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New York • Chicago • Los Angeles

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VALUATION OF EMPLOYEE STOCK OPTIONS:
SUMMARY OF VIEWS FROM FASB'S OPTION VALUATION GROUP

At the core of the debate over the expensing of employee stock options is how to value such options accurately and fairly. The majority view of FASB's Option Valuation Group (OVG), a panel of nine experts dominated by members from academia, supports a non-specific, flexible approach to value options based on a contingent-claims framework* using "models and assumptions that a marketplace participant would use." This letter summarizes the majority views of the OVG in terms of estimating the model assumptions that are key in reflecting the differences between employee stock options and exchange-traded options. These views were expressed in a day-long public meeting with the FASB on July 8, 2003.

Estimating Volatility:

- The long-term nature of employee stock options places a premium on the volatility assumption
  - OVG members do not support the use of a single estimate of volatility but rather an initial estimate based on implied and historical volatilities and the use of a stochastic process to account for volatility changes through the life of an option depending on stock price paths and other factors such as reversion to the mean phenomena

Expected Life:

- The use of expected life to account for the valuation discount, inherent in employee stock options due to non-transferability, provides a poor and likely conservative value for employee stock options

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* "As the name implies, a contingent claim is an asset whose payoff and, therefore, whose value is contingent or depends on the value(s) of some other underlying asset(s). The contingent-claims framework is a methodology for valuation that explicitly recognizes this dependency and values the contingent claim as a function of the value of the underlying asset(s). The most prominent application of this approach is risk neutral valuation in which the underlying asset can be combined with a risk-free bond to replicate the returns of the contingent claim. When this replication is possible, the value of the contingent claim can be determined without the need to estimate the expected returns on the underlying asset. The Black-Scholes model is a special case of this." Dr. Stephen Ross (E-mail to the FASB, dated July 21, 2003.)

- OVG members do not support the use of expected life assumptions in valuing employee stock options as permitted currently under FAS 123

- Rather OVG members believe that exercise and forfeiture data can be readily analyzed to provide valuation adjustments to account for early exercise behavior based on stock price, vesting restrictions and perhaps demographic characteristics such as age and position within the company

Reload Options:

- A reload (or restoration) feature, or any stock price dependent feature, can be properly valued using a contingent-claims-based model

  - As such, a separate valuation would not be required for subsequent reload grants made after the initial option grant

Non-Public Companies:

- The use of the minimum option value model (MOVM) to value private company options provides estimates that are inherently wrong because the model assumes zero volatility

  - OVG members suggest that public company comparables provide suitable assumption estimates which can be used to value private company options in a contingent claims framework

Valuation of Restricted Shares Versus Restrictions on Option Exercise:

- OVG members believe that no discount for restricted shares is required based on the argument that there exist hypothetical third-party market participants that would accept a de minimis discount because they are large long-term investors in a particular stock (e.g., a large institutional investor such as CalPERS)

Conclusion

If the FASB elects to adopt a principles-based approach premised on the use of a non-specific flexible model, it will likely "lead to excessive complexity and high cost of application, a race to the bottom to find the lowest acceptable number, and poor comparability among companies using similar plans." These are the views of Fred Cook, our firm's Chairman, who is a member of the OVG and who does not share the majority's views of the best way to measure an expense for employee options. Further, if employee stock options survive as a viable long-term incentive for employees, such an approach would probably spawn a new valuation industry, like the pension valuation industry to administer and value option programs.

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General questions about this letter can be addressed to Fred Cook in our New York office at 212-986-6330 or by e-mail at fwcook@fwcook.com. Copies of this letter and our letter of July 14, 2003, to the FASB following the OVG meeting are available on our website at www.fwcook.com. Minutes of the OVG's July 8 meeting are available at http://www.fasb.org./board_meeting_minutes/07-08-03_ovg_minutes.pdf.