

Karen Salmansoh:

From: Director - FA

Sent: Wednesday,

To: Karen Salmansoh

Subject: FW: File Reference No. 1102-001

Letter of Comment No: 281
File Reference: 1102-001
Date Received: 2-12-01

Karen, this comment letter should go out tomorrow morning. It is not necessary to send the index with this letter.

Len

-----Original Message-----

From: carlo.pippolo@ey.com [mailto:carlo.pippolo@ey.com]

Sent: Wednesday, February 12, 2003 2:54 PM

To: Director - FASB

Subject: File Reference No. 1102-001

Attached is our initial comment letter in response to the FASB's Invitation to Comment on the Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed IFRS, *Share-Based Payment*.

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February 11, 2003

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

Invitation to Comment

Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed International Financial Reporting Standard (IFRS), *Share-Based Payment*

Dear Ms. Bielstein:

Ernst & Young appreciates the opportunity to respond to the Invitation to Comment on the Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed IFRS, *Share-Based Payment*. Given the increasing use of stock-based compensation by enterprises throughout the world, Ernst & Young believes that it is important to develop an internationally agreed upon approach to the manner in which stock-based compensation is reflected in the financial statements of issuing enterprises. Therefore, we strongly support the efforts of the FASB and the IASB to achieve that end.

As this letter explains in more detail, after revisiting this issue in light of the current circumstances, and despite our continuing concerns about reliably valuing employee stock options, Ernst & Young supports the efforts of the FASB and IASB to promote a worldwide accounting standard requiring the recognition of the cost of stock-based compensation based on the fair value of those awards on the grant date. The need for more relevant compensation expense information exceeds the risks associated with the reliability and comparability of the measurement of compensation expense. Valuation experts continue to work to develop option-pricing models that will result in better estimates of value for employee stock options. We support these efforts and hope that the IASB and FASB will consider the resulting advances in valuation techniques as they deliberate how the fair value of stock options and other equity awards should be measured.

As indicated in our previous comment letters regarding Statement 123 and the G4+1 Special Report, *Accounting for Share-Based Payment*, Ernst & Young previously opposed the accounting for employee stock options at fair value because of its concerns

about the subjectivity and reliability of employee stock option values derived from option-pricing models. Such models were not designed for employee stock options and, as a result, both Statement 123 and the Proposed IFRS require that the assumptions used in option-pricing models be arbitrarily modified to derive a value that is asserted to take into account the unique aspects of employee stock options, for example, the lack of transferability and vesting requirements. We continue to be concerned that the subjectivity of certain assumptions that have a dramatic impact on option values (e.g., volatility and expected life of the option) significantly reduces the reliability and comparability of estimated values for employee stock options.

However, there are significant benefits associated with accounting for employee stock options at estimated fair value as opposed to an intrinsic value model followed by most companies in the United States. In the current environment in which investors and regulators are scrutinizing corporate governance practices, the greater transparency from fair value accounting for employee stock options provides more relevant information to investors than a model such as APB Opinion No. 25, *Accounting for Stock Issue to Employees*, which typically results in the recognition of no compensation expense regardless of how many options are granted to employees. An intrinsic value model provides a disincentive against granting performance options (which are subject to "variable accounting") whereas many compensation experts believe such performance options represent better approaches to creating appropriate incentives for employees. The disincentives in Opinion 25 against the use of certain types of stock-based compensation are not economically justifiable and drive inappropriate business decisions.

The intrinsic value accounting model under Opinion 25 has resulted in a large number of practice issues. The FASB and EITF have issued over 200 pages of accounting rules to help preparers apply the accounting model. The model has become much too complex and rules-based, a situation that often results in an unintentional misapplication of the rules. Accounting implementation issues undoubtedly will arise under a fair value model, but there will be significantly fewer issues as the underlying principles of a fair value model are more easily understood. The resulting accounting for different stock-based compensation arrangements and changes to these arrangements will be easier to apply than the Opinion 25 model, although the valuation challenges raised by a fair value model clearly are more difficult than under an intrinsic value model.

During the debates surrounding the FASB's stock compensation project that led to the issuance of Statement 123, many users of financial statements, particularly analysts that publicly commented on the FASB's proposal, were not supportive of the FASB's proposed model for accounting for employee stock options. Based on our review of comment letters received by the IASB on its project, it appears that analysts today are much more supportive of a fair value model for recognizing expense associated with employee stock options. Also, due to the pro forma disclosure requirements of Statement 123, preparers and auditors have an increased familiarity with option-pricing models today compared to ten years ago. In addition, the use of option-pricing models in the design of compensation arrangements has become more prevalent in the last decade.

We have reviewed the IASB's Proposed IFRS and will respond separately to the IASB with our comments. Because our views on the IASB's proposal, as well the differences between that proposal and Statement 123, will be developed in cooperation with our international member firms, we expect to submit our response to the IASB on or shortly before its comment letter deadline of March 7, 2003. Because of this time frame, we will not be able to respond to the detailed questions in the Invitation to Comment before the deadline imposed by the FASB. However, once we have submitted our comment letter to the IASB, we will respond to the detailed questions in the Invitation to Comment. We hope that the Board will consider those comments if and when it begins deliberations on any stock compensation project.

It is unfortunate that the February 1, 2003 comment deadline falls during a period of intense activity among many financial statement preparers and auditors with respect to the issuance of annual financial statements, responding to the many rules proposals recently issued by the SEC, and implementing provisions of the Sarbanes-Oxley Act. The stock-based compensation accounting model currently applied by most U.S. companies has existed for over 30 years. While we understand the Board's desire to reconsider the accounting for stock-based compensation, concerns about delaying that reconsideration by a few months should not outweigh the need to engage in rigorous, deliberate due process, particularly in light of the potential controversial nature of the issue.

Ernst & Young will be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP