

Letter of Comment No: 4041 File Reference: 1102-100

Business Roundtable

1615 L Street NW Suite 1100 Washington, DC 20036-5610

Telephone 202.872.1260 Facsimile 202.466.3509 Website businessroundtable.org

June 23, 2004

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

Henry A. McKinnell, Jr. Pfizer Chairman

Franklin D. Raines Faonie Mae Co-Chairman

Edward B. Rust, Jr. State Farm Co-Chairman

John J. Castellani President

Patricia Hanahan Engman Executive Director

Johanna I. Schneider Executive Director External Relations Dear Mr. Herz:

Re: Stock Option Expensing File Reference 1102-100

In response to the above-referenced Invitation to Comment, I'm writing to present the position of Business Roundtable.

Business Roundtable is an association of chief executive officers of leading corporations, with a combined workforce of more than 10 million employees in the United States and \$4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive workforce essential for future competitiveness.

Our membership reflects a diversity of views on the subject of whether options should be expensed, with some of our companies having elected to expense options currently under existing FAS 123, some having announced they will expense, and others having stated their view that expensing employee options is not appropriate or necessary. Consequently, our purpose is not to comment on whether or not option expensing should be mandated under GAAP.

However, our membership broadly supports the views reflected in this comment letter, and in particular the following key point: Business Roundtable believes that, if there is to be expense recognition for the value of an employee stock option at grant, the method of estimating that value must be fair and reasonable, reflect real economic values and costs, and be reasonably comparable across various industry sectors. We do not believe that FASB has demonstrated that the "fair value" models it has proposed meet these criteria, and we have serious concerns that, in fact, they do not meet this standard.

The Valuation Issue

Our concerns with the complexity of the proposed models and their ability to produce a credible fair value are shared by many in the business community, including, we understand, several large accounting firms. These concerns need to be addressed by FASB to maintain confidence in the credibility of GAAP.

The definition proposed for "fair value" is reasonable, namely, the price willing investors acting without coercion would be willing to pay for an equity instrument with similar characteristics (emphasis added). Yet no evidence is offered, nor have tests been performed, to determine whether the proposed lattice-based models produce value estimates which meet this definition. We believe the proposed models substantially **overstate the value of employee options** because they do not adequately recognize the special characteristics of such options, namely nontransferability, nonhedgibility, and black-out periods until vesting. FASB has not demonstrated that basing valuations on the expected life, instead of maximum life, of options adequately addresses these characteristics and concerns.

Consequently, our first and major recommendations are that FASB:

- (1) Conduct a market test to determine whether the proposed models produce grant values approximately equal to what a large number of active market participants would be willing to bid for call options on a diverse group of public stocks having identical characteristics to employee options on these same stocks,* and
- (2) **Delay the proposed implementation date** for the new standard until the test has been performed and the results validated, audited and shared widely with the business and investor community.

If the test determines, as we believe it will, that market participants would not be willing to pay a price for such call options equal or close to the grant value estimated by the model, then FASB must modify the model to meet its "fair value" definition and defer the proposed requirements for mandatory expensing until it has done so.

If the market test shows that the proposed models overvalue employee options, then instead of "leveling the playing field" there will be an accounting bias **against options**, with the result that a useful tool for motivating employees and aligning their interests with shareholders will be diminished or eliminated. We believe that any option expensing standard adopted by FASB must be policy neutral. We do not believe that ignoring the policy implications of a standard that could overvalue options is equivalent to being policy neutral.

^{*} FASB should encourage IASB to align IFRS 2 to any changes in FASB's proposed accounting standard which result from the test.

Other Concerns, Issues and Recommendations

- 1. <u>Footnote Disclosure</u> In order to enhance the transparency and investor understanding of option expensing, FASB should require companies to break out equity costs in the footnotes between (1) costs determined by option-pricing models, such as for stock options and stock appreciation rights, and (2) costs <u>not</u> determined by option-pricing models, such as for restricted stock and performance shares. The wide latitude afforded companies in making assumptions about inputs to the binomial model is likely to result in different assumptions, even within the same industry sectors, resulting in financial statements that are potentially more obscure instead of more informative. The ability of investors and the financial markets to evaluate the implications of option expensing and compare its effects across industries will be impaired or defeated completely if option expense is rolled into other equity compensation expense calculations. Alternatively, at a minimum, FASB should make clear that this is a permitted supplemental disclosure.
- 2. <u>Broad-based Plans</u> FASB should retain the 5% discount presently allowed for broad-based plans that are not subject to expensing under FAS 123. This roughly equates to the underwriting discount companies would pay in offering securities to the public, and therefore, is not a cost.
- 3. Restatements Companies should be allowed either (1) to restate options expense retroactively (which creates comparability between reporting periods), or (2) to use the proposed modified prospective method and report the alternative in the financial statement footnotes. Companies that have voluntarily early adopted current FAS 123 should be able to continue to apply the prospective method.
- 4. Tax and Cash Flow Symmetry FASB should correct the proposal's asymmetrical effects in treating excess tax benefits and excess tax deficits. As proposed, if the earnings charge for options exceeds the amount ultimately deductible from taxes, 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. This same suggestion of symmetrical treatment should apply also to the statement of cash flows.
- 5. <u>Graded Vesting</u> For grants with graded or serial vesting the widely common practice of having options vest incrementally over a term of months or years FASB should continue to allow companies a choice between straight-line accruals or front-loaded accruals instead of mandating the more complex front-loaded accruals. If front-loaded accruals are to be mandated for graded-vesting grants, then the effective date should be delayed at least a year because major systems modification will be required by many companies. We do not object, however, to identifying the front-loaded valuation approach as "preferred," so long as it is not mandated.

June 23, 2004 Page Four

Thank you for the opportunity to comment. The Roundtable looks forward to discussing our positions and answering your questions in person on June 29.

Sincerely,

John J. Castellani

cc: The Honorable William Donaldson

Chairman, Securities and Exchange Commission