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Letter of Comment No: 149
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MP&T Director
File Reference No. 1102-001
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
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Sent via email and U.S. mail

RE: Invitation to Comment – Accounting of Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and its Related Interpretations, and IASB Proposal IFRS, *Share-based Payment* – Issued November 18, 2002

Dear MP&T Director:

This letter reflects the thoughts of the Compensation Consulting Consortium, LLC (3C) on your Invitation to Comment. We appreciate the opportunity to express our views on several of the questions posed and hope that our responses will be useful to you in your deliberations.

3C is a compensation consulting firm based in Chicago and Pittsburgh. This firm was established in 2002 by partners who each have been advising corporate clients on compensation-related matters for over 17 years. Our clients include large public companies, private companies and non-profit organizations.

General Response to the Stock Option Expensing Issue

We view the current debate as a reaction to significant reductions in shareholder value and placing the blame for this outcome on executive pay practices, especially stock options. The undercurrent is that stock options, which can avoid expense (but not fully-diluted EPS), are causing problems and should be expensed to avoid similar problems in the future. If FASB decides to require all companies to adopt FAS 123 or its successor, the playing field will be leveled among the long-term incentive vehicles in cash, restricted stock and options. If this occurs many companies already facing large grant overhang issues will gravitate toward other vehicles, which are not as strongly linked to shareholder value creation. That outcome is probably not avoidable, as FASB can no longer allow two different methods of accounting for stock options. If your deliberations come to same conclusion, our answers to some of the questions posed may help in the ensuing debate.

Issue 2(a): *Should FASB mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?*

Option Pricing Model Issues

Black-Scholes or the binomial option models simply estimate the value of an option vis-à-vis the value of a share and allow traders the opportunity to arbitrage incorrect option values. Both models are valuable in thinking about short-term option values of publicly traded shares but are inadequate in establishing the value of stock options. The limitations of the model are well known to FASB and yet it is viewed as the best valuation solution available. To this response, we have two alternative suggestions (one is posed under question 2(d)):

Impose Minimum Value

An executive stock option could be viewed in similar terms as a loan to an executive to purchase shares of company stock, which has one interesting feature – the executive can walk away from the loan, not pay the accrued interest and not take ownership of the shares. Using this simple example as a basis for an option model, the company would charge earnings annually for the imputed interest on the exercise price of the option as long as it is outstanding. This interest rate could be established at the risk-free rate and would fairly address the value of the grant without overstating it or understating it. This approach would not require allocating a present value calculation over an estimated option life and would not require forfeiture estimates. It also would not unduly penalize technology and other companies with high stock volatility, but in fact fairly represent the value transferred. The following is a side-by-side analysis of the minimum value model and Black-Scholes for illustration purposes:

	Black-Scholes		**Minimum Value**	
Exercise Price	$10.00		$10.00	
Term	10	years	10	years
Volatility	40%		40%	
Risk-Free Rate	4%		4%	
Dividend Yield	2%		2%	
Expected Term	7		7	
Earnings Charge	$3.87		$3.16	

Issue 2(d): *What modifications to option pricing models should be made to improve the consistency and reliability of the measurement?*

Impose Standardized Assumptions

It would not take a formal study of 1,000 U.S. public companies to demonstrate how much option valuation assumption variation exists in current disclosure. The inconsistencies in the current disclosures make their results suspect. We would propose that volatility be calculated based on broad industry sectors and that the historical volatility be similar in length to the expected option life. We would also propose that option life be at least 70% of the maximum life. For a 10-year option, the option life would be 7 years. Those companies that claim shorter lives would have no problem shortening the maximum life of the option to fit their pattern. For example, a 5-year option would translate to a 3.5 year life. Also, FASB should publish a source for risk-free rate of interest. Standardized assumptions would help provide comparative results. The current freedom to select assumptions does not provide comparative results and therefore erodes the validity of the results reported. Since these current results have been approved by independent auditors, simply leaving reasonableness up to auditors is clearly not an effective solution.

There is a related issue here in that we have noticed companies currently trying to minimize their expense by making aggressive assumptions relative to option life, volatility, risk-free rate of return and dividend yield. Many of these companies are still under APB 25, which is only footnote disclosure. This minimize-value strategy is a concern for comparison purposes but also for how these values translate into internal valuation purposes for grant purposes. Low option value creates a demand for more shares to meet certain target compensation values, which may in an indirect way artificially discount the value of the stock option.

Issue 17: *Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.*

Any reduction in earnings due to option expensing should be reflected in the fully-diluted EPS calculations but not counted twice.

Thank you again for allowing us to weigh in on this important issue.

Sincerely on Behalf of 3C

Brian P. Enright

Brian P. Enright
Partner