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Letter of Comment No: 5851
File Reference: 1102-100

From: Kimberly Pinter [KPINTER@nam.org]
Sent: Wednesday, June 30, 2004 4:20 PM
To: Director - FASB
Subject: File Reference No. 1102-100

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

RE: File Reference No. 1102-100

Dear Ms. Bielstein:

On behalf of the National Association of Manufacturers (NAM), I respectfully submit our comments and position on the FASB's March 31, 2004, exposure draft of a proposed statement on accounting for share-based payments that would amend FASB statements nos. 123 and 95 and supersede APB 25.

The NAM is the nation's largest industrial trade association. Our 14,000 members include 10,000 small and mid-sized companies and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country. The NAM's mission is to enhance the competitiveness of manufacturers and to improve American living standards by shaping a legislative and regulatory environment conducive to U.S. economic growth, and to increase understanding among policymakers, the media and the public about the importance of manufacturing to America's economic strength. We appreciate this opportunity to present our views on the proposed standard.

The NAM strongly supports broad-based employee stock option plans as a way to encourage employee ownership, help create jobs, enhance productivity, and keep U.S. companies competitive. As detailed in our comments below, the NAM has serious concerns about the FASB's proposal to require mandatory expensing of stock options. Mandatory expensing would increase the cost of using stock options, particularly broad-based plans, and could lead to the elimination of these important incentives. Additionally, at a time when manufacturers are at a 22 percent cost disadvantage vis-à-vis their foreign competitors and even non-market economies are recognizing the growth and productivity benefits of offering stock options, we believe that it is especially ill-advised to further tie the hands of American companies by making options too expensive to offer to attract and retain talent.

Specific Concerns

Recognition of Compensation Cost

Issue 1:

The NAM does not agree with the Board's conclusion that employee stock options should be recognized as a compensation expense. Stock options are granted by employers to align the interests of employees with those of the company and encourage future behavior rather than compensate past performance, and thus are not properly classified as "compensation." Moreover, they represent a potential ownership interest in the company rather than a claim on company assets. Dilution of ownership is already reflected in the EPS calculation and should not be counted again as an expense against company assets.

Issue 2:

Furthermore, the NAM disagrees with the Board's conclusion that stock options should be recognized as a compensation cost in the financial statements rather than allowing supplemental pro forma disclosure of net income and earnings per share (EPS) information. The current footnote treatment of stock options allowed by APB 25 is appropriate because it both accounts for stock option grants and properly qualifies the information contained therein. Current methods used to value stock options have proven to be wildly inaccurate. To include a number based on these valuations models in the actual earnings calculation rather than in a footnote implies that the number is an accurate measure rather than speculation, as is in fact the case. Consequently, this practice would result in less accurate, less transparent financial statements.

Measurement Attribute and Measurement Date

Issue 3:

While traditional accounting principles generally require valuation of speculative instruments at grant date and fair value is probably the right measure, there is no valuation model currently available to accurately ascertain the "fair value" of employee stock options. Consequently, if the board insists on moving ahead with the current proposal and require companies to use an inaccurate model to determine valuation at grant date, it would be appropriate to allow for some type of "truing up" mechanism to reconcile the financial statements with what actually occurred.

Fair Value Measurement

Issue 4:

Employee stock options are an instrument that serves to align the interests of the employee with the interests of the company. A number of unique features of stock options further that goal while at the same time making them very different from other more conventional devices and therefore very difficult to value. For example, unlike traditional "options," employee stock options are not transferable. In fact, they do not even belong to the employee at the time they are granted. Instead, the options "vest" over a period of time, generally two to five years. Because the company's *future performance* determines the value of the options, delayed vesting provides an incentive for the employee to stay with the company and do his or her part to make the company as productive and successful as possible. This attribute serves to give the employee a piece of the American dream and a sense of entrepreneurship. It also injects a high level of speculation into any attempt at valuation because there is no guarantee that the options will ever vest in the first place.

Even if the options do vest, employees often have a number of years to exercise the options, and there is no way to predict when they might be exercised. Additionally, if the stock price has fallen since the grant date, the options will be "under water" (i.e., worthless) and will never be exercised. Currently available valuation models do not adequately address this possibility.

Another valuation issue that is not effectively addressed is volatility. Generally speaking, the volatility of some exchanges is higher than others, and similar stocks on two different exchanges could be subjected to vastly different volatility assumptions. A uniform volatility assumption would improve financial statement comparability.

The FASB's exposure draft basically allows use of the binomial or Black-Scholes method, which are intimately related. Consequently, the issue is not whether there is sufficient comparability based on what method is chosen but whether these methods are reliable. In the words of Mark Rubinstein, a finance professor at UC Berkeley's Haas School of Business and one of the developers of the binomial method (preferred by the FASB), "Don't use it. It doesn't work." ("Pitched Battle on Options, Federal Regulators Face Off against Tech Companies at Palo Alto Forum on Expensing," San Francisco Chronicle, 25 June 2004, P. C1) The NAM agrees that these methods are not accurate and that expensing should not be required – if at all – unless and until a more accurate valuation method is available.

Employee Stock Purchase Plans

Issue 6:

The NAM does not agree with the FASB's conclusion that an employee stock purchase plan (ESPP) should be considered non-compensatory only if the terms of purchase afforded the employee are no more favorable than those available to all holders of the same class of shares. Both APB 25 and FAS 123 currently permit an issuer to provide a discount for employee stock purchases. A discount is appropriate because ESPPs provide companies an alternative means of raising capital rather than issuing stock on the open market. The discount afforded employees through ESPPs reflects the savings realized by the company in reduced transaction costs and regulatory compliance compared to a public offering. Therefore, a safe harbor discount should be preserved to keep the cost of capital raised through ESPPs on par with the cost of capital raised through a wider offering.

Additionally, the impact of characterizing an ESPP discount as *per se* compensatory would make it more expensive for companies to offer ESPPs and could lead to their elimination at many companies. This result would be contrary to the intent of Congress when establishing ESPPs, which were specifically designed to encourage employees to voluntarily become owners of the companies for which they work. Therefore, the incentive nature of ESPPs should be preserved, and any ESPP that complies with Internal Revenue Code requirements should not be subjected to onerous new accounting rules.

Conclusion

As discussed above, the NAM does not agree that stock options are a compensation expense. Furthermore, even if stock options are classified as an expense, there are no accurate valuation models currently available. Therefore, expensing should not be made mandatory unless and until more accurate methods can be established. In the event companies are required to use an unreliable valuation method, they should be allowed to later use a truing up mechanism to reconcile their prior statements with reality. Finally, we believe it is inappropriate to include ESPPs in any new standards mandating stock option expensing.

Given these conclusions and the significant potential of negative impact on U.S. manufacturers, their international competitiveness, and the economy as a whole, we strongly urge the FASB to conduct comprehensive field testing before finalizing a new rule. Field testing to determine whether the proposed valuation models result in realistic, market-based, grant-date values should be an integral part of the rule-making process. We further urge that the proposed implementation date be delayed until such testing can be completed.

Thank you in advance for considering our views.

Sincerely,



Michael E. Baroody