## **MERCER**

**Human Resource Consulting** 

February 1, 2003

Ms. Suzanne Q. Bielstein MP&T Director-File Reference 1102-001 Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Subject: Invitation to Comment

Letter of Comment No: 178 File Reference: 1102-001

Date Received: 2-1-03

## Dear Ms. Bielstein:

We appreciate the opportunity to respond to the Board's Invitation to Comment on 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, dated November 18, 2002. These comments are made in the context of Mercer Human Resource Consulting's role as compensation consultants, and do not necessarily reflect the views of either our parent company, Marsh & McLennan Companies, or any specific client.

Our comments should not be read as supportive of mandatory fair value accounting pursuant to Statement 123 or the Proposed IFRS. Indeed, we think that both Statement 123 and the Proposed IFRS have flaws, as indicated in our response to the questions posed in the Invitation to Comment.

Here is a summary of the key points in our response:

- We support a safe harbor approach that would treat as noncompensatory all broad-based, tax-favored equity plans, such as Section 423 plans in the US and Save-As-You-Earn plans in the UK. It would encourage companies to provide equity ownership opportunities to rank and file employees, without the potential for adverse accounting consequences. And it would not compromise accounting principles applicable to other types of plans since it establishes a "bright line" standard.
- We support a standard that would permit more flexibility in determining valuation approaches. Specifically, companies should be permitted to select the type of option pricing model that can most reliably measure the value of their employee stock options. This will be particularly important if fair value expensing becomes mandatory, and as a result, there is a proliferation of alternative types of stock-based compensation plans. In addition, we think companies should be permitted to incorporate adjustments for nontransferability (other than a

shortened expected life) and nonexercisability during blackout periods and before an option first becomes exercisable.

 As a complement to increased flexibility in selecting option pricing models and assumptions, we support enhanced disclosure to facilitate comparability and transparency.

We would be pleased to discuss our comments with the Board or the staff. Please contact me with any questions at 212-345-7648, or <a href="mailto:susan.eichen@mercer.com">susan.eichen@mercer.com</a>.

Sincerely,

Susan Eichen

c/uny documents/fasb/fasb invite resp letter 02.01.03.doc

RESPONSE TO INVITATION TO COMMENT, File Reference 1102-001 Submitted by: Mercer Human Resource Consulting 1166 Ave. of the Americas New York, NY 10036

## PRIMARY SIMILARITIES AND DIFFERENCES FROM INVITATION TO COMMENT

Issue 1: Statement 123 provides a scope exclusion for ESOPs and certain ESPPs, and the Proposed IFRS does not. Which view do you support and why? (Refer to page 19.)

We support the Statement 123 position with respect to ESPPs. In fact, we would like to see the exclusion for ESPPs expanded to include a safe harbor that would treat as noncompensatory all broad-based, tax-favored stock plans, such as Section 423 plans in the US and Save-As-You-Earn schemes in the UK. Such a safe harbor would promote sound public policy. It would encourage companies to provide equity ownership opportunities to rank and file employees, without the potential for adverse accounting consequences. And it would not compromise accounting principles applicable to other types of plans since it would establish a "bright line" standard.

If the exclusion for ESPPs remains narrow, or is eliminated, we would like to see accounting for look-back plans simplified. Certain provisions of FASB Technical Bulletin 97-1 are highly impractical. For example, plan types g and h require a company to calculate the cost of a modification each time an employee changes his or her withholdings. For companies with thousands of participants, this is costly and time-consuming—and the result is generally not material.

We do not have a comment regarding ESOPs.

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. (Refer to page 20.)

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? (Refer to page 21.)

With regard to the fair value of an employee stock option, we believe that a quoted market price for a similar instrument provides the best estimate.

In the absence of a quoted market price, we believe an option pricing model is an appropriate method of measuring the option's value.



