CHAMBER OF COMMERCE OF THE

UNITED STATES OF AMERICA

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Letter of Comment No: 322 A File Reference: 1102-100

Director of Major Projects Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference No. 1102-100

On behalf of the U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses and organizations of every size, sector and region, we submit the following comments in response to the Proposed Statement of Financial Accounting Standards, Share-Based Payment, an Amendment of FASB Statements No. 123 and 95. The Chamber strongly opposes the proposed amendments to require companies to expense stock options at "fair value" and urges FASB to retain the current policy of allowing companies to expense the intrinsic value and to disclose pro forma estimates of "fair value" and the impact of stock dilution, footnoted in corporate annual reports.

We believe the current approach is theoretically correct and provides all the necessary information for analysts and other interested parties to evaluate the value and operating potential of the firm, the compensation policy, and impact of options on shareholder dilution. If FASB feels that additional disclosure is necessary, we believe that such information can best be handled by expanding the disclosure requirements but continuing to keep such disclosure as footnotes.

First, we question the premise that a mandated expense for the "fair value" of employee stock options at grant is appropriate and whether it would result in a more accurate, comparable, or transparent representation of operating performance of the firm. We believe, as does FASB, that stock options are a form of compensation and that the "cost" of that compensation to the firm should be expressed as an expense on the income statement. However, we disagree that the best measure of that cost is the "fair value" of the option to the employee.

One can point to numerous forms of compensation and benefits where the cost to the firm differs from the economic value to the employee. Health insurance benefits are just one example. When a firm provides health insurance coverage to an employee, it reports the cost of the benefit, computed as the premium paid by the company to the health provider, as an expense. However, the value to the employee in virtually all cases exceeds the premium cost. That is why firms provide the coverage as a benefit rather than giving the equivalent cash to the employee and requiring the employee to obtain his/her own coverage. The reason for this difference

between "cost" and "value" stems not only from tax considerations but also from bargaining power. Similar arguments can be made for other forms of non-cash benefit compensation.

Forcing companies to expense the "fair value" of the option will result in a systematic overstatement of the cost, even if the "fair value" could be accurately measured or estimated. We believe that a more appropriate approach is the current policy which allows companies to follow APB 25 and report the "intrinsic value" of the option as an expense and to include an estimate of its "fair value" and dilution impacts in pro forma statements included in footnotes. The intrinsic value of an option issued with a strike price equal to the current price of the underlying stock is appropriately zero, that is, it creates no expense for the firm.

This point was recently emphasized in an article by Lawrence B. Lindsey and Marc Sumerlin that appeared in <u>The Wall Street Journal</u> on June 21, 2004. They write, "A true expense reduces the net asset value of the firm. But no such reduction in net asset value occurs when a stock option is granted. Granting an option does dilute the value of shares of existing shareholders by effectively increasing the number of potential shares outstanding. But, the total value of the firm and its profits remains unchanged; ..." The Chamber believes that such dilution effects can best be handled with augmented disclosure statements contained in footnotes.

Not only is the FASB proposal to use the "fair value" of the option as an estimate of the "cost" to the firm theoretically flawed, but the estimates of "fair value" are themselves subject to much controversy. The Black-Scholes and binomial methods were designed for freely tradable options, not employee stock options. Those models do not take into account the unique attributes and restrictions of employee stock options and, as a result, they systematically overstate the value of employee stock options.

The Black-Scholes model has been discredited by experts on both sides of the expensing debate. Binomial methods are untested and complex. In addition, the lack of specification and agreement on one valuation method sacrifices comparability. Companies in different industries, as well as companies within the same industry, will use different valuation methods with different assumptions and inputs. We are gravely concerned that the result will not be more clarity, transparency, and accuracy, but rather more confusion and a loss of confidence in financial statements. At the very least, we urge FASB to conduct comprehensive field testing of multiple valuation models before proceeding further.

An additional point of concern is FASB's approach to accounting for options that expire unexercised. The proposal would require that the "fair value" of options on the date granted be expensed over the vesting period. For options that do not vest, there would be no expense. However, when a vested option expires unexercised, FASB will not allow any restatement of the prior expense. We believe this treatment is inconsistent, illogical and will lead to a systematic overstatement of costs and understatement of profitability and the value of the firm. This practice will lead only to confusion and the expanded use of pro forma statements.

Finally, the Chamber shares FASB's desire for more accurate, transparent and useful financial statements, but we do not agree that the proposals contained in the exposure draft achieve this end. Instead, the proposals appear motivated by a desire to rein in a method of

compensation that has lost its "political correctness" and wrongly been associated with recent abuses in corporate behavior. On the contrary, we believe that stock options granted as incentive stock options or under employee stock purchase plans enable corporations to attract and retain employees, help to align the interests of management, employees and shareholders, and allow employees to participate financially in the success of the company. Over the past decade or more, companies have increasingly offered stock options and other employee ownership plans, traditionally reserved for executives, to their rank-and-file employees to help attract and retain workers, to help boost worker productivity and build team spirit. Indeed, according to a recent study, more than 14 million Americans hold stock options. This equity ownership has fueled the growth of small business, spurred innovation, and contributed to the competitiveness of U.S. businesses and strength of the economy in general.

The Chamber believes that adoption of the proposed standard would severely impair the flexibility that corporations have traditionally enjoyed in making these options available while producing no improvement in the clarity, transparency, accuracy or usefulness of financial statements.

Thank you for considering our views.

Sincerely,

R. Bruce Josten