

Letter of Comment No: 6
File Reference: 1102-001
Date Received: 7-1-03

February 1, 2003

Financial Accounting Standards Board MP&T Director - File Reference 1101-001 401 Merritt 7 P.O. Box 5116 Norwalk. Connecticut 06856-5116

Re: Invitation to Comment on Accounting for Stock-Options

Dear Sir or Madam:

On behalf of the members of the Technology Network ("TechNet"), thank you for the opportunity to submit our comments on the Invitation to Comment, Accounting for Stock-Based Compensation: A Comparison of FASB Statement 123 and IASB Proposed IFRS, Share-based Payment, dated November 18, 2002 (the "Invitation"). We appreciate the opportunity to offer our views on this important matter.

TechNet is a national network of more than 200 chief executive officers and senior partners of the nation's leading companies in the fields of information technology, biotechnology, venture capital, investment banking and law. We are proud of the role that our industries have played in the growth of the U.S. economy, due in large part to the use of broadbased stock option and other equity-based incentive plans to attract and retain talented employees. By giving employees at all levels a chance to share in their company's financial

success through equity ownership, broad-based stock option plans boost productivity and are essential to America's competitiveness and economic growth.

For reasons outlined below, TechNet has serious concerns with the mandatory expensing approach outlined in International Accounting Standards Board's proposed International Financial Reporting Standard ("IFRS"). We believe that the longstanding approach embodied in FASB Statement No. 123 is the preferable method of accounting for stock options. Statement No. 123 provides relevant information to investors, reflects the fact that employee stock options do not constitute an expense, and supports the public policy goal of fostering broad-based stock option plans. In contrast, we believe that the proposed IFRS would result in financial statements that provide less clarity and consistency to investors. Further, the proposed IFRS would encourage companies to concentrate share ownership in the hands of senior executives by making it prohibitive to offer broad-based plans.

Employee stock options do not represent an expense.

The questions and issues posed in the Invitation stem from an assumption that stock options constitute a corporate expense, as noted in the Invitation. We fundamentally disagree with this premise. Although the Board has not invited comment on this matter, we consider it of paramount importance in deliberations regarding an accurate and consistent approach to the accounting for stock options.

While there is virtually uniform agreement that an employee stock option represents something of value to an employee, there is absolutely no agreement among accounting experts that the issuance of employee stock options represents a corporate expense. Several experts, including two of the major accounting firms, expressed this view to the IASB in response to their reissuance of the G4+1 stock options Discussion Paper in July 2000. The fact that an option may have value to an employee is not relevant to the debate regarding whether options represent an expense to the corporation and should have no impact on the accounting treatment for options.

The issuance of stock options does not result in a corporate level cost that impacts net income. A promise to issue options or shares in return for a promise to provide services in the future does not meet the definition of a liability. When an option is issued, there is no outflow or consumption of corporate assets and no decline in the value of corporate assets, nor is there the creation of a liability representing actual or expected cash outflows. In fact, to the extent options are ultimately exercised, corporate assets are increased by the amount of cash that the employee must pay to exercise the option.

Recent studies of employee stock options and compensation at a comprehensive sampling of companies provides further evidence that stock options are not compensation in that they are generally not viewed by the employee or employer as compensation for labor performed and are not granted in lieu of salary compensation. In their recent book, *In the Company of Owners:*The Truth About Stock Options And Why Every Employee Should Have Them, Rutgers

University Professors Joseph Blasi and Douglas Kruse found that, in the companies examined,

February 1, 2003

average employees who held options were paid competitive wages and benefits irrespective of

any options held. Options instead represent "capital income" that workers receive for sharing the

risk of ownership in the corporation.

It might be arguable from an economic standpoint that the corporation incurs an opportunity

cost in issuing stock options, but generally accepted accounting principles have not required the

recognition of opportunity costs. Further, reliable calculation of the opportunity cost associated

with the issuance of stock options would clearly be impossible.

If employee stock options are considered an expense on the basis of opportunity costs, then

companies should be able to account for the economic benefits that result from employee

ownership. Amending GAAP to incorporate such costs or benefits into the financial statement

would clearly lead to distortions, inaccuracies and investor confusion.

II. The proposed IFRS to require stock options to be treated as an expense will not give

investors accurate and reliable information.

We believe that requiring employee stock options to be treated as an expense would lead to

misleading financial statements because no accurate, reliable and tested method of valuing stock

options currently exists.

There are fundamental problems with applying current option pricing models, including the

Black-Scholes valuation method, to employee stock options. Because existing models were

designed to value short-term, freely tradable stock options, which have little in common with employee options, many of the unique aspects of stock options are not accounted for in these models. As a result, companies that are required to expense or that choose to do so under Statement No. 123 must factor a range of subjective assumptions into complex valuation formulas. Predictions of a range of variables, from interest rates to stock volatility to employee behavior, will dictate the outcome of these calculations, resulting in widely divergent results depending on the subjective assumptions a company makes.

First, existing models were designed to value freely transferable options, yet there are significant restrictions on the transferability of employee stock options. Employee stock options cannot be bought, sold or pledged. Current option pricing models do not factor in a lack-of-marketability discount to address such restrictions.

In addition, models such as Black-Scholes were designed for options that are exercisable only upon expiration. Employee stock options, in contrast, typically have long vesting requirements of up to 10 years and are then exercisable for a period of time, but are worthless if the employee terminates employment prior to vesting. Option pricing models do not accurately account for these factors.

Perhaps the most significant prediction that must be incorporated into option pricing models is the volatility of the underlying stock expected over the life of the option. Commonly used historical estimates of volatility can vary over a significant range depending on the length of the

historical period and the sampling frequency selected during the period. Volatility potentially

affects valuation the most and corporate estimates of future stock volatility truly represent efforts

to predict the future.

Current models favor companies in non-volatile industries and penalize those in highly

volatile industries. Assuming stock price and other terms are the same, if the stock price is

declining in the volatile market and staying constant in the non-volatile market, the option value

will be significantly higher for the company in the volatile market.

As a result of these shortcomings, current option pricing models, including the Black-Scholes

model, allow a corporation to come up with huge differences in the expense number depending

on the inputs that are used. By failing to account for the restrictions and other characteristics of

employee stock options, current option pricing models produce unreliable and misleading results,

particularly with respect to companies in volatile industries.

We note that the proposed IFRS attempts to address the issues that arise when existing

valuation models are applied to employee stock options through proposed adjustments to the

models. Minor refinements to the existing models, however, will not address the fundamental

issues associated with these valuation models.

The established approach required by Statement No. 123 allows companies to provide data

about stock options without inaccurate income statement expense calculations that would be

required by proposed IFRS. Statement No. 123 enables investors to review and compare financial statements without a hypothetical compensation charge. To the extent investors find it useful to consider this hypothetical compensation charge, the information is readily available to allow them to do so. Disclosures already required by the Board include the weighted average exercise price, the number of options granted and available under the stock option plan, and fully diluted earnings per share. Improvements can be made to enhance the timeliness and accessibility of this data, as discussed below. However, this information is available to those who consider it relevant.

The issues associated with option pricing models are of concern whether a company utilizes the footnote disclosures as set forth in Statement No. 123 or the mandatory expensing approach proposed by the IASB. However, mandating that a distorted charge be incorporated in the financial statements will result in significantly less clarity, consistency and reliability in financial statements, to the detriment of investors.

III. The IASB's proposal will distort financial statements because any "cost" that may exist with respect to employee stock options is already reflected in earnings per share.

Any cost that may exist with respect to shares or options issued to employees results from the potential dilution of each investor's share of company ownership, which may increase when options are granted. This cost is already reflected in the income statement in the earnings per share (EPS) calculation. Reducing net income when employee stock options are granted will result in an inaccurate "double charge" in the financial statements.

Because the potential "cost" of issuing employee stock options is borne by existing

shareholders in the form of potential dilution, we believe that the most appropriate way to reflect

the so-called "cost" of employee stock options is through consistent and extensive disclosures of

data regarding shareholder dilution.

IV. Investors should have access to accurate and timely disclosure of employee stock

option transactions.