18/10

A third alternative is a valuation based on an arm's length appraisal by a third party, such as an investment banking firm. However, we believe that this "black box" approach is a less acceptable alternative. First, to avoid impairment of comparability among companies, the assumptions used by the third party to value the option would need to be disclosed. This might require disclosure of proprietary information. Second, third party appraisals are likely to derive a value based on either quoted market prices of similar instruments or, in their absence, an option pricing model, possibly with some customized modifications. Therefore, we believe that injection of a third party appraisal into the measurement process would simply obfuscate the underlying valuation method.

This comment does not suggest that third parties should be prohibited from assisting companies in determining the fair value of a stock option, so long as they comply with any requirements regarding the use of an option pricing model and associated disclosures.

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? (Refer to page 21.)

We do not believe a specific model should be prescribed in the accounting standard. While specifying a particular model theoretically would improve comparability among companies, we believe that no single model is suitable for valuing all types of employee stock options. This point will become even more important if companies redesign their equity-based compensation programs to take advantage of the many opportunities provided by any requirement to expense stock options using a fair-value method. For example, for certain types of performance-based options, a binomial model might be the best valuation approach, while for others, monte carlo simulation may provide a more accurate and/or precise result. Furthermore, we understand that it is the position of economists and financial academics that any type of option can be valued—but there is no "one size fits all" model that can accommodate all varieties.

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? (Refer to page 21.)

We support additional disclosure to improve the understandability and comparability of financial results. This disclosure might include the type of model used; the underlying assumptions; the basis for determining those assumptions (e.g., volatility based on implied volatility, historical volatility blended with market average volatility); the degree to which the assumptions used differ from actual past experience (e.g., if an expected life assumption is used, how does it differ from prior exercise patterns?); and the method of adjusting the option value for lack of transferability.



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 consistency and reliability of those outcomes, please describe those modifications and why they should be required. (Refer to page 21.)

We support provisions allowing for additional modifications to improve the consistency and reliability of results obtained from standard option pricing models applied to employee stock options.

With regard to lack of transferability, we believe the standard should provide more flexibility in determining an appropriate adjustment. We do not believe that the use of expected life should be mandated to reflect the lack of transferability of the option, but should be permitted as one alternative. In addition to this approach, we support permitting the use of a standard "haircut" to reflect the option's illiquidity. There are numerous studies that compute the discount applied to a security or asset to account for the fact that it cannot be sold. The studies we have seen suggest a discount of approximately 10% per year is appropriate. The discount would be applied to the value of the option computed under an option pricing model that reflects the features of the option, as if it were publicly traded.

We also support permitting the use of a modification to reflect "blackout periods" during which the option cannot be exercised. This would include periods prior to the time at which the option becomes exercisable, as well as quarterly blackout periods that precede companies' carnings announcements. This adjustment may not be feasible with the standard Black-Scholes model, which assumes exercise at the end of the term. But other models can incorporate this adjustment to produce a more accurate value.

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? (Refer to page 21.)

There is little doubt regarding the need for additional education and guidance on valuing stock options. However, we do not believe that accounting standard-setters should provide that guidance. Information presented as "guidance" frequently becomes "rules," leaving little room for interpretation of facts and circumstances and professional judgment.

Issue 3: Do you believe that employee and nonemployee transactions are distinct and, therefore, warrant different measurement dates for determining the fair value of equity instruments granted? If so, why? If not, why not? (Refer to page 24.)

We concur with the Proposed IFRS in its premise that employee and nonemployee transactions should be treated in the same way. In both cases, the company has received value in the form of services or goods in exchange for equity instruments. A contract or



agreement has been reached between the company and its employees or outside provider of goods or services. In addition, implementation of EITF 96-18 is rife with problems of interpretation regarding measurement date—as evidenced by recent EITF debates on this issue.

Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not? (Refer to page 24.)

As stated in our response to Issues 2(b) and 3, we believe that any type of option can be valued, and there is little difference between awards to employees and nonemployees. In some limited transactions with nonemployees, it may be appropriate to postpone final measurement of an award until after the grant date. We believe that identification and accounting treatment of those situations should be left to the judgment of the company and its auditors.

