

Letter of Comment No: 264
File Reference: 1102-001
Date Received: 2-11-03

February 11, 2003

MP&T Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
director@fasb.org

File Reference No. 1102-001

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

This letter presents the comments of the Business Solutions Group of E*TRADE Financial in regard to the above referenced Invitation to Comment.

The Business Solutions Group of E*TRADE Financial provides stock plan administration software and/or services to over 2,500 US-based corporations that offer equity-based incentives to their employees. As a service provider in this industry, we monitor developments in equity compensation practices so that we can inform our clients of new developments and ensure that our software and services are in compliance with current regulations and standards. We have followed the developments in accounting practices concerning employee stock options and other compensatory equity arrangements for many years and respectfully submit the following comments.

Treatment of Forfeitures and the Units-of-Service Approach

As a developer of administrative software that calculates and accrues stock option expense, we are most concerned about the proposal to change from the modified grant date approach under SFAS No. 123 to the units-of-service approach proposed by the IASB. Our comments on this subject relate primarily to Issue 10, and secondarily to Issues 5-8 and 12.

From a theoretical standpoint, we believe that the notion of issuance is important. We do not believe that the company incurs expense for compensation that is never issued. If the employee does not earn the compensation, and therefore does not have any opportunity to enjoy the benefit provided by the compensatory arrangement, and the shares underlying the arrangement are not ever issued and in fact do not ever create any shareholder dilution, we believe there should be no expense for the arrangement. We believe that forfeitures should be accounted for as they occur (as is required under Statement 123). We believe the IASB's approach of estimating forfeitures without truing up the estimates for actual forfeitures increases the level of speculation inherent in the measurement process and ultimately impairs comparability while also creating opportunities for abuse.

We also have significant concerns from a practical standpoint. The units-of-service approach represents a significant departure from the methods currently used in the U.S. to attribute compensation expense. To our knowledge, there is no other compensatory arrangement in the U.S. for which this approach is utilized. Therefore, adopting the units-of-service approach will require companies and their auditors to learn a completely new and unfamiliar method of expense attribution. The administrative cost of learning this new approach and updating existing systems and processes to account for it could be substantial. In addition, introducing a completely unfamiliar attribution method significantly increases the potential for errors to occur as the U.S. transitions to the units-of-service approach.

While this approach appears clear in the IASB's relatively straightforward example, we suspect that in practice, the application of this approach will be much more complex. The units-of-service approach can be fairly easily applied to a group of options that are all granted on the same day and subject to the same terms, but this does not represent how options are actually granted. In our experience, companies typically grant options not on a single date, but on numerous dates throughout the year. We expect that it will be much more complicated to apply the units-of-service approach in this more realistic scenario, where perhaps only a single option is granted on any given date during the year. For example, assume a company grants stock options continuously throughout the year to all newly hired employees. Each option is granted on a different date, based on the optionees' hire dates. Assume also that the company expects 20% of the employees to forfeit their options. Which 20% of the options should the company assume will be forfeited – the options granted in the beginning of the year or the options granted at the end of the year? Should they assume that 20% of each option will be forfeited? And, in addition to determining which options will be forfeited, how should the company estimate how many units of service will be received before the options are forfeited? Now add to this scenario options that vest not in a single instance but on a monthly basis, as is typical for technology companies. This complexity is likely to produce a number of questions and interpretive issues that the auditing firms, and in some cases, FASB, will be called upon to resolve. We also would note that the chosen attribution method has a significant impact on diluted earnings-per-share, effecting not only the numerator but also the denominator (since, under the Treasury Stock Method, any unamortized expense associated with stock options is considered a source of proceeds that the company can use to repurchase stock). As with any new procedure, it is impossible to anticipate all of the issues that will arise through practical application; it could be years before all of these

issues have been resolved and companies are attributing stock option expense using consistent methods.

The practical concerns we describe above would be acceptable if the units-of-service approach were clearly appropriate and beneficial. But, we believe this approach is not an appropriate method of attribution for compensation expense and that it introduces a substantial opportunity for inconsistency and abuse. We urge FASB to carefully weigh these costs against any perceived benefits in the units-of-service approach. In addition, because of the administrative and interpretative issues involved in transitioning to the units-of-service approach, we expect that it would be necessary for FASB to allow much longer transition period for the new standard than might otherwise be necessary.

In addition to our concerns with respect to the IASB's treatment of forfeitures and the units-of-service approach, based on our experience and observations in this industry, we would like to offer comments on a number of additional issues:

Issue 1: Statement 123 provides a scope exclusion for certain ESPPs, and the Proposed IFRS does not. Which view do you support and why?