We strongly support comprehensive, accurate and timely disclosures of employee stock

option transactions. We believe, however, that providing data about the assumptions underlying

option valuation calculations, as the proposed IFRS would require, may be helpful in clarifying

the assumptions made, but would not address the fundamental issue: existing option pricing

models, when applied to employee stock options, will compromise financial statement reliability

and comparability. Investors should have meaningful information about employee stock options.

In response to the Board's Proposed Statement of Financial Accounting Standards,

Accounting for Stock-Based Compensation - Transition and Disclosure, dated October 4, 2002,

TechNet submitted comments outlining in detail proposed disclosures about employee stock

options.

These disclosures included the following information:

employee and executive option grants;

year-to-date option activity, as well as option activity in the prior fiscal year;

• "above water" and "underwater" option information as of the reporting date (i.e.

Options that have an exercise price below a company's current share price, as well as

options with an exercise price above the company's current share price).

• the portion of options that go to executives versus the portion provided to the rest of

the company's employees.

In addition, separate tables were proposed, providing new, detailed information about

options granted to a company's listed officers, including:

new options granted during the quarter;

options exercised during the quarter and the value of those options;

• the total number of options held by executives;

• the dollar value of options that are "above water".

These proposed quarterly disclosures would also provide new information about dilution,

enabling shareholders to see the potential impact of new option grants on the total number of

shares outstanding.

Over 30 TechNet and American Electronics Association member companies have adopted

comprehensive quarterly disclosures about employee stock options and are providing these

disclosures in connection with their quarterly Securities and Exchange Commission filings. We

continue to believe that the current standard embodied in Statement No. 123, coupled with

detailed quarterly disclosures about employee stock options and stock transactions, would provide investors with data that is significantly more accurate and meaningful than the information conveyed by a mandated expensing standard.

V. Mandatory expensing will threaten the trend toward broad-based employee ownership

Increasingly, employee stock options are being offered by companies in a range of industries and the clear national trend has been toward increased employee ownership particularly among non-managers. Data from the National Center for Employee Ownership over the last few years shows that the number of companies that offer options to all employees continues to grow.

In the high technology and biotechnology industries, stock options and broad-based employee ownership have been an engine of growth, helping to build some of the nation's most innovative companies. TechNet member companies—including many of today's technology leaders as well as start-ups—have grown due in large part to the ability to use employee stock options to attract and retain skilled employees at all levels of the corporation.

A mandatory expensing standard is likely to result in the elimination of broad-based employee stock option plans. Professors Brian Hall of Harvard Business School and Kevin Murphy of the Marshall School of Business, University of Southern California, have conducted research showing that the perceived value of stock options to executives at time of grant is

typically one-half to two-thirds of the value under the Black-Scholes method, and may be as little

as one-third. The Journal of Accounting and Economics, April 2002. If forced to absorb a cost

50 to 200 percent greater than their perceived value, companies will face a major obstacle to

offering options.

For companies that broadly issue employee stock options, the inaccuracies that result through

application of existing option pricing models are more likely to have a material negative impact

on financial statements, while companies that issue options only to senior officers will not be as

significantly affected. Under a mandatory expensing standard, companies will be forced to

restrict stock option grants rather than adding a significant expense, in accounting terms, to the

financial statement. The result will be a decline in broad-based stock option plans.

The importance of broad-based stock options is undisputed. Studies confirm that broad-

based plans have a significant impact on productivity, innovation and economic growth.

Companies that offer stock options to most or all employees have experienced significant

increases in productivity. Most recently, Professors Blasi and Kruse provide empirical evidence

of the benefits of broad-based employee stock option plans and their positive impact on

corporations in their book, In the Company of Owners.

VI. Conclusion

TechNet strongly believes that the flexible approach set forth in Statement No.123 provides

appropriate information to investors and that a mandatory expensing standard should be rejected.

Financial Accounting Standards Board

Re: Invitation to Comment on Accounting for Stock Options

February 1, 2003

The established accounting standard under Statement No. 123, combined with comprehensive

quarterly disclosures about employee stock options, will provide investors with the most accurate

and meaningful information available about employee stock options.

Thank you for the opportunity to comment on this important matter. Please contact me at

(650) 213-1164 for any further discussion of our comments.

Sincerely,

Rick White

President and CEO

Reb White