Dear Ms. Bielstein:

The International Employee Stock Options Coalition ("IESOC") respectfully offers its comments on the Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (the "Exposure Draft"). The IESOC is comprised of a diverse range of industries, including high-tech, biotechnology, manufacturing, and service companies that support broad-based employee stock option plans. Our membership includes public companies, large and small, newly-public companies, and private companies. Many of our member organizations and companies also have significant operations abroad as well as in the United States. As a result, we are keenly interested in this issue both from the standpoint of the Exposure Draft as well as in the international arena. We appreciate the opportunity to offer our comments.

Executive Summary

- The Exposure Draft will not improve financial statement reliability, transparency, or comparability and would not fulfill the Board’s stated mission: to establish and improve...
standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. For these reasons, it should be rejected.

- The developer of the Board’s preferred option pricing model, the binomial model, has told the Board “Don’t use it. It doesn’t work.”

- We believe that option pricing models will not “work,” because the granting of employee stock options does not represent a corporate expense. While the Exposure Draft sets forth reasons to support the Board’s position, that rationale is devoid of any reference to existing accounting principles or concept statements that support that view.

- The most appropriate accounting treatment for employee stock options is to continue to allow companies to use APB Opinion No. 25 to account for employee stock options and should be required to disclose all relevant information. Many members of the IESOC have voluntarily adopted additional disclosures that they believe provide additional relevant information to financial statement users and we encourage others to do so as well.

- Alternatively, pro forma disclosure of the purported expense would result in more meaningful information than mandatory expensing. In this way, those who believe that the purported expense is meaningful would have it available and could more easily see its impact on the financial statements. Those who believe, as we do, that the number is

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1 www.fasb.orgfacts.
meaningless, could simply ignore it. Pro forma disclosures would satisfy all constituents, not just those who are on one side of this complex issue.

- To the extent an option pricing model were used to compute a purported value of employee stock options, the result must be adjusted to take into account all of the unique attributes of the instrument. Discounts for lack of marketability, inability to hedge, risk of forfeiture, and black-out periods would be essential. The Exposure Draft provides no guidance on how these necessary discounts would be computed or applied.

- The costs that would result from implementation of the Exposure Draft are significant and outweigh any purported benefit. Outside professional costs to customize a binomial option pricing model – one that we now know will not “work” – will exceed $100,000, even for a small company, assuming complete, accurate, and easily accessible records exist. These costs do not take into account the internal personal costs that would be incurred in the 8 to 10 weeks that would be required to customize an option pricing model, or the increased audit costs that would result.

- For private, newly-public, and small public companies, the Exposure Draft is particularly problematic. The expense to implement an expensing standard would be enormous, whether that standard is one of “fair value” or variable intrinsic accounting, and should be rejected.

- Field testing of any expensing standard is essential and necessary to safeguard the integrity of financial statements. There is widespread agreement that Black-Scholes significantly overstates the estimated cost of employee stock options. That is undoubtedly one reason the Board considered prohibiting its use outright, and ultimately
de-emphasized it in the current Exposure Draft. The binomial method, which is based on Black-Scholes, is equally flawed when it comes to employee stock options and, as noted above, its developer has recommended that FASB not use it. All of this points more than ever to the importance of comprehensive, cross-industry field testing of multiple valuation models.

- Given the insurmountable problems that exist with the Exposure Draft, any final standard that may be issued should be delayed until the technical problems with the proposed standard can be addressed and sufficient implementation guidance developed.

- Although the IASB has proposed a new stock option standard, this standard has yet to be adopted. We believe that the IASB’s proposed standard is as flawed as the Exposure Draft and that it should be rejected.

**Issue 1: Do employee stock options give rise to recognizable compensation costs?**

As a preliminary matter, we believe that it is completely appropriate, and indeed essential, that the Board seek comment on this fundamental issue. We further believe that the complete lack of consensus on this issue vividly illustrates that the approach currently encompassed in Statement No. 123 is the most appropriate. Unlike a mandatory expensing standard, all constituents are served by this approach, not just those who believe that options represent an expense.

From a technical standpoint, we do not believe that the granting of employee stock options creates an expense and we have found no existing accounting principles or concept statements that support treating options as an expense. Moreover, the estimates that would be required under the Exposure Draft are unique for each company, unlike other estimates in the
financial statements, such as depreciation and health care costs increases, which are similar across all businesses. Thus, implementation of the Exposure Draft's proposals will increase the lack of comparability in corporate financial statements, rather than increase comparability and transparency.

Statement of Financial Accounting Concepts No. 6 defines an expense as an “outflow[] or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing good, rendering service, or carrying out other activities that constitute the entity’s ongoing major or central operations.” ¶ 80. No outflow or using up of corporate assets occurs when employee stock options are granted and, as the Board has correctly determined, there is no corporate liability.

We fundamentally disagree that the granting of employee stock options is similar to the examples used in the Exposure Draft’s basis for conclusions. At paragraph C13, the Board states that it “believes that an entity receives assets – employee services – in exchange for equity share options.” The Board goes on to say that this creates an asset (services) which, when used, results in an expense. Basis for Conclusions, ¶ C13. The Board rationalizes this position by stating that “Because an entity cannot store services, they qualify as assets only momentarily unless those services are capitalized as part of another asset.” The Board provides no support for this novel position, we are unaware of any support for this position in the accounting literature, and we are unaware of any other “momentary assets” that are accounted for as an expense.

The fallacy of the Board’s position is illustrated by the longstanding treatment of forfeited options, i.e., those that never vest. For example, assume a company had an employee, who received options on the day he arrived. Those options were valued at $100 at grant and
were subject to 4 year cliff vesting, that is all of the options vested 4 years after they were granted. Assume that the employee remains with the company and his options vest. The company would have recognized $100 of expense in exchange for the services performed by him (under the Board’s theory). Assume, however, that the employee, instead, left the company or was fired 1 day before his options vested. The company would, in effect, not recognize any expense, yet the employee still would have performed the exact same services and the company would have received the exact same benefit or “momentary asset.” Accordingly, we do not believe that the Board’s rationale is supportable.

Some have recently asserted that the Board’s treatment of forfeitures does not create an inconsistency because the forfeiture provisions were simply intended to reflect the lack of transferability and risk of forfeiture that exists with employee stock options, and, thus, no inconsistency exists. While this may originally have been the Board’s thinking, Statement No. 123 rejected this rationale:

This Statement requires that the compensation cost for an award of employee stock options reflect the number of options that actually vest. That is the same as the provision of the [Statement No. 123] Exposure Draft, although the rationale is somewhat different. The Exposure Draft explained that provision as a means of adjusting the grant date value of an award of forfeitable stock-based employee compensation to reflect the risk of forfeiture. The measurement method in this Statement is intended to be consistent with an entity’s having no enforceable right to future employee services or other consideration for forfeitable awards. An award of stock-based employee compensation does not result in the issuance of equity instruments until the award is vested. Recognizing compensation cost only for the number of instruments actually issued (vested) is consistent with that view of the nature of a nonvested award.
Statement No. 123, Basis for Conclusions ¶ 167. The current Exposure Draft does not take a contrary position.³ Basis for Conclusions ¶¶ 86-88. For this further reason, we believe that our analysis is correct.

The Exposure Draft also argues that even where a shareholder pays directly “a part of an employee’s cash compensation (or other corporate expense), the transaction and the related costs are reflected in the entity’s financial statements, together with the stockholder’s contribution to paid-in capital.” Again, the Board’s reasoning is not consistent with stock option reality. In the examples used in the Exposure Draft, (i.e., cash compensation) a corporate liability clearly exists. The mere fact that that liability is paid by a third party does not change the fact that when the corporate liability is established, an expense is created at the corporate level. The Board has specifically concluded that in the case of most employee stock options, a liability is not created. As a result, the Exposure Draft’s use of this example simply creates an apples and oranges comparison that does not support the Board’s position.

Some also have stated that employee stock options should be accounted for as an expense because they represent an “opportunity cost.” We are unaware of any other so-called opportunity costs that are accounted for in financial statements. Moreover, to the extent that there were any rationale for accounting for such purported costs, which we do not believe there is, any expense would have to be reduced by the opportunity benefits that the company derives in the form of increased employee productivity and market returns. Drs. Blasi and Krause, authors

³ "The Board sees no reason why estimating the number of instruments for which the requisite service is expected to be rendered will be more difficult than making similar estimates in those situations.” Basis for Conclusions ¶ C87. Thus, although the current Exposure Draft would eliminate a choice in methods that exists in Statement No. 123, the underlying rationale of the current Exposure Draft remains consistent with that of Statement No. 123.
of the seminal book on employee stock options, *In the Company of Owners*, cited a study that showed that the productivity of the tested companies was 20 percent higher than companies without broad-based stock option plans. In addition, these firms averaged 9 percent greater market returns. While the benefit of employee stock option programs may be reflected in the overall market value of a company, such benefits are not necessarily reflected in the company’s financial statements. Thus, any purported opportunity cost alone would not reflect the true “cost” of employee stock options. We know of no existing accounting principles that would establish how such costs and benefits could be measured. As a result, this argument for expensing is without support as well.

Finally, the Board has stated that options granted to non-employee service providers are an expense and that expense is computed at fair value. As this argument goes, if options issued to a third party are an expense that can be valued, so, too, must options granted to an employee be treated the same way. The treatment of options issued to third-party option providers is relatively new. Indeed, until the Board issued FASB Interpretation No. 44 in March of 2000, the prevailing accounting treatment, which was approved by all of the major accounting firms, was that such options could be and were accounted for under APB No. 25.

At the time FASB Interpretation No. 44 was issued, it was common practice in some parts of the country to “pay” outside service providers, such as lawyers, accountants, and consultants, with stock options. In the four years since the issuance of Interpretation No. 44, that practice has all but stopped. Importantly, to the extent such options are still issued and expensed at fair value, as required by Statement No. 123, there is an objective frame of reference to determine whether the value is in fact “fair.” For example, if an attorney were to provide 100
hours of services to a company and received 50 options in exchange, one would presume that if that attorney’s normal billing rate were $100 per hour, the fair value of the options would be $10,000 or close to it, regardless of the pricing model that were used to establish the value. We believe that the company’s auditors would insist on such a valuation to the extent the expense were material.

For options issued to employees, the same analysis does not hold. For example, an option pricing model would assign the same value to an option granted to the CEO as it would to one issued to a mail clerk. If the value of the option is supposed to be a proxy for the “value” of the employee services that the corporation receives, the Board’s rationale fails entirely. Thus, we do not believe that the Board’s third-party option example provides any support to its view that stock option issued to employees is an expense.  

**Issue 2: Are pro forma disclosures an appropriate substitute for recognition of compensation cost in the financial statements?**

We continue to believe that the most appropriate accounting treatment is to continue to allow companies to use the APB No. 25 standard of intrinsic value at grant. In 1993, when the Board was debating Statement No. 123, several of the large accounting firms supported this position. For example:

- Coopers & Lybrand stated that “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

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4 We also commend to the Board, the letter filed by Kip Hagopian, comment letter number 8, for an expansive discussion of why employee stock options do not constitute an expense and for a list of several highly-regarded accounting professors who reviewed and concur with his conclusion.
this time.” December 29, 1993 comment letter on Statement No. 123 exposure draft from Coopers & Lybrand at pages 1-2.

• Ernst & Young concluded that “although admittedly a simple approach, intrinsic value on the grant date provides a more reliable and comparable measure than using option pricing models that were developed for purposes other than to value employee stock options, and whose values do not have general acceptance.” December 6, 1993 comment letter on Statement No. 123 exposure draft from Ernst & Young at page 7.

• KPMG Peat Marwick agreed that “[t]he intrinsic measurement method that is used in APB Opinion No. 25 . . . should be retained.” December 28, 1993 comment letter on Statement No. 123 exposure draft from KPMG Peat Marwick at page 1.

There has been no fundamental change since 1993 that would justify a different conclusion. The option valuation models that were in existence in 1993 and are referenced in Statement No. 123 are identical to the models that are referenced in the Exposure Draft. They are as flawed now as they were then (as discussed in detail below). Accordingly, there has been no fundamental change that would justify different accounting treatment.

With respect to pro forma disclosures, the Board concluded that pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. We disagree. While we continue to believe that footnote disclosure of the Statement No. 123 information supplemented, if necessary, by additional information that investors would find relevant, is the most appropriate treatment, we do not object to pro forma disclosure reflecting the purported expense. In this way, those who believe that the purported expense is a meaningful number would have it available and could easily see its impact on the financial statements.
Those who believe the number is meaningless could simply ignore it. Although the SEC has generally disfavored pro forma financial statements, pro forma financial statements explicitly sanctioned by the Board would recognize the considerable valuation problems and widespread lack of consensus that exist in this area and would serve all constituents – not just those who are one side of this very complex issue.

**Issue 3: Is fair value the relevant measurement attribute and is grant date the appropriate measurement date for equity instruments issued by public companies?**

As discussed above under Issue 2, we continue to believe that intrinsic value at grant are the appropriate measurement attribute and date, respectively.

While, as discussed below, we do not believe that there currently exists a reliable method for determining the fair value of an employee stock option, for those who do choose to use a fair value method, we believe that grant date is the appropriate measurement date.

**Issues 4(a), 4(b), 4(c), and 4(d): Do you agree with the conclusion that the fair value of options can be measured reliably with lattice models, does the Exposure Draft provide sufficient guidance to “ensure that the fair value measurement objective is applied with reasonable consistency,” how should volatility be estimated, and does the Exposure Draft give appropriate recognition to the unique characteristics of employee stock options?**

We agree with the Board’s position that if a fair value standard were used, that standard should be one of willing buyer-willing seller. We also believe that market prices are the most reliable measure of fair value. Based on discussions that various members of the IESOC have had with leading investment bankers, the market value of an option that is subject to vesting, cannot be traded, and cannot be hedged is zero or very close to it. This is true notwithstanding that employees clearly view the options as “valuable.” One could have an asset that he considers very valuable, but one party’s perception of value is not the measure of that asset’s fair value if there is no third party who agrees.
Option Pricing Models

"Don't use it. It doesn't work." These are the words of Professor Mark Rubinstein, one of the developers of the binomial model that the Board states is its preferred valuation tool. If the creator of the model does not think that his own model can be used to value employee stock options, that, in and of itself, should end the debate over whether it works.

The reasons for this view are clear. The existing option pricing models referenced in the Exposure Draft, binomial or lattice models and the Black-Scholes model, were not designed to value employee stock options. These are the identical models referenced in Statement No. 123 and they are as inappropriate today as they were in 1993. Indeed, the Board seems to recognize this fact with respect to Black-Scholes, given that it considered banning the use of that model in its deliberations leading up to the current Exposure Draft.

Because binomial models are simply derivations of Black-Scholes, they suffer the same fatal flaws. Although they are more complex and give the illusion of greater precision, this is simply not the case. Binomial models also will produce unreliable numbers, just like Black-Scholes. In a recently-issued paper written by PricewaterhouseCoopers, they show that

- A value from a binomial model should become close to that from the Black-Scholes formula as the number of [iterations used in the binomial model] is increased, since the two approaches are based on the same theory. As the number of [binomial] nodes increases, the possibilities at the later times represented in the tree eventually closely approximate the smooth probability distribution used in the Black-Scholes formula. . . . given the mathematical theory underlying the Black-Scholes and binomial approaches, it is expected that the values should converge.
PricewaterhouseCoopers DataLine 2003-37: Understanding the FASB’s Proposed Binomial Approach For Calculating Stock Option’s Fair Value, at pp. 6-7. If the Board believes that the numbers produced using the Black-Scholes model are unreliable, it must be, as Professor Rubinstein has said, that the use of a binomial model will produce results that are equally unreliable.

In 1993, all four of today’s major accounting firms agreed that the same option pricing models referenced in the current Exposure Draft could not reliably measure the cost of employee stock options. For example, Coopers & Lybrand stated at page 4 of their December 29, 1993 comment letter:

At this time, we are aware of no reliable way to measure the effect of the differences between ESOs and publicly traded options or to modify present models to account for these differences. Notwithstanding the FASB’s efforts on this project, the proposal to adjust the option’s value for actual and employment and performance conditions is at best incomplete. Further, there is no market mechanism to establish or verify for ESOs as they cannot be bought or sold in a traded market.

Similarly, Deloitte & Touche stated that “we have significant reservations about whether option-pricing models or any other valuation methods can reliably and objectively determine the fair value of an employee stock option. For the reasons described below, we support use of the minimum value method for all companies.” November 5, 1993 comment letter on Statement No. 123 exposure draft from Deloitte & Touche at page 3.

KPMG was

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 with the same features and assumptions but different ‘black boxes.’ For example, options on dividend-paying stocks can have different values
(the difference increases as the dividend rate and level of volatility increase) depending on whether a Black-Scholes or binomial model is used.

December 28, 1993 letter on Statement No. 123 exposure draft from KPMG Peat Marwick at pages 4-5.

Finally, Ernst & Young believed

that existing option pricing models do not produce a reasonable or relevant value of employee stock options. The option pricing models were designed to value traded options, which have significantly different attributes from nontraded employee stock options. Although the Board has proposed modifications to the models, we are unconvinced that those adjustments truly capture the reduced value of employee stock options as compared to traded options. For example, although use of the shorter expected term (as opposed to the option's full contractual term) reduces the fair value of an employee stock option, we are unaware of any empirical evidence that equates that reduction in value to an appropriate nontransferability discount.

December 6, 1993 comment letter on Statement No. 123 exposure draft from Ernst & Young, at page 2. What was true in 1993 is equally true today. Neither the models referenced by the Board nor the concerns have changed. Although at least some of the Big 4 have vacillated on this issue and have reached a contrary conclusion in their most recent comments, they provide no basis for their new position, perhaps because, as Professor Rubinstein recently stated, none exists.

**The Exposure Draft would Result in a Lack of Consistency, Comparability, and Reliability**

The Exposure Draft will not result in any consistency between companies or even within the same company from year to year. It would permit so much flexibility that a company could potentially generate any number of values using the same model, by simply changing the various assumptions used. Because all of the assumptions are simply guesses of what will happen in the future (e.g., future volatility, employee exercise behavior, future dividends, future interest rate),
any number of assumptions for the same variable could be reasonable, yet the results that would be derived would vary materially.