Issue 5: Do you believe the notion of issuance is conceptually of importance in the design of a standard on stock-based compensation? If so, why? If not, why not? (Refer to page 25.)

We believe that issuance is conceptually important in developing an accounting standard for stock-based compensation. We support the philosophical focus of Statement 123, which is to measure the value of the equity instruments given, as opposed to the Proposed IFRS, which focuses instead on measuring the value of the services received. Therefore, we concur with Statement 123's principle, as stated in the Invitation to Comment (p. 24), that "equity instruments subject to service or performance conditions are granted but not issued because they represent a conditional obligation to issue equity instruments in exchange for valuable consideration at a later date."

Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined by Statement 123, at the grant date? If so, why? If not, why not? (Refer to page 25.)

See Issue 5.

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? (Refer to page 28.)

We believe the effect of forfeitures due to the possibility of failure to achieve performance conditions (but not continued service requirements) should be incorporated into the fair value of the equity instrument. An award that cannot be earned unless performance contingencies are satisfied is clearly less valuable than one that is earned based solely on continued service.



Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that award? If so, why? If not, why not? (Refer to page 28.)

As stated in our response to Issue 5, we believe that compensation expense should be based on whether the shares are issued (vesting of restricted shares or stock options). Therefore, if an award holder fails to satisfy the conditions required to retain or receive the award, compensation expense should be adjusted to recognize that fact.

Issue 9: Do you agree that the result of the IASB's approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value? If so, why? If not, why not? (Refer to page 29.)

We believe that the IASB's approach to valuing equity instruments of nonpublic entities may result in a value that is closer to fair value than Statement 123's minimum value approach. However, we believe that the IASB's approach is less desirable than minimum value. It is likely to overstate the volatility of private companies, reducing the credibility of their financial statements (and placing them at a disadvantage relative to public companies regarding the reported cost of equity awards). In addition, it is more complex to implement than minimum value. This may present a hardship for smaller, private companies, and the cost of implementation would far exceed the incremental benefit of accuracy that might be obtained.

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.)

See Issue 5.

Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not? (Refer to page 35.)

See Issue 5.

Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by an enterprise? If so, why? If not, why not? (Refer to page 38.)



We believe that compensation expense should reflect the actual outcome of performance conditions required for an award to be issued. As stated in our response to Issue 5, we support the concept that issuance of an equity award determines whether expense should be incurred.

Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not? (Refer to page 40.)

No comment.

Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not? (Refer to page 43.)

See Issues 3 and 4.

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? (Refer to page 46.)

We believe that tax benefits derived from stock-based compensation should be recognized in the income statement, to the extent that the cost of that compensation has previously been recognized. This approach is consistent with Statement 123's philosophical focus on the issuance of equity awards. Since the tax benefit is not realized until after the awards are issued, it would appear to be a capital transaction, to the extent that the benefit exceeds the compensation cost incurred in connection with the award. Any excess associated tax consequences should be allocated to contributed capital, not to the income statement.

The IFRS alternative is complicated; its requisite use of intrinsic value to report US tax benefits would be inconsistent with the use of fair value to recognize cost in the financial statements. Accounting for taxes is an area that is challenging even for experienced practitioners, and the IFRS approach would further hamper the transparency of financial statements.

Issue 16: As discussed in paragraph 83 of this Invitation to Comment, the Proposed IFRS expands on the disclosure requirements in Statement 123. Do you believe that those expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?) (Refer to pages 47 and 48.)

See Issue 2(c).

Issue 17: Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements. (Refer to page 48.)



In addition to the above comments, we believe that information regarding the cash flow effects of option exercises, as well as the intrinsic value of options exercised and outstanding would be useful. However, we are concerned that the costs of compliance could be significant, particularly for smaller companies, and the accuracy of these additional disclosures may be difficult to rely upon. (This comment is based on our experience working with smaller companies, as well as some larger ones, whose stock option administration systems are sometimes challenged when asked to produce even the most basic management reports.)

