

PROSHARE

Letter of Comment No: 85
File Reference: 1102-001
Date Received: 1-31-03

FASB: ACCOUNTING FOR STOCK-BASED COMPENSATION

INVITATION TO COMMENT November 18 2002

COMMENTS FROM PROSHARE

BACKGROUND

1. ProShare welcomes this opportunity to respond to the FASB's Invitation to Comment issued on 18 November 2002.
2. ProShare is the UK's leading independent organisation that promotes wider share ownership and financial education. One of our key roles is to promote employee share plans, especially broad-based plans. We help companies that wish to put such plans in place, we carry out research and surveys of market practice, we train and develop share plan professionals and we recognise best practice through our annual awards. In addition we campaign for a favourable regulatory and tax environment for employee plans.
3. Almost all UK listed companies, and many unlisted companies, have tax approved all employee plans. We estimate that at least 2,000 companies have one or more all-employee plans. The UK has the highest incidence of broad-based employee plans in the European Union.
4. In addition, employee plans are now the single most important route in the UK to becoming a private investor and have made a significant contribution to savings by employees. The initial value of all the stock and options distributed to employees under tax-approved plans is estimated to have exceeded £35 billion.

IASB PROPOSALS AND FASB'S RESPONSE

5. We have been following closely the debate on accounting for share-based payments since the Discussion Paper issued by the G4+1 Group in July 2000. We have attended most of the IASB meetings on this issue and earlier this month we invited Bob Garnett and Kimberley Crook from the IASB to address a large group of UK businesses and share plan professionals on ED2. We are currently preparing our response to the IASB on ED2, to the UK's ASB on FRED31 and to EFRAG on their Comment Letter.
6. ProShare believes strongly in the principle of international convergence in accounting standards and therefore welcomes the approach taken by FASB. There is a need for a new standard on share-based payment that would be adopted worldwide. It is vital that this includes the United States either by the FASB adopting a new International Financial Reporting Standard or by introducing changes to FAS 123. If not, we are firmly of the view that the differences in

accounting treatment would be so significant as to create an uneven playing field between the US and other countries which would distort the allocation of capital and future employment patterns.

KEY CONCERNS WITH ED2

7. In brief, our key concerns with ED2 are:

- The inclusion of all share plans. We believe that any new IRFS should make it clear that all-employee plans fall outside its scope on the grounds that these are in principle different from stock option plans and other plans offered largely to executives on a discretionary basis. All-employee plans are not offered in return for services and are not seen as part of the pay package by employers or employees. By way of contrast, executive and discretionary plans are often regarded as part of remuneration.
- The difficulties in adapting option-pricing models to value employee stock options, especially in the case of smaller companies or companies that find it difficult to estimate their share price volatility or future dividend yields.
- The complexity of the proposed calculations. In particular the need to adjust the fair value of the option to reflect the expected units of service and then readjust for the actual units of service received.
- The sensitivity of some of the disclosure requirements.

PROSHARE COMMENTS ON FASB ISSUES

8. Our comments are focussed on two Issues where we see a fundamental difference between the approach adopted by FAS 123 and that suggested in ED2. If such differences are not aligned in some way, we believe that there would not be sufficient similarity between the two standards and the objective of international convergence would have failed. In both cases, we tend to prefer the approach taken in FAS 123 to the approach taken by the IASB.

9. The three key areas are:

- Issue 1 –exclusion for non compensatory plans
- Measurement
- Disclosure

Issue 1

10. We support the approach taken in FAS 123 to exclude ESOPs and certain ESPPs. We think that the principle behind this approach is correct. In these cases the company does not receive employee services in return for shares or options. As in the UK, participation in all-employee plans is open to all, the

level of participation is determined by the employee (within the statutory limits) and two key objectives of such plans are to help employees to benefit from the success of the company and to encourage saving and retirement planning.

11. We do not therefore accept that, in these circumstances, an asset of “employee services” exists that is immediately consumed and no accounting entry for an expense should be required.
12. The benefit that results from participation in such plans is not easily defined, but it is not “nothing” as the IASB claim in BC32. It may be represented by an increase in intellectual capital through a more motivated and better-trained workforce or it might be described as “corporate glue”. It relates to corporate culture, general employee satisfaction, motivation and employee engagement with the aims of the business, and is not something attributable to the daily efforts of any individual employee.
13. Such a benefit is also difficult to measure but it is nonetheless a real and generates an enduring intangible asset which explains why existing shareholders agree to dilute their holdings through the issue of new shares at a discounted price to employees. We would argue therefore that, the correct approach is that adopted by FASB which is to treat these plans as “non-compensatory”.
14. If the FASB decide to maintain this distinction, we would however ask that the criteria need to be better developed than as currently set out in FAS 123. We say this because recent decisions by the FASB in this area have, in our view, been somewhat arbitrary and have tended to favour US plans over other similar non-US plans. We would suggest that in determining whether a plan is non-compensatory, it would be better to adopt a principles based approach, rather than a rules based approach.

Measurement

15. We note the fundamental differences between ED2 and FAS 123 as regards measurement. We should perhaps begin by saying that we think that the measurement approach taken in ED2 is flawed in that there seems to be an element of double counting in adjusting the fair value of the option to reflect anticipated service, and then readjusting the estimated charge to reflect the actual units of service received.
16. Assuming this is corrected, we would still have the prospect of two fundamentally different measurement bases. The ED2 approach is firmly grant-based whereas the FAS 123 uses a mixed grant-vesting approach. This could produce material differences in the charge made to the accounts depending on which standard was being used. For example, in a case where a large number of options lapse because the options are underwater at the time of vesting and during the subsequent window of exercise, the amount of the

charge to the accounts would be significantly different, depending whether it is calculated under FAS 123 or ED2.

17. We find it difficult to say which basis of measurement is “right” – as it appears do many contributors to the option accounting debate. We therefore think that the IASB and FASB need to reconcile this fundamental difference in approach before any new IRFS is introduced. Failure to reach agreement on this point would jeopardise the steps being taken to achieve convergence.

Disclosure

18. Although we applaud the transparency achieved by full disclosure, we are concerned about the ED2 requirement to disclose sensitive commercial information in order to explain the basis for estimating the value of share-based payments. We are disappointed that this point is not discussed in the Invitation to Comment, and we would urge FASB to give it serious consideration.

31st January 2003

ProShare (UK) Ltd
ProShare
Centurion House
24 Monument Street
LONDON
EC3R 8AQ

Tel: + 44 (020) 7220 1756
Fax: + 44 (020) 7220 1768
E-Mail: diane.hay@proshare.org