As stated in its comment letter and as reiterated in the testimony of Cisco’s CFO before the Board at the Palo Alto roundtable discussion,

LECG Corporation recently completed an analysis of five option pricing models including four lattice models as well as the Black-Scholes model. A single hypothetical option grant was valued using each of these models. LECG attempted to adjust the models to reflect the unique characteristics of ESOs. The purpose of the analysis was to understand the variability and comparability of the models using the same option grant. The analysis concluded that the valuations varied widely depending on the model selected and approach used to develop the inputs. The assumptions used for the inputs to the model can have a significant amount of variability depending on the estimation method used. For instance, a broad range of volatilities can be developed depending on the time parameters selected and assumptions regarding the company’s projected stock price. The values for the hypothetical option grant ranged from $14.67 to $80.27, representing a variation of over 400%. The data concludes that comparability cannot be achieved using the same grant using differing models and estimation approaches for a single company. Extrapolating this effect to multiple grants, employees, and companies would undoubtedly result in broad variability in earnings for all companies with significant employee option plans. This analysis seriously questions the reliability of financial statements that would be based on the models that are currently available. As a result, financial statements will have less credibility due to the lack of comparability and the huge variation of values based on the assumptions used in the valuation models.

June 4, 2004 comment letter at pp. 4-5 (Letter 3078). Thus, if adopted, the Exposure Draft would ensure that the fair value measurement objective is not applied with reasonable consistency.

With respect to the volatility input, specifically, if an option pricing model were to be used, we believe that zero is the appropriate input. This would eliminate the substantial issues that exist in attempting to predict this input. Indeed, where the expense generated is material to the financial statements, we believe that there are significant audit issues presented that we do
not believe can be overcome. For example, how are the auditors supposed to audit the company’s prediction of future volatility? For many of the companies in the IESOC, volatility is event driven and wholly unpredictable.

- When, over the 10 year life of most options, is a drug company going to develop a new break through drug?
- Should the drug company anticipate test trial success or failure? FDA approval or problems?
- How can this possibly be predicted for something that is not even developed?
- How are auditors supposed to audit the assumptions made and CFOs and CEOs supposed to certify their financial statements when slight differences in assumptions, all of which may be reasonable, create material differences in financial results?

To complicate matters further, while new developments often increase volatility, that is not always the case. In short, failure to mandate a standard input for this variable will be a trial lawyer’s dream and every company’s and auditor’s nightmare.

Others, too, have supported the use of minimum value (zero volatility), including one of the largest compensation consultant companies in the country, whose founder was a member of the Board’s Option Valuation Group ("OVG"). In his July 14, 2003 letter to the Board, Frederick W. Cook, of Frederick W. Cook & Co., said that he “favor[ed] expanding the definition of 'fair value' to encompass the minimum value method (MVM).”

As noted above, Deloitte & Touche also supported using a zero volatility approach in 1993. In their June 4, 2004 comment letter on the Exposure Draft, BDO Seidman concurred:

Forcing employers to estimate expected volatility, when objective techniques for doing so don’t exist, will sustain an illusion that options are being measured at
fair value. We believe it would be better to forthrightly acknowledge that expected volatility (and, as a result, fair value) can't be objectively estimated, and permit employers to use zero volatility (minimum value). If the Board finds that unpalatable, then permit employers to use a standardized volatility measure, like the average volatility of the Standard & Poors 500 index.

June 4, 2004 comment letter at page 2 (Letter 3072).

The use of a broad-based index, such as the Russell 3000, would be a viable alternative. Requiring all companies to use the same index, as suggested by BDO Seidman, would make the most sense, but we believe that index needs to be broader-based than the Standard & Poors 500 Index. The Standard & Poors 500 Index is heavily weighted by large-cap companies whereas the Russell 3000 represents a broad cross-section of companies, large and small. As a result, we believe it would be a more appropriate index to use. We do not believe that different companies should use different indices depending on, for example, the industry they are in. Doing so would give conglomerates their choice of indices, thereby allowing potential manipulation of results, and for many of the individual companies in the IESOC, they alone comprise the entire industry. This is especially true for many of the private or newly-public companies in the IESOC.

Use of zero volatility or, in the alternative, a broad-based index, would eliminate the otherwise insurmountable problems that arise when attempting to predict future volatility, would enhance comparability across industries and within industries, and would be easily auditable. Again, however, even if this were permitted, existing option pricing models still would not generate a value for an employee stock option that approached its fair value under a willing buyer-willing seller standard.
Any Valuation Model Used Must Reflect All of the Characteristics of the Instrument Being Valued.

Although the Exposure Draft would require that the model used “reflect[] any and all substantive characteristics of the instrument,” App. B, ¶5, neither binomial models nor Black Scholes can or was designed to reflect “any and all substantive characteristics” of an employee option. The Exposure Draft provides absolutely no guidance as to how to compute such a discount.

The Exposure Draft also fails to discuss specific discounts for other attributes of employee stock options that would impact their fair value, such as an inability to hedge and risk of forfeiture. To the extent such discounts would be permitted under the Exposure Draft’s broad mandate that the model used “reflect[] any and all substantive characteristics of the instrument,” App. B, ¶5, it again fails to provide any implementation guidance as to how to do so. We believe that to the extent an option pricing model were used, the Board should establish standard discounts that would be applicable to all companies or provide a method for computing the discounts that would be applied to reflect the various necessary discounts.

Neither Statement No. 123 nor the Exposure Draft explicitly discusses a discount for the lack of marketability that exists with respect to employee stock options. As the Board has been told by numerous experts, such a discount is essential, regardless of the model used to value the option.

Dr. Johnathan Mun stated in both his May 14, 2004 and June 1, 2004 letters to the Board that based on sound financial and economic theory, “[t]he author’s suggestion is to allow the incorporation of marketability discounts [to] be taken by firms issuing [employee stock options].
The Board’s OVG also agreed:

Mr. Tovey asked whether a discount should be applied to options for nontransferability during the vesting period. The [OVG] generally agreed that the value of a nontransferable employee stock option is lower compared to a similar transferable market instrument, and that a discount should be applied.

