

THE CHARLES SCHWAB CORPORATION

101 Montgomery Street, San Francisco, California 94104

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Letter of Comment No: 205

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Suzanne Bielstein, Director - Major Projects :
Financial Accounting Standards Board
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Re: 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 IFRS, Share-based Payment (File Reference No. 1102-001)

Dear Ms. Bielstein:

The Charles Schwab Corporation (the "Company") is pleased to respond to the FASB's 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 IFRS, Share-based Payment*. We strongly support the FASB's objectives of improving U.S. financial accounting and reporting standards and promoting international convergence around high quality accounting.

We believe the IASB should adopt the US standard of accounting for employee stock options as a basis for convergence, rather than divergence, of international accounting standards. The relative magnitude of employee stock options issued by US companies compared to others requires the FASB and its constituents to be leaders in the process of evaluating accounting standards for employee stock options, not followers of the international board. In its Invitation to Comment, the FASB requested suggestions on how application of option-pricing models and the consistent use of key assumptions might be improved to provide better estimates of compensation expense. Therefore, our comments herein address the US accounting standard for employee stock options as it relates to the application of option-pricing models. We have also commented on other selected issues of interest to us.

Summary

Individual investors need reliable financial information in order to make informed investment choices. We believe the information about employee stock options included in financial statements should be comparable between publicly traded companies. The current accounting standards involve a series of multiple choices in accounting for employee stock options, such as whether or not employee stock options are recorded as an expense, which of three different methods of recording the expense is selected, which option-pricing model is used, and differences in assumptions around inputs to these models. This lack of consistency erodes the individual investors' ability to understand financial statements because different companies are not calculating and reporting the option value in the same way.

THE CHARLES SCHWAB CORPORATION

While there continues to be extensive debate in the investment community about whether options should be expensed, we understand the desire for heightened transparency in this day and age. Accordingly, the discussion around expensing options is a valuable, albeit controversial topic. If the “will of the people” is to expense employee stock options, we are concerned that the FASB has not established a uniform valuation standard to ensure comparability among different companies. Therefore:

- We are concerned about the lack of a standardized valuation model that appropriately values the unique characteristics of employee stock options and the lack of comparability of calculated stock option values between companies.
- We are concerned about the lack of transparency in determining the inputs to the models used to calculate hypothetical values for employee stock options.
- We are concerned about the negative economic impact the FASB’s actions might have in limiting the use of broad-based employee stock ownership plans.

Though we do not object to recognition in the financial statements of measurable and meaningful economic information, we do object to the creation of a “fictitious” expense resulting from option-pricing models that clearly and significantly overstate the cost of employee stock options. Further, we believe that recording a hypothetical value for stock option awards using subjective assumptions produces unreliable information for shareholders and other financial statement users.

We believe it is necessary that the FASB adopt a uniform approach to valuing employee stock options because we do not see that an agreed-upon methodology exists today. We recognize that in issuing Statement 123, the FASB had hoped to encourage the development of improved methods of valuing employee stock options that would eventually result in better accounting for stock-based employee compensation. To date, this has not been achieved. We also note that a number of the valuation principles required by Statement 123 are not necessarily theoretically sound, but are a compromise to encourage adoption of fair value accounting where a consensus could not be reached after a prolonged and divisive debate.

Until a standardized employee stock option-pricing model is adopted, we believe continued full disclosure of stock option activity is the appropriate accounting model. In fact, after a number of conversations with our institutional stockholders and other members of the investment community, we are convinced that a significant segment of that community relies primarily on this information when assessing the cost of option programs.

Overall Comments Regarding Options-Pricing Models

No market exists for employee stock options. Further, the estimated fair value of employee stock options using an option-pricing model will never be validated by an actual stock transaction. Statement 123 is the only US accounting standard that does not provide some mechanism to “true-up” an estimated expense when all the relevant uncertainties included in the

THE CHARLES SCHWAB CORPORATION

original estimate have been resolved. For this reason, the model or technique used to value employee stock options must be highly reliable and have broad acceptance by investors.

We do not believe that existing option-pricing models, such as the Black-Scholes and binomial option-pricing models provide fair value estimates within acceptable limits for recognition in financial statements. The assumptions regarding volatility and expected life of options are not standardized and result in significant variability in the outcome of the models. These models also do not fully reflect the discount required for non-transferability. Therefore, the existing option-pricing models overstate employee stock option values by some significant amount.

We believe a standardized employee stock option-pricing model should be developed to provide for the unique characteristics of employee stock options including non-transferability, the impact of early exercise, and the illiquid market for long-dated derivatives. Specifically:

- An option-pricing model that places less reliance on stock volatility would be more appropriate and preferable.
- A discount for the lack of transferability is essential for valuing employee stock options. An option that has substantial restrictions is clearly worth less than a freely tradable option. Published research supports this observation.

As the FASB has articulated, a stated objective of issuing stock options is to align employee interests with those of shareholders and thereby motivate employees to work to maximize shareholder value. At Schwab, we support the use of broad-based employee stock option plans. The consequences of an accounting standard that “over-prices” such options for expensing on its financial statements will be to curtail or eliminate their use.

Conclusion

The existing valuation techniques used to value traded options, including the Black-Scholes and binomial option-pricing models, do not value employee stock options in a manner that is reliable and useful to making investment decisions. The range of uncertainty in volatility assumptions used in these models does not provide a reliable and consistent estimate of fair value. Further, these models do not fully reflect the discount required for non-transferability of employee stock options.

