

# EMPLOYMENT POLICY

Via E-mail: director@fasb.org

June 29, 2004

Ms. Suzanne Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856-5116

Letter of Comment No: 5544 File Reference: 1102-100

Re: FASB Exposure Draft No. 1102-100 (Share-Based Payment)

Dear Ms. Bielstein:

The Employment Policy Foundation (EPF) submits these comments to the Financial Accounting Standards Board (FASB) in response to the exposure draft of *Share-Based Payment* dated March 31, 2004. EPF is a non-partisan economic policy research and education organization that focuses on the consequences of workplace policies and trends affecting American employees and employers.

Employee stock option grants are an innovative compensation approach that encourages efficiency and productivity growth. For many companies, especially for those on the leading edge of technological change, employee stock options are an important element of an employment policy framework that encourages economic growth and rising prosperity. These comments address the impact of the proposed guidelines from that perspective.

#### Overview

The goal of ensuring high quality, transparent and comparable information should guide the design and implementation of accounting standards. Despite FASB's stated purpose to improve transparency and comparability of information, the proposed expense treatment of unexercised employee stock options may have the opposite effect – making accounting statements speculative and confusing. The proposed conjecture about the cost of unexercised stock options will not improve understanding of the financial health a company and may create a disincentive for companies to use employee stock options to increase productivity and to ensure that employees' interests are closely aligned with company performance and promote stockholder wealth maximization.

The issue of reporting employee stock options on financial statements is a question of how best to report the existence of option obligations. In the United States, employee stock options are already fully reported in financial statement notes. Changing the format of reporting to an Ms. Suzanne Bielstein June 29, 2004 Page 2

expense estimate at the time of the grant would only create confusion and make accounting statements less representative of actual firm performance.

## **Employee Stock Options Differ from Other Forms of Compensation**

The FASB proposal regarding stock options (and other share-based payments to employees) treats stock option grants identically with other forms of compensation. The requirement to recognize a stock option expense in the current income statement assumes that stock option grants are the same as wages, *i.e.*, they imply a cost that is both a certainty and clearly associated with company results (income) of the current period.

The reality is that stock options grants do not create a related cost in the current period. No cost, including the implicit cost of shareholder ownership dilution, is incurred until and unless the option is exercised. Options typically are not exercisable until several years after the grant. When and whether they are exercised depends on future conditions and future costs.

Regardless of cost, a stock option grant is not associated with performance of the employee or the company in the current accounting period. An option is explicitly granted as an incentive for future performance. The option exercise price is set higher than the current market price of the company stock to motivate the employee to invest his or her personal effort and imagination in the company in ways that will result in more profitable performance and result in a higher stock price in the future. The prospective performance basis of the grant is what makes stock options different from other forms of compensation.

### **Stock Options Differ from Other Options**

The draft proposes that, in the absence of an established market price for options, a firm should estimate the fair value of options granted by applying an option-pricing model that takes into account various factors. The problem with such a guideline is that employee stock options typically differ from other options in three important ways, each of which negatively impacts the accuracy of the proposed methods of option valuation.

First, most employee stock options are not transferable. Typical options written in the context commodity and stock markets are bearer contracts. In contrast, employee stock options can only be exercised by an individual who is originally granted the options. The lack of transferability likely reduces the value of employee stock options and makes any forecast of value less precise.

Second, employee stock options have longer time constraints than market-traded options. Typical options expire in one to six months. Employee stock options often expire in four to six years after being granted. The time considerations associated with employee stock options make their value at grant highly speculative and difficult to estimate.

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Third, employee stock options typically have no intrinsic worth at issue. The intrinsic worth of a stock option is the difference between the market price of the stock at the time of the option grant and the strike price. Employee stock options are usually issued at or above the market price at the time of the grant. Even if their value were not constrained by vesting periods that prevent exercise until a later date, the intrinsic value at grant would be zero. Stock options only become valuable if employee loyalty and productivity translate into increased earnings and competitive success.

Given the nature of stock options, present methods of modeling other option prices are unsatisfactory for producing accurate or meaningful estimates of the value of employee stock options that might be exercised over long periods. Black-Scholes estimation can hypothetically calculate values for tradable stock options. However, the Black-Scholes method does not provide accurate forecasts of the market value of employee stock options because of afore-mentioned differences between non-tradable employee stock options and other option contracts. Other methods involve pure guesswork by so-called market experts and subjective appraisers.

The Internal Revenue Service recognized the inherent difficulties of valuing employee stock options by allowing corporations to deduct the net cost of stock options from corporate income taxes only after an option is exercised, and the deduction is from the taxable income in the year when the contract is exercised. This practice reflects the reality that proper valuation of an employee stock option is not certain until it is exercised.

### FASB Should Approach the Stock Options Issue Cautiously

EPF believes the need for caution in designing guidelines regarding the recognition of unexercised employee stock options is critical. Changes to current accounting guidelines could create disincentives to use a compensation innovation that has been shown to improve worker performance, increase productivity growth, and raise the value of stockholder equity. In 2000, between 8 and 10 million employees held unexercised options, and since 1992 the number of employees holding stock options has increased 10-fold. Undoubtedly, the prevalence and extent of broad based employee stock options would decline if companies were compelled by new guidelines to account for employee options, which cannot be accurately valued.

If stock options were eliminated entirely, EPF estimates suggest the total productivity growth in affected firms would be reduced by 16 to 19 percent over a 10-year span. This estimate is based upon the most comprehensive study to date comparing companies that offer broad based stock option programs with those that do not.<sup>2</sup> Based upon growth in the use of broad-based stock option compensation programs since 1992, the number of employee option holders could grow to 30 million employees by 2020. These employees and the stockholders for whom they work would be directly harmed by the proposed changes to accounting guidelines. If stock options were eliminated, each employee could cumulatively lose up to \$80,000 in compensation over the next 15 years, and stockholders would lose concomitantly as slower productivity growth translates into lower profits and less productivity growth. Even if implementation of the

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proposed guidelines did not lead to complete elimination of employee stock option grant by firms, they could greatly reduce use of a valuable tool for spurring productivity growth. Accounting for options before they can be properly valued will discourage the broad based provision of employee options leading to some reduction of productivity growth over the next decade. Negative consequences associated with changes to current accounting practices suggest caution should guide attempts to account for unexercised options.

#### Conclusion

Stock options have become an important part of employee compensation. However, unexercised stock options possess unique characteristics, which require special treatment in accounting for their value. Although the current practice of disclosure in notes serves to inform users of financial statements, attempting to recognize unexercised options through speculative expense deductions in financial statements could produce serious negative consequences for private sector productivity growth, employee welfare, and stockholder wealth.

Sincerely yours,

/signed/

Edward E. Potter President

<sup>&</sup>lt;sup>1</sup> National Center for Employee Ownership, "Current Practices in Stock Options Plan and Design."

<sup>&</sup>lt;sup>2</sup> Joseph Blasi, Douglas Kruse, James Sesil and Mayo Kroumova, "Public Companies with Broad-based Stock Options: Corporate Performance from 1991-1997," National Center for Employee Ownership, 2002.