Minutes of the FASB Option Valuation Group Meeting, July 8, 2003, at p. 5.

Regardless of the model used to value an employee stock option, a discount for blackout periods, that prevent the option holder from exercising an option, also is essential. The Board’s OVG agreed. Minutes of the FASB Option Valuation Group Meeting, July 8, 2003, at p. 6 (the OVG “generally supported a valuation approach that would consider the legal treatment of insider information.”). While the Exposure Draft would explicitly permit black out periods to be taken into account, it provides no guidance on how to do so.

**The Cost Will Outweigh Any Potential Benefit**

Our discussions with valuation experts indicate that the outside professional cost just to customize a binomial option-pricing model that we again now know will not “work” will exceed $100,000, even for a small company. This estimate also assumes complete, accurate, and easily accessible records and these costs do not even take into account the internal personnel or information technology costs that would be incurred or the increased audit costs. Moreover, it would take from 8 - 10 weeks to customize a model for a single company.

While academic papers have been written discussing such complex binomial approaches reflecting the correlation of stock price and early exercise, such models are not generally available at the present time, and if they were they would need to be adapted to fit each company’s unique circumstances – vesting provisions, assumed exercise/stock price
correlation factors, etc. Developing these models and the underlying analysis to support the necessary assumptions will require considerable time and effort.

PricewaterhouseCoopers DataLine 2003-37: Understanding the FASB’s Proposed Binomial Approach For Calculating Stock Option’s Fair Value, at p. 7. We believe that the Board should, as Dr. Rubinstein recommends, reject the use of both Black-Scholes and binomial models to estimate the fair value of employee stock options. Given the well-documented problems with valuation, we strongly suggest that the Board retain the intrinsic value accounting permitted under APB No. 25 or, in the alternative, permit pro forma disclosure rather than mandatory expensing of a wholly unreliable number.

**Issue 5: Is the variable intrinsic value method with remeasurement through the settlement date an appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value?**

No. The variable intrinsic accounting proposed by the Exposure Draft is inappropriate for companies, public and private. It is nothing more than the variable accounting required for variable options under APB Opinion No. 25. While that may be an appropriate treatment for variable options, it is not an appropriate treatment for fixed options and is wholly inconsistent with the Board’s long-standing, and we believe correct, view that grant date is the appropriate measurement date. By requiring remeasurement, the variable intrinsic method is essentially exercise date accounting. The Board has rightly rejected this approach.

For private companies, the variable intrinsic value method will not result in any cost savings. Our discussions with auditors and valuation personnel indicate that the out-of-pocket cost to implement this method would range from approximately $30,000 - $100,000 in external consultant and auditor costs alone. Moreover, many private companies do not have sufficient
staff to do the additional work that would be required under the Exposure Draft internally, or the funds to hire additional highly trained and costly finance and accounting staff. This is equally true for newly-public and smaller public companies, although they would not, like a private company, have to incur the cost of establishing a value for the underlying common stock which does not trade or obtaining support for not changing the value of the stock from period to period. For larger public companies which issue broad-based options to nearly all of their employees, this also would not present a viable alternative and would not, in any way, reflect the fair value of employee stock options. Thus, in our view, the costs that would be imposed under the variable intrinsic value method far exceed any perceived benefits that could be derived.

**Issue 6: Are employee stock purchase plans non-compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares?**

Yes, such plans clearly would be non-compensatory. However, we also believe that other types of employee stock purchase plans also should be viewed as non-compensatory. ESPPs are designed to encourage employees to purchase shares and also do not result in the company incurring the significant costs associated with a public offering. These costs can differ from company to company and from issue to issue. As a result, the IESOC believes that the current rule of APB No. 25, which follows the tax rules as to what level of discount is considered non-compensatory, should be retained. This rule is well-understood, simple, consistent, and also takes recognition of the fact that the company has a significant cost savings when employees purchase unrestricted stock through an ESPP.
Issues 7, 8, and 9: Do you believe that the vesting period is the appropriate period over which to recognize any expense and do you agree with the Exposure Draft’s method of accruing costs when a graded vesting schedule exists.

As discussed above, we do not believe that any expense should be recognized. However, under either a permissive expensing standard or if pro forma reporting were the standard, then we believe that the vesting period is an appropriate period to use.

We vehemently disagree, however, with the proposed method of accruing costs when a graded vesting schedule exists. Virtually all companies that offer broad-based options use a graded schedule where, after the first six months or one year, options vest on either a monthly or even daily schedule. This is done because it is a good corporate governance practice and it benefits the employee.

Accruing costs as proposed in the Exposure Draft needlessly complicates the computations, increases costs substantially for no real benefit, and inappropriately front-loads the expense. For example, if a company issued options on the first day of a year and one-quarter of those options vested at the end of the first year and then monthly vesting occurred for the next 36 months, the Exposure Draft would require that single grant of options to be viewed and accounted for as 37 different grants. The costs also would be front-loaded. Under the Exposure Draft, approximately 52% of the expense would be recognized in the first year, 27% in the second, 15% in the third and 6% in the fourth. There is simply no support for the necessary corollary that the employee’s service in the first year is more than twice as valuable as the service in the second year and over 12 times more valuable than in the fourth year.  

5 In their June 7, 2004 comment letter (letter 3086), Lehman Brothers, a leading financial services firm, believes that “financial statement users will find counter intuitive a method
Companies with broad-based plans generally issue options more than once a year to current employees and are constantly issuing options to new employees. These issuances also would be subject to the same rules. The record-keeping costs alone would be astronomical. Moreover, if companies wanted to revise their option plans to change the vesting schedule, they likely could not change the terms of outstanding option grants and they would incur significant legal costs to change the terms of the stock option plan for newly issued options. The increased audit costs also would be substantial.

These problems do not come through in the Exposure Draft's examples, given that all of those examples relate to options granted to one or only a limited number of executives. For companies that issue broad-based options, this proposal will significantly increase costs for no benefit.