We encourage the FASB to adopt a standardized employee stock option-pricing model that takes into account the unique characteristics of employee stock options not accommodated by existing models. Until such a model is available, we believe that continued full disclosure of employee stock option activity is the appropriate accounting model.

We would welcome the opportunity to participate in a cross-industry task force charged with developing an employee stock option-pricing model that meets the criteria we have described in this letter.

THE CHARLES SCHWAB CORPORATION

Response to Selected Issues for Respondents

Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions.

Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?

Yes, we believe the standard should mandate the use of an employee stock option-pricing model that takes into account the characteristics unique to these financial instruments. These unique characteristics include the following:

- Long term
- Illiquid market
- Restricted and non-transferable
- No ability to realize gains prior to vesting
- No ability to realize the “time-value” of the option between the exercise date and expiration date

It is unlikely that a trading market will ever develop for options with employee stock option characteristics and therefore this hypothetical model may never be validated. For this reason, the model should be standardized to provide comparable results across different companies related to volatility inputs and should apply a discount for non-transferability.

Issue 2(b): If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why?

As discussed in our response to 2(a), we believe a standardized employee stock option-pricing model should be mandated. Providing alternative valuation techniques or accounting methods does not achieve a level playing field for companies that utilize employee stock option plans.

We do not believe that the existing option-pricing models, such as the Black-Scholes and binomial option-pricing models, provide fair value estimates within acceptable limits for recognition in financial statements. The assumptions regarding volatility and expected life of options are significant to the outcome of the models, are not standardized, and result in significant variability in the outcome of the models. These models also do not fully reflect the discount required for non-transferability.

By way of illustration, the weighted average fair value of stock options granted in 2001 by the Company was estimated to be \$7.26 per option using the Black-Scholes option-pricing model

THE CHARLES SCHWAB CORPORATION

and assuming an expected stock volatility of 50%. A modest increase in the volatility to 60% results in a value of \$8.32 per option, a 15% increase in value. We have surveyed the broker-dealer companies we consider to be comparable to the Company and found that the volatility assumptions used by these companies to estimate fair value of employee stock options for 2001 ranged from 30% to 90%. Substituting this range in the Black-Scholes model for the Company's 50% volatility assumption results in a range of fair value of \$5.15 to \$10.89 per option. This represents a 30% to 50% variance around the Company's estimate due to a change in a single input to the model. Clearly, this range of uncertainty does not provide a reliable and consistent estimate of fair value.

The restrictions inherent in employee stock options, such as the inability to transfer the option to a third party for cash, cause the value of an employee stock option to be less than the value of a tradable option before the expiration date. However, even with adjustment for the expected life of options, it is generally accepted that the Black-Scholes option-pricing model overstates the value of employee stock options -- we just don't know by how much. A review of standard discounts applied in valuing restricted stock compared to non-restricted stock suggests a discount of from 20% to 45% might be a reasonable estimate of the overstatement.

Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?

We believe that employee stock option activity is adequately reflected in the current disclosure requirements of Statement 123 and Statement 148.

Issue 2(d): Statement 123 and the Proposed IFRS require that certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required.

Statement 123 provides guidance for use in making volatility assumptions and requires use of the expected life of options as opposed to the contractual life. The latter adjustment is thought to compensate for the non-transferability of the employee stock options.

We believe that a standard employee stock option-pricing model should be required that takes into account the unique characteristics of employee stock options, as discussed previously.

Issue 2(e): Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas?

THE CHARLES SCHWAB CORPORATION

Statement 123 states the fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option.

As addressed in 2(b), we believe it is necessary to standardize the measurement of the volatility factor used in option-pricing models and apply a discount for non-transferability. Further, we believe a standardized employee stock option-pricing model should be mandated that takes into account the unique characteristics of employee stock options not accommodated by existing models.

Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimate of fair value per equity instrument (IASB approach)? If so, why? If not, why not?

Statement 123 requires the reversal of compensation expense for options that are forfeited. We agree with this methodology.

Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why? (Refer to page 35).

We believe that the straight-line attribution method is appropriate. A method of attribution requiring a higher degree of precision is unnecessarily burdensome. Additionally, the straight-line method is transparent and easily understood.

Issue 15: Do you believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not?

We believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in a manner consistent with the accounting for the stock-based compensation expense. Where no compensation expense is recognized under the ABP 25 intrinsic value model, actual tax benefits realized by a company are reported as a component of shareholders' equity. Where the hypothetical fair value of options is recognized as compensation expense in the financial statements, a hypothetical tax benefit using a company's effective tax rate should be similarly recognized. Going forward, the recorded tax benefit would only be adjusted if the estimated compensation expense were adjusted.

Issue 17: Please describe any additional disclosure that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.

As we talk with institutional stockholders of the Company, they tell us that they are satisfied with our disclosures and that expensing employee stock options would not necessarily be an

THE CHARLES SCHWAB CORPORATION

improvement to our financial reporting. We therefore believe that a quarterly summary of option program activity and regular disclosure of management's philosophy behind its employee stock option program provides investors adequate insight into the program's financial impact.

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We appreciate the opportunity to express our views. If you have any questions regarding our comments, please contact Geoffrey Huggins, Senior Vice President – Accounting Policy at 415-636-3191.

Yours truly,

/s/ Christopher V. Dodds

Executive Vice President
Chief Financial Officer