## SECONDARY SIMILARITIES AND DIFFERENCES FROM APPENDIX A

Issue A1: Statement 123 distinguishes between a principal stockholder and a stockholder for certain transactions, and the Proposed IFRS does not. Which view do you support and why? (Refer to page 52.)

We support the IFRS position, both conceptually and practically. We do not believe transactions with "principal" stockholders and other stockholders should be treated differently.

Issue A2: Do you believe that a probability-weighted average amount of the range should be used when no amount in the range is better that any other? If so, why? If not, what other amount within the range would you propose when no amount in the range is better than any other? Why? (Refer to page 56.)

In selecting appropriate assumptions for use in an option pricing model, a probability-weighted average could produce a more accurate result than that of Statement 123. Statement 123 specifies that if no estimate within a range is better than any other within the range, the estimate that produces the lowest option value should be used.

While a probability-weighted approach might produce a more accurate estimate, we believe the cost of implementing this approach might exceed the benefit of any increased accuracy.

We support allowing companies to choose either approach in selecting assumptions, accompanied by disclosure describing their approach.

Issue A3: Do you agree that option-pricing techniques have sufficiently evolved since Statement 123 was issued to address reload features and, if so, should Statement 123's requirements be changed? If not, why not? (Refer to page 57.)

We strongly agree that option-pricing models can address reload features, and that Statement 123's requirements regarding reloads should be changed. Companies should be permitted to include in their initial fair valuation of a stock option a premium for any



reload feature the option contains. Subsequent reload grants, therefore, should not be treated as new awards that trigger additional measurement of compensation expense.

Issue A4: Do you believe there are circumstances in which an entity may not be able to reasonably estimate the fair value of equity instruments at the grant date? If so, please provide examples of such circumstances and describe how those equity instruments should be accounted for until a reasonable estimate is determinable. (Refer to page 57.)

As stated in our response to Issue 2(b), we believe that fair value can be estimated for any equity instrument, provided companies are allowed to use valuation techniques that include adequate flexibility to recognize specific features of an award.

We believe there is a single grant date for the vast majority of equity awards. However, we do not discount the possibility that multiple grant dates might be possible for some awards. In addition, as stated in our response to Issue 4, in some limited circumstances it may be appropriate to postpone final measurement of an award until after the grant date. We believe that identification and accounting treatment of those situations should be left to the judgment of the company and its auditors.

Issue A5: Do you believe there is a single grant date or multiple grant dates for the preceding example? Why? (Refer to page 58.)

See Issue A4.

Issue A6: Should SARs be measured at fair value rather than intrinsic value? If so, why? If not, why not? (Refer to page 58.)

SARs should be measured at intrinsic value if settled in cash to maintain the distinction between equity instruments and liabilities specified in Statement 123.

Issue A7: In accounting for equity award modification, should the fair value of the original award be calculated using (a) the shorter of the remaining expected life of the original award or the expected life of the modified award or (b) the remaining expected life of the original award? Why? (Refer to page 61.)

No comment.

Issue A8: Do you believe that an accounting standard on stock-based compensation should include provisions for distinguishing between repricing and other modification events? Why? (Refer to page 61.)

We do not believe that the standard should distinguish between repricing and other modifications. The distinction between repricings and other modifications stems from APB 25's requirement that exercise price and number of shares be known at grant date to



permit fixed accounting treatment. This is an irrelevant concept under the fair value approach, either under Statement 123 or the proposed IFRS.

Issue A9: Which method of accounting for settlements of unvested awards do you believe is more representationally faithful and why? (Refer to page 62.)

No comment.

Issue A10: The Proposed IFRS considers certain factors, including past practice or a stated policy of settling in cash, in evaluating how an entity should account for certain contracts that can be settled in cash or equity, at the entity's option. Do you agree with this view? If so, why? If not, why not? (Refer to page 63.)

No comment.