We believe there should be a scope exclusion for certain ESPPs. We believe that where it can be demonstrated that the plan is not compensatory in nature but is instead designed to promote stock ownership or raise capital, it is inconsistent to require recognition of compensation cost. For purposes of determining compensatory status, we encourage FASB to rely on the guidance provided in paragraph 4 of APB Opinion No. 25 and paragraphs 24-29 of FASB Interpretation No. 44. We do not believe that investors are significantly concerned about the financial impact of these plans. In addition, these plans present little potential for abuse since they must be non-discriminatory and relatively small amounts of stock are acquired under them.

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?

We believe that all currently available option pricing models, including the Black-Scholes model, overstate the value of employee stock options, primarily due to overemphasis on volatility. Volatility can have an extreme affect on the value computed by option pricing models. For example, under the Black-Scholes model, when a relatively low volatility factor is used (20% to 30%), the option value is also relatively low (approximately 30% of the stock value, assuming a five-year life, 5% risk-free interest rate, and no expected dividends). But when volatility is increased to 80%, which is not atypical for technology companies, the option value is 67% of the stock value. In this scenario, a \$10 option would have a Black-Scholes value of \$6.70. We do not believe that investors would pay close to 70% of the stock value to acquire an option on stock with 80% volatility nor do we believe that this in any way represents the value of the option.

Therefore, we encourage FASB to sponsor research on the development of new models that more accurately value employee stock options and that reduce the impact volatility has on option value.

In lieu of any better models being available, we suggest that allowing companies to use the minimum option value method, which ignores volatility, is the only accurate, fair, and consistent method of measuring option value.

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?

We do not think it is necessary to mandate use of a specific option-pricing model. We believe that the current research on the application of option pricing models to employee stock options is inadequate. As new models are developed that provide a more accurate valuation of employee stock options, companies should be permitted to use those models for measurement purposes.

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.

We believe that when measuring option value, companies should be able to apply an expected life that is less than the contractual term of the option. Due to the difficulties and uncertainties involved in estimating when employees will exercise their stock options, we believe that the vesting schedule is the appropriate measure of expected life. This modification, combined with the minimum option value method, would relieve much of the speculation currently inherent in the measurement process under Statement 123 and would introduce more financial statement comparability.

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.

Through our software and services, we have been assisting companies with option valuation since Statement 123 was adopted. We have found that companies employ a wide variety of practices when selecting the factors used in option-pricing models. In some cases, companies have selected factors that we understood to be specifically prohibited under Statement 123 and were permitted, sometimes even encouraged, by their external auditors to use these factors. We believe the only way to achieve consistency is to reduce the level of speculation involved in measuring option value by using the minimum option value method and treating the vesting period as the expected life.

Issues 3 and 14: 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? Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of the transaction with non-employees?

We do not believe there is any significant distinction between employee and nonemployee transactions or that the company incurs any greater or lesser expense for equity offered to employees or nonemployees. In fact, in many cases, companies use the exact same instruments to compensate both employees and nonemployees. Therefore we believe that the same measurement method and date should apply to both.

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 the fair value than minimum value?

No, we do not. We believe Statement 123 is correct in allowing nonpublic entities to use the minimum value method to measure compensation. We believe it would be a gross overstatement of value to include volatility when valuing an option for stock that has effectively no volatility because it is not publicly traded and may never be publicly traded. The value computed in such a situation would be a purely fictional amount that no investor would ever reasonably consider paying for an option on the underlying stock. We do not believe that including such a fiction as an expense would in any way increase the usefulness of the company's financial statements to potential investors.

Issue 13: Do you believe that this issue [attributing expense over expected life rather than service period] is important in considering an attribution model's validity?

No. We believe that expenses should be recognized over the same period in which the services related to that compensation are performed and the revenue related to those services is realized. The services relating to stock compensation are performed over the vesting period of the award, services performed after the vesting period has elapsed no longer relate to the award.

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?

We believe that it would be useful for the disclosures to include the number and classes of employees that received grants under the company's stock programs. We believe investors would be interested in knowing which classes of employees receive grants and what portion of the grants are allocated to executive officers.

Otherwise, we find the IASB's proposed disclosures to be quite onerous and we are concerned that investors will be discouraged from reading the disclosures by the sheer volume of them. We believe a number of the disclosures (specifically those relating to volatility, vesting conditions,

Financial Accounting Standards Board
File Reference No. 1102-001
February 11, 2003
Page 6

expected forfeitures, and expected life) can be eliminated by reducing the level of speculation involved in measurement of expense, as we have discussed previously.

We thank you for your time and consideration. If you have any further questions or concerns, please contact me at (650) 331-5883.

Sincerely,

Dan Kraut
General Manager
Business Solutions Group
E*TRADE Financial
E-mail: dkraut@etrade.com