FREDERIC W. COOK & CO., INC.
90 PARK AVENUE, NEW YORK, N.Y. 10016 - TEL. (212) 986-6330
NEW YORK • CHICAGO • LOS ANGELES

May 10, 2004

Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Exposure Draft – Share-Based Payment:
An Amendment of FASB Statements No. 123 and 95

This letter presents the comments of Frederic W. Cook & Co, Inc. in regard to the above referenced Invitation to Comment. Our response is organized into two sections: first, option pricing models – a major issue; and second, comments and suggestions in other areas.

OPTION PRICING MODELS – A MAJOR ISSUE

If the FASB is to impose an earnings charge on financial statements for the value of employee stock options at grant, it is important that the method chosen for measuring that value be fair and reasonable, reflect real economic values and costs, and be comparable across various industry sectors. It is unclear whether the proposed models, which were developed for transferable options and warrants with relatively short terms, meet these criteria. Our experience, which includes working with over 1,500 companies over a period of 31 years, indicates that traditional option pricing models tend to overstate the value of employee options. Employees very rarely, if ever, are willing to purchase employee options at the values indicated by traditional option pricing models. While it might be argued that employees are more risk averse than a typical investor, we believe the unwillingness to pay values consistent with pricing models is due, in at least in part, to the special characteristics of employee options. These include nontransferability, nonhedgeability, and blackout periods before vesting. These factors indisputably reduce option value in relation to options without such conditions.

We support the FASB's objective of leveling the playing field between stock options and other forms of equity incentives. But, the playing field will not be level if the models used to determine expense overvalue options. Rather, such an accounting environment would bias practice against employee options in a way which diminishes or eliminates their usefulness.

The definition of "fair value" that the FASB uses seems fair and reasonable. To paraphrase the definition used in the draft guidance, fair value is the amount for which an equity instrument could be bought or sold in a current transaction between willing parties taking into account the **specific terms and conditions of the instrument to be valued** (emphasis added). However, the FASB offers no evidence that the proposed models produce a value that would meet this definition. In other words, the FASB is asking the business community to take this important precept as a matter of faith. The only explanation that the FASB offers that these models take into account the nontransferability of employee options is to allow companies to use expected option term rather than maximum term. No evidence is offered that this accommodation reduces the value of the employee option to the level that willing buyers would, in fact, pay for a nontransferable option.

We believe our skepticism about the ability of the option models proposed to accurately value employee options is shared widely in the business community. Before imposing these models on corporations which issue, and would like to continue to issue employee stock options, we strongly urge the FASB to **conduct a market-based test of the models**, and to **delay the effective date** of the new accounting standard until this test has been met and the results validated, audited and shared widely in the business community.

OTHER COMMENT AREAS AND RECOMMENDATIONS

1. **Restatement** – Companies should be allowed to restate prior period earnings in a manner consistent with the new requirements, using the same pro forma net income and EPS as disclosed in footnote disclosure under current FAS 123 for the prior periods. This will permit comparability of operating income from one period to the next, without the arbitrary effect of a major change in GAAP accounting.

2. **Graded vesting** – Companies should be allowed to continue to choose between straight-line accruals or front-loaded accruals when they issue equity grants with graded vesting. To mandate front-loaded accruals for all new grants introduces a tremendous amount of complexity and calculations, particularly for companies with monthly or daily vesting.

3. **Reload options** – There is no reason for an exception to the general principle of modified grant date accounting that states that the value of a grant should be measured at its grant date if it can be so valued. No reason is given for forcing this one exception on reload grants. Option valuation experts have testified that the value of a reload feature can be built into the estimate of fair value at grant. Companies that wish to include a reload feature should be allowed to do so without the requirement to value each reload grant separately, which is punitive.

4. **Equity restructurings** – Companies that undergo equity restructurings should be allowed to adjust their outstanding stock option/SAR grants using as a safe harbor the formulas and principles embodied in EITF 90-9. This would be much simpler than

forcing a comparative fair value calculation which might have unforeseen consequences on the grants and which will be quite difficult to explain or understand to participants and to shareholders.

— Examples would include the spin-off of a more volatile unit from a less volatile parent, or the acquisition of a less volatile unit by a more volatile parent

5. Pro forma disclosure – Paragraph B193 should be reworded so that companies are expressly permitted to make pro forma disclosures in their financial statement footnotes as to what net income and EPS would have been had there not been a fair value earnings charge for employee stock options. This would facilitate the interests of sophisticated investors who wish to assess the operating performance of companies without the estimated grant date value of stock options.

— More information is better than less information in the interests of transparency

6. Income taxes – It seems grossly unfair and asymmetrical to require that, in situations where the earnings charge for options exceeds the amount ultimately deductible, the incremental deficit flows through the income statement, but in the reverse situation the incremental positive bypasses the income statement and is a direct credit to capital surplus. The same treatment should be accorded either way. The same comment and suggestion of symmetrical treatment should apply also to statement of cash flows.

7. Footnote Disclosure – The footnote disclosures specified in paragraph B191b should be required for each year an income statement is required (as it is under current rules), not just the most recent fiscal year.

Sincerely,

Frederic W Cook

for Frederic W. Cook & Co.,
Compensation Consultants

cc: Mr. Michael W. Tovey