Moreover, the Exposure Draft's proposal that employees be grouped for purposes of predicting exercise behavior further exacerbates the problems. Companies would essentially be required to hire a social scientist to help them group employees. And what are the appropriate groupings? Hourly versus professional? Men versus women? People with children of college age versus empty nesters versus people with young children? New professionals versus more established professionals? The potential groupings are endless and we do not believe that social scientists or actuaries can reliably predict future employee behavior. In the end, however, just like it is impossible to predict future volatility of a stock, it is impossible to predict early exercise behavior of an employee because such behavior is wholly-dependent upon the personal views of expense valuation that accelerates expense recognition into the early years of an award...” We agree.
and risk-profile of each individual as well as market forces (including, importantly, options being under water).

For private companies the problems are even more extreme. For the private companies in the IESOC, there is no exercise behavior to study because the options cannot be exercised in virtually all instances. For all of these reasons, we disagree with the Exposure Draft’s proposal.

**Issue 11: Is the method for accounting for income taxes appropriate?**

We do not believe that the method for accounting for income taxes proposed in the Exposure Draft is appropriate if an expensing standard were mandated. To the extent an expense is recognized for employee stock options, then the Board must accept all of the consequences that flow from that characterization of the event. Thus, if there is a tax benefit that flows from the granting of an option, then that benefit should be reflected in the income statement.

We also oppose the Exposure Draft’s rejection of the portfolio treatment of Statement No. 123. In effect, companies would be required to maintain their deferred tax analysis at the individual grant level for each individual employee. For companies with broad-based plans, this is incredibly complicated and cost prohibitive.

**Issue 12: Are the disclosure objectives set forth in the Exposure Draft are appropriate and complete?**

As discussed above, we believe that disclosure, and not expensing, is the appropriate treatment for employee stock options. In our view, any disclosures that provide meaningful information are appropriate. In fact, numerous members of the IESOC have voluntarily increased the disclosures in their SEC filing.

We are, however, concerned about the Exposure Draft’s proposal that companies disclose their 10-year forecast of expected dividends. Disclosure of such highly sensitive predictions
makes no sense and could unnecessarily expose corporate directors to legal liability if their predictions turned out to be incorrect. Again, this is another fundamental problem with applying an option pricing model that was designed to value short-lived, freely tradable options to long-lived, severely restricted employee stock options.

**Issue 13: Transition: Do you believe that entities should be permitted to elect retrospective application?**

To the extent a company were to choose to expense under a permissive expensing standard, we believe that many investors will demand retrospective application and that it should be permitted. However, we believe an even more significant transition issue is the effective date of any final pronouncement. We continue to believe that both Black-Scholes and binomial models are fundamentally flawed and that their use should be rejected.

If the Board continues to believe that binomial models are “workable,” or if it determines that newly developed models such as the model developed by Drs. Bulow and Shoven of Stanford University, or the interest cost method that some have suggested should be used, we reiterate our request for extensive field testing of any such methods.

As we stated in our January 22, 2004, letter to the Board, a copy of which is attached hereto, to date, most companies have applied the Black-Scholes method only in their footnote disclosures. The Board has now all but rejected the use of that model in favor of binomial models. Given Dr. Rubinstein’s admonition that the Board not use the (binomial) model which he developed, it is essential that any proposed models be rigorously tested. Only after the Board examined 10 years of data did it conclude that Black-Scholes did not value employee stock options with sufficient reliability. It would be irresponsible to mandate compliance with a
standard, the core principles of which have never been tested. Surely field testing is essential under these circumstances to ensure the integrity of financial statements.

An American Enterprise Institute ("AEI") conference earlier this year underscored the need for field testing. Highly regarded finance, economic, and accounting experts, including SEC Commissioner Paul Atkins, Glenn Hubbard, the former Chairman of President George W. Bush’s Council of Economic Advisors, and Kevin Hassett, AEI’s Director of Economic Policy Studies, identified, among other things, fundamental problems with existing valuation methods. Their comments, a summary of which is attached to our earlier letter, provide further evidence that comprehensive field testing is warranted. Others too, such as Warburg, Pincus (Letter 3210), the U.S. Chamber Of Commerce (Letter 3227), have supported field testing in their comment letters to the Exposure Draft. In his July 14, 2003 letter to the Board, OVG member Frederick Cook also called for field testing as did the Business Roundtable ("BRT") in its January 31, 2003 comment letter (Letter 169) to the Board’s earlier Invitation To Comment on this important topic:

We recommend the FASB develop and sponsor a comprehensive market test of the grant value of employee stock options. Specifically, a large number of investment banks and other institutions with sophisticated modeling techniques should be asked to provide bid and ask prices for at-the-money options to purchase stocks of a large number of diverse companies. The test should specify that (1) the options are not transferable . . ., (2) the options cannot be exercised until after a typical vesting period . . ., and (3) the investment bank or other purchaser may not hedge the option position by, for example, borrowing stock and shorting it against the option. In addition, such a test could be refined to reflect specific features of individual option plans . . . so that plans that incorporated desirable governance features would benefit from a lower charge.

Field testing is not a new concept. Indeed the Board has engaged in extensive field testing before, for example, in 1998 in the context of the Board’s business combinations projects, in 1996 in connection with Statement No. 133, and in 1994 in connection with its proposed standards for financial statements of not-for-profit organizations and accounting for contributions.

Even the Association for Investment Management and Research ("AIMR") – an expensing advocate – has urged the Board to conduct field testing as part of the Board’s standard-setting process. In AIMR’s words:

- "AIMR’s Financial Accounting Policy Committee has on several occasions communicated directly to the FASB in support of field testing in the standards-setting process. *Field tests can be enormously helpful in identifying implementation problems that neither preparers nor users of financial statements could have anticipated at the conceptual level.*"


The IESOC believes that extensive field testing is essential before any changes are made to existing standards. The Board’s plan to issue a final standard by the end of this year is unrealistic and would be inappropriate.

For private companies, we believe the effective date of any new standard, unless it is a continuation of the APB No. 25 intrinsic value method, should be delayed at least an additional year beyond any effective date applicable to public companies. Such a delay would be essential to allow the gathering of required data, to develop new systems related to stock option awards, reduce the pressure on companies without sufficient internal staff to implement any new
standards, and, recognize that private companies will be the last to receive the attention of valuation and audit firms.

