenet of accounting that standards should be altered only when there is clear evidence that a proposed change would improve financial reporting. There is no convincing proof that any financial statement user would benefit from the changes being discussed regarding accounting for stock options. Current standards would be supplanted by new ones which introduce hypothetical, arbitrary and capricious measurement systems, providing little benefit to users of financial statements, providing little benefit to users of financial statements and exerting an adverse impact on the U.S. economy, particularly a vital segment."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"After carefully reviewing the Exposure Draft, we do not support the issuance of a final statement based on its approach."

KPMG Peat Marwick
December 28, 1993

"We continue to believe that in view of our concerns with the Board's proposal, present practice supplemented with additional disclosures is a superior approach. The potential effect of options is already reflected in the earnings per share calculation."

Ernst & Young
December 6, 1993

"....we urge the Board to retain current accounting for ESOs and not to proceed with a standard requiring hypothetical and arbitrary recognition in financial statements."

Coopers & Lybrand
December 29, 1993

ON THE ISSUE OF MEASURING OF FAIR VALUE

"Consequently, any requirement to use an option-pricing model must comprehend an awareness that the model produces a theoretical estimate, which is no more than a surrogate for an indeterminable fair value. And, given that fair value cannot be determined, the level of measurement precision required by the Exposure Draft is unwarranted. It not only increases the complexity and cost of complying with the proposal, but also increases the potential for noncomparability among enterprises.

There are six variables used in the Black-Scholes and binomial option-pricing models. Three of these variables (current price of the underlying stock, exercise price, and risk-free interest rate) can be determined somewhat objectively. Three of the variables (expected volatility, expected dividend yield, and expected term of the option), however, require a subjective assessment of the future. Illustration 1 of the Exposure Draft presents an example of an option with a Black-Scholes price of $18.02. Adjusting all three of the subjective variables by 50% up and down together produces Black-Scholes prices ranging from a low of $7.73 to a high of $29.05. This analysis demonstrates that by changing these variables, the price of an option can be increased or decreased dramatically."

Deloitte & Touche
November 5, 1993

"Our study found that the key assumptions used in valuing stock options --stock price volatility and expected option term -- are subject to considerable judgment and significantly affect option values. Because of the sensitivity of option values to changes in underlying assumptions, there is a wide variation in values among companies which will adversely affect the comparability and usefulness of financial reporting."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"The Board's proposal will not result in meaningful improvements in financial reporting, and the benefits of changes to the present accounting standards will not outweigh the very significant costs."

J. Michael Cook
Chairman and
Chief Executive Officer
Deloitte & Touche
January 12, 1994

"The key findings of our study that support this view are as follows:

- Key valuation assumptions are subject to considerable judgment and significantly affect option values. For example, a five-percentage-point change in volatility (which can often be justified solely by alternative ways of looking at historical volatility) produced, on average, a 15 percent change in option value. A change in expected term from three years to five years (again easily justifiable) produced, on average, nearly a 40 percent increase in option value. The key assumptions are subject to so much judgment and guesswork that selections among a wide range could be justified as the best estimates. The end result would adversely affect the comparability of financial statements of companies in the same industry and at the same state of development."

Coopers & Lybrand
December 29, 1993

"The output of an option-pricing model is only a mathematically-derived "theoretical" value, which may or may not be indicative of fair value. Since a market for employee stock options generally does not exist, there is no objective way to assess whether the theoretical value approximates the

price at which the option could be sold in an active market."

Deloitte & Touche
November 5, 1993

"We continue to believe that existing option pricing models do not produce a reasonable or relevant value of employee stock options."

Ernest & Young
December 5, 1993

"Our conclusion is that the methodology in the ED for calculating the fair value of employee stock options significantly overstates their fair value, but by how much is pure conjecture. Furthermore, there is no future event that ultimately will verify the accuracy or inaccuracy of the estimate of grant date fair value."

Price Waterhouse
December 17, 1993

"We believe that using option-pricing models for ESOs does not result in sufficiently reliable information because of the wide variation in values among companies and the sensitivity of such values to changes in the underlying assumptions. Accordingly, the proposed changes in accounting would have an adverse impact on the comparability and usefulness of financial statements."

Coopers & Lybrand
December 29, 1993

"As acknowledged in the Exposure Draft, the Black-Scholes and binomial option-pricing models were not designed to deal with long-term, forfeitable and nontransferable employee stock options."

KPMG Peat Marwick
December 28, 1993

"The following discussion supports our continuing recommendation for a fundamental change in the direction of the stock compensation project."

KPMG Peat Marwick
December 28, 1993

"....we urge the Board to retain current accounting for ESOs and not to proceed with a standard requiring hypothetical and arbitrary recognition in financial statements."

Coopers & Lybrand
December 29, 1993

"Finally, we are concerned with the auditability of the "expected volatility" and "expected dividend yield" during the expected term of the option. Although these assumptions are necessary to calculate a theoretical fair value amount using option-pricing models, it is difficult for companies to provide sufficiently reliable audit evidence to support these assumptions after considering the benefit of hind-sight."

KPMG Peat Marwick
December 28, 1993

"If the FASB remains determined to address accounting for employee stock options, I am also distressed by the imposition of valuation techniques commonly associated with tradable options as the primary mechanism for determining the cost of restricted stock options granted to employees. This approach would require businesses to make difficult and arbitrary determinations in order to put a price tag on their options programs and provide hypothetical information which will confuse readers.

To be sure, there are a number of option valuation models available, but they are designed for publicly traded options. Employee stock options are typically long term, non-transferrable, and subject to a number of conditions, including continued employment. There is no market mechanism to establish a value for these options. Thus, it is very difficult to identify a procedure for valuing them that would provide a meaningful improvement over present practices."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"We are not comfortable with an approach that uses a "black box" to generate an accounting value when we are not able to articulate what is happening in the "black box" or explain why it is appropriate to accept different answers for valuing options....."

KPMG Peat Marwick
December 28, 1993

"At this time, we are aware of no reliable way to measure the effect of differences between ESOs and publicly traded options or to modify present models to account for these differences."

Coopers & Lybrand
December 29, 1993