



February 3, 2003

MB&T Director  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116  
Attn: File reference No. 1102-001

Letter of Comment No: 175  
File Reference: 1102-001  
Date Received: 2-3-03

RE: 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

Dear Director:

America's Community Bankers (ACB)<sup>1</sup> is pleased to offer comments in response to the Financial Accounting Standards Board's (FASB) 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. The Board has asked whether, in accordance with the objectives of improving U.S. financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, it should propose any changes to the U.S. accounting standards on stock-based compensation.

#### **ACB Position**

ACB supports continuation of Statement 123 as amended by Statement 148, which permits but does not require expensing of stock options on the income statement. The current mandatory footnote disclosure provides for a presentation that some financial statement users find useful, despite being subject to the fair value measurement flaws associated with option pricing models. The most valuable information in employee stock option disclosures is the shareholder dilution impact arising from the issuance and exercise of employee stock options.

<sup>1</sup> ACB represents the nation's community banks of all charter types and sizes. ACB members, whose aggregate assets exceed \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

## **Background**

Both the FASB and the IASB accounting standards for stock-based employee compensation<sup>2</sup> state that, because stock-based compensation (referred throughout this letter as “employee stock options”) has value, the compensation should be accounted as an expense on the income statement over the period of time in which the employee provides services, typically the vesting period. FASB is principally soliciting views on similarities and differences between the U.S. and the proposed IASB standards, as well as other aspects of stock-based compensation.

The Invitation to Comment is not a Discussion Memorandum and FASB believes that a project on stock-based compensation is a more appropriate forum than this Invitation for Comment for the broader issues such as whether employee stock options should be expensed. The most widely used fair value measurement techniques for stock options, including Black-Sholes and other binomial option pricing models, are not appropriate for employee stock option valuation. Such methodologies tend to significantly overstate the value of employee stock options. By applying option pricing models directly, employee stock option expensing would thus result in less reliable and inaccurate income statements, which are likely to mislead rather than enlighten users of financial statements. If FASB continues to require an option pricing model based determination of fair value as a disclosure or on the income statement, FASB may want to consider requiring a significant discount from the option pricing model calculated value in reporting the “cost” of the employee stock option. The discount would take account of the difference between the attributes of employee stock options and the standard assumptions in option pricing models.

### **Measuring Cost to the Firm Rather than Value to the Employee Should Be the Focus**

At the outset, we suggest that the objective should be the measurement and reporting of the compensation cost to the firm and not the value of the stock options to the employee. There is a significant conceptual difference between value and cost in this regard. The cost to the firm is ultimately the dilution of the equity ownership of other shareholders. There are opportunity costs to the employer in the granting, issuance and exercise of stock options, but opportunity costs are generally not measured in financial accounting. The valuation techniques addressed in the Invitation for Comment relate to determination of the value of the stock option to the employee based on the objective of providing comparable accounting treatment for cash and stock-based compensation.

### **Valuation on Employee Stock Options Remains an Unsettled Issue**

The option pricing models were not intended to be applied to long-dated employee stock options that may not be exercised, exchanged or transferred for years. In 1995, FASB through Statement 123 determined that stock options issued to employees should be measured at fair value rather than intrinsic value, based on the presumption that a stock option’s value consists of both intrinsic value and a time value component. Furthermore, FASB concluded at that time that

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<sup>2</sup> The FASB and IASB standards referred to in the letter are Statement 123 amended by Statement 148 and the proposed IFRS, respectively.

employee stock options can be adequately measured through the use of option-pricing models. Statement 123 requires that the model take into account the following factors: the date that the options are granted, the exercise price, expected life of the option, the current price of the underlying stock and the risk-free rate.

On page 10, the Invitation to Comment states that “while the Board is aware of the various issues inherent in the use of these models, it believes that the compensation expense calculated using them produces decision-useful information for financial statement users. However, the Board is interested in receiving suggestions on how application of option-pricing models and the consistent use of these assumptions might be improved.” Furthermore, on page 20, the Invitation to Comments acknowledges criticisms of applying option pricing models to employee stock options.