**Issues 14(a) and 14(b): Election of the variable intrinsic value method and cost benefit analysis.**

The IESOC believes that the variable intrinsic value method is neither consistent with fundamental premise of the Exposure Draft (i.e., grant date valuation) from a theoretical standpoint nor that it provides private companies with a viable and cost effective alternative. As discussed above, there is unlikely to be any cost savings.

**Issue 15: Should the rules applicable to private companies also apply to small business issuers?**

We do not believe that the alternatives provided for private companies under the Exposure Draft are viable or satisfy a cost benefit analysis. If, however, private companies were permitted to use a method that truly balances costs and benefits, then we believe small businesses should also be entitled to use those rules as well.

**Issue 17: Differences between the Exposure Draft and IFRS 2.**

There are significant differences between the Exposure Draft and IFRS 2. As discussed above, we believe there are fundamental flaws in the Exposure Draft. IFRS 2 is equally, if not more flawed. Moreover, notwithstanding the IASB’s issuance of IFRS 2, there currently is no required international accounting standard for employee stock options. The IASB’s “standard” at this time is still, in effect, a proposed standard because it has yet to be approved or adopted. As the Board is aware, IASB standards are not self-executing. For example, in the European Union, IASB standards must be adopted before they are applicable. *The European
Union has not approved IFRS 2. As a result, there currently is no adopted, international standard that the Board could converge with.

In any event, however, while we are fully supportive of the concept of international convergence, convergence for the sake of convergence makes no sense. We believe that the IASB and the Board should work towards a standard that is workable and auditable and which balances costs and benefits and results in comparable and reliable financial statements. As Chairman Herz said in a December 12, 2002 speech, the Board must “make sure that our promulgation of standards that require fair value measurements doesn’t outstrip the ability of people in the real world to properly implement the concept.” The Exposure Draft entirely fails this mandate.

Issue 18: Understandability of the Exposure Draft

The Board’s stated goal is “to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence.” The Exposure Draft does not achieve this goal. It fails to recognize the essential elements of employee stock options that differentiate them from freely tradable options. Moreover, where the Exposure Draft attempts to recognize these differences, for example, by stating that black-out periods should be taken into account in the valuation, the Exposure Draft does not provide sufficient guidance to explain how this should be accomplished. For all of the reasons discussed above, we believe the proposed standard is wholly unworkable in the real world (e.g., treating each separate vesting as a separate grant) and, because of all the predictions of future events that would be required, unauditable.
We again reiterate our belief that the proposed standard is in need of complete revision and that any new proposed standard must be subject to extensive field testing prior to adoption.

We thank you for your consideration of our views and would be happy to discuss them further with the Board at the Board's convenience.

Sincerely,

The International Employee Stock Options Coalition

[Signature]

Kim Marie Boylan
Latham & Watkins, LLP,
on behalf of the International Employee Stock Options Coalition
Attachment to International Employee Stock Options Coalition
Comment Letter

June 30, 2004

File Reference 1102-100
January 22, 2004

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Mr. Herz:

On behalf of millions of U.S. employees and investors, the members of the International Employee Stock Options Coalition (IESOC) urge the Financial Accounting Standards Board (FASB) to conduct comprehensive field testing of multiple models for valuing employee stock options before proceeding any further with its pending project on stock options. Given the widespread recognition that an accurate and reliable method for valuing employee stock options does not exist, we respectfully suggest that investors, issuers and all stakeholders in the financial reporting system would be well-served by such testing.

Many coalition members are eager to participate in field testing, and to do so quickly. Indeed, there is FASB precedent for such testing, and at least one prominent organization has urged that FASB conduct field testing with respect to standard-setting generally. The IESOC stands ready to assist the FASB expeditiously, in any and all ways, in the development, implementation and analysis of the field tests.

Significant field testing of multiple valuation proposals with the open participation of broad industry groups, including technology companies, auditing firms and valuation consultants, would serve investors well and could help mitigate the growing controversy surrounding valuation. We suggest that at least 100 companies across numerous industry segments, as well as the Big 4 accounting firms and several valuation consultants, test multiple methods.

To date, most companies have applied the Black-Scholes method only in their footnote disclosures. It now appears that FASB will recommend not only the Black-Scholes method but also a binomial or similar method. There is no body of knowledge from footnote disclosures on these other methods, however, in terms of the assumptions companies would make and other key factors. Surely field testing makes sense under these circumstances in order to safeguard the integrity of financial statements.

A recent American Enterprise Institute conference underscored the need for field testing. Highly regarded finance, economic and accounting experts, including SEC Commissioner Paul Atkins, Glenn Hubbard, the former Chairman of President George W. Bush’s Council of Economic Advisors, and Kevin Hassett, AEI’s Director of Economic Policy Studies, identified, among other things, fundamental problems with existing valuation methods. Their comments, a summary of which is attached, provide further evidence that comprehensive field testing is warranted.
**Background**

The IESOC believes that broad-based employee stock option plans are integral to the formation and growth of high technology, biotechnology and other companies and that the current accounting treatment for stock options should be continued. In our view, stock options do not constitute an expense as no cash payment or outflow of corporate assets is made. The cost of stock options is borne by stockholders through potential dilution, and this expense is already accounted for, and disclosed to investors, in diluted earnings per share.

We agree that there should be greater visibility to stock options and, to that end, many of our member companies have proactively expanded their quarterly and annual stock option disclosures to provide further information to investors.

Latest reports indicate that FASB will require companies to expense all employee stock options pursuant to an existing option pricing model, i.e., the Black-Scholes model, or a binomial or similar model. Experts from numerous fields, expensing advocates and opponents alike, and numerous commentators have raised concerns that these models are highly inaccurate and unreliable when used to value employee stock options, as opposed to freely tradeable options.

The IESOC agrees. The Black-Scholes model, binomial methods, and Monte Carlo modeling all fail the tests of reliability, comparability and consistency. These existing methods simply do not produce credible, transparent, consistent, comparable and unbiased financial information. More specifically, under existing models:

- **Consistency and comparability will be at risk.** The need to make subjective determinations of the variables used in stock option valuation models will lead to a reduction in existing levels of comparability and consistency in financial reporting across companies and industries.

- **To date, accurate valuation of employee stock options has proven to be an impossible task.** Valuing stock options granted by high technology and biotechnology companies is particularly complex because estimating certain valuation variables is highly subjective and impacted by factors out of management's control.

- **None of the existing valuation models is currently adequate for valuing employee stock options.** We believe that the models under consideration by FASB fail to adequately incorporate factors unique to employee stock options and could subsequently compromise the reliability, integrity and comparability of financial reporting, as well as open the door to manipulation.

When one couples issues of volatility, expected holding periods, early exercise, forfeitures, risk free rates of return and trading blackout periods with common issues of the lack of a market, vesting requirements and non-transferability, it becomes crystal clear that there will be significant issues of accuracy and reliability within a company's financial statements as well as consistency and comparability across companies and industries.
While we continue to oppose in the strongest terms the expensing of all employee stock options, we recognize that FASB also continues to press forward. If the Board ultimately proposes mandatory expensing of all options on the face of the income statement, we believe it has an obligation – before adopting a new accounting standard – to consider multiple valuation methods, test them, and evaluate their accuracy and reliability.

**There is FASB Precedent For Field Testing**

FASB recently conducted field testing in connection with its project on business combinations (purchase/pooling). The purpose of such field testing was "to determine whether the approach that the Board is pursuing for accounting for goodwill that arises in conjunction with a purchase business combination is operational." A 1999 memorandum prepared for members of FASB’s Financial Accounting Standards Advisory Council discusses the key issue of goodwill amortization, and refers to the results of FASB’s field testing. Indeed, field testing "confirmed the Board’s concerns about the operationality of the proposed approach, the opportunities for gamesmanship the approach would have provided, and the lack of rigor in impairment testing." As a result, the Board changed its approach to amortization.

Records also indicate that the FASB conducted field testing in connection with its proposed standards for financial statements of not-for-profit organizations and accounting for contributions in 1994. In addition, FASB conducted field testing in connection with FAS 133 in 1996.

Field testing is the only prudent way to proceed on the stock options project:

- As before, the Board ought to determine whether its approach on valuation is "operational."
- As before, the Board ought to determine whether its approach on valuation will create "opportunities for gamesmanship."
- And, as before, the Board ought to determine whether its approach is sufficiently rigorous.

**Others Have Supported Field Testing Generally**

The Association for Investment Management and Research (AIMR) – an expensing advocate – has urged FASB to conduct field testing generally as part of the standard-setting process. In AIMR's words:

"AIMR's Financial Accounting Policy Committee has on several occasions communicated directly to the FASB in support of field testing in the standard-setting process. Field tests can be enormously helpful in identifying implementation problems that neither preparers nor users of financial statements could have anticipated at the conceptual level."

If there were ever a project for FASB to follow AIMR's recommendation, the stock options project must surely be it.

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FASB's "Cost-Benefit" Analysis is Inadequate

In September 2003, press reports indicated that FASB had decided to conduct "road testing" of actual valuation models. These media accounts reported that a number of companies "pledged cooperation in taking part in a 'road test' of the accounting standard before FASB formally issues" a new standard. Numerous companies volunteered to participate in such testing. It was widely understood that actual models would be tested for accuracy and reliability.

FASB has replaced the kind of field testing we recommend here with a cost-benefit kind of analysis that will not impart any relevant or material information about the accuracy and reliability of valuation methods. FASB has told companies that volunteered to participate in field testing that it will instead ask them to assess the out-of-pocket costs that they will incur as a result of attempting to comply with the new standard. FASB has communicated that it does not intend to actually test valuation models. In FASB's words:

"In particular, the Board seeks to assess and understand the costs, in qualitative terms, that would be required to design and implement a lattice option-pricing model. The scope of the Program does not include testing of lattice option pricing models.

The field testing program that we recommend is fundamentally different and considerably broader than FASB's ongoing "cost benefit" analysis. Such a broader program – consistent with what appeared to be FASB's original intent – is necessary for any number of reasons, not the least of which is the substantial controversy surrounding valuation.

Suggested Parameters for Field Testing Multiple Valuation Methods

As noted above, we believe that mandatory expensing of employee stock options using currently available valuation models compromises the core financial accounting objectives of comparability, reliability, trustworthiness and consistency. In our view, field testing should include elements that will produce data enabling reasonable judgments about whether expensing stock options enhances or erodes these core objectives.

In order to judge the impact of expensing on comparability, we recommend that field testing include several different industries and multiple companies within each industry. In addition, companies should be chosen that have markedly different levels of stock option usage. By carefully choosing the participants for field testing, FASB can obtain sufficient data bearing on comparability.

Field testing should also require participants to produce a variety of different estimates of their putative stock options "expense" using different valuation models and different inputs for each model for several prior reporting periods. Such data can be used to judge the year-to-year consistency of using a valuation model to determine the alleged "expense" and its impact on the reliability of financial statements.
Such data could also reveal the degree to which changes in the assumptions and inputs skew the outcomes of the various models. This data would allow FASB to assess the degree of trustworthiness (or untrustworthiness) of available valuation models.

We hope that FASB will consider these suggestions in designing field tests, and we would welcome the opportunity to provide further details on suggested methodology and approach.

Conclusion

Those who want to require the expensing of all employee stock options have the burden of demonstrating that such a new accounting standard would enhance the reliability, comparability and consistency of financial statements. Field testing of multiple valuation models across companies and industries is critical. The views of valuation consultants and auditors also are essential to determine the "workability" of any proposal.

The IESOC calls upon FASB to attempt to address the fatal shortcomings of existing option pricing models or develop a new model before mandating inclusion of materially inaccurate numbers on the face of financial statements. FASB should field test multiple models through footnote disclosure until it can be determined whether they do, in fact, "work." Coalition member companies would be pleased to work constructively with the Board in identifying the models to be tested, developing the methodology, identifying companies and industries, and analyzing the resulting data.

Sincerely,

Rick White
President

The IESOC supports broad-based employee stock option plans. It is comprised of trade associations and companies representing a diverse range of industries, including high technology, biotechnology, manufacturing and service companies, in the U.S. and abroad.

Memorandum from Mike Tovey to FASB Field Visit Program Participants, November 7, 2003, at 1 (emphasis added).