Thus, the Board is aware that the employee option valuation issue is widely debated and unsettled to this day. Whether employee stock options should be treated as an expense, the option pricing model must result in reliable, accurate and consistent valuations of the employee stock options among industries and companies. Unfortunately, the commonly used option pricing models, including Black-Sholes which was state-of-the-art in 1995 when Statement 123 was published and other binomial models, do not meet this test. The direct application of traditional stock option models, specifically Black-Scholes, does not take into account the unique characteristics of the employee stock options.

To further the objective of accurate representation of value, it would be logical for management of a company to be allowed flexibility to account for the facts of circumstances. A problem with giving preparers latitude in developing assumptions is that wide variations in calculated values may result and results may not be comparable across industries and companies. The valuations of course are very sensitive to the assumptions used.

### **The Unique Characteristics of Employee Stock Options**

The fundamental methodological problems lead to inaccurate and inconsistent results, for example, between equities of firms with different volatility measures<sup>3</sup> at the time the option is granted. Until and unless resolved, these issues lead to problematic compensation expense representations on income statements.

As noted, the widely recognized traditional option pricing models are not a satisfactory measurement tool for employee stock options, an assertion that the authors of the Black Scholes pricing model readily acknowledge and accept. The models were designed to emulate short-term option pricing behavior and were not developed with employee stock options in mind. Even variations on Black-Scholes designed to reflect long-dated options employ stringent assumptions that do not necessarily reflect real world events, such as a risk-free rate for the

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<sup>3</sup> For instance, Frederic W. Cook of Frederic W. Cook & Co., Inc. in a presentation entitled “Valuing Employee Stock Options – Problems and Opportunities” at an American Enterprise Institute forum, Employee Stock Options and Corporate Earnings on November 20, 2002 referred to research that showed option pricing values were twice as high for the QQQ index compared to the Dow Jones Industrial Average.

vesting period which may be five to ten years or more and constant volatility for the period prior to exercise. Such models tend to overstate the value of employee stock options, and the calculated values vary based on assumptions. Furthermore, they have not proven to be good predictors. This is true even, taking into account modifications in the option term from the stated maximum term to the expected term of the option and adjusting for the potential for forfeiture of the option.

When valuing stock options specific assumptions can be applied. Employee stock options are not transferable, one of the key assumptions in option pricing models. The option pricing models typically assume that the option can be sold and transferred at any time. The employee stock option may only be exercised after the vesting period. In addition, the employee may not sell or transfer equity-based instruments during specific times of the year, for example, during the "black out" periods. The stock option may not be exercised and thus forfeited by employees, because they are risk-averse investors or wish to diversify away from concentrations in a specific company's equities. Similarly, termination of employment prior to the end of the vesting period and non-compete clauses for executives results in nonexercise of the option.

Perhaps the critical variable is the volatility of the stock assumption, which probably has the most significant impact in the option pricing model calculation. Companies that are highly volatile at the time of issuance would have much higher valuations. Depending on the periods chosen, highly volatile equities will lead to much higher reported expense but may not be reflective of the stock's trading pattern later on- as the exercise date becomes imminent. Historically, firms with highly volatile equities tend to have been the most extensive issuers of employee stock options.

### **Discount the Option Pricing Model Calculation to Account for Overvaluation**

When the option pricing models are applied, accounting standards should allow for adjustments to reflect the overvaluation inherent in applying the option pricing model assumptions. Such adjustments are necessary whether the company chooses footnote disclosure or decides on the expensing alternative. A number of adjustments to option pricing models have been suggested. They include assigning zero volatility, incorporating the delayed exercise date into the model, placing a cap on volatility, and valuing options up to the vesting date when the option can be exercised. Decisions made subsequent to the vesting period reflect individual investment decisions rather than value of compensation provided by the employer. Should the Board continue to require option model pricing to determine fair value, we believe the most straight forward way to account for overvaluation is to take a significant discount from the model calculated value.

Considering the current state of stock option valuation, we also believe that standard-setters should not mandate the use of a particular model. We see no alternative to companies having broad latitude in view of the unsettled issues about estimating long-term option valuation. While we think flexibility in developing and applying valuation models make intuitive sense, differing assumptions can result in wide variability in valuations (and reported stock option expense),

which would certainly be confusing to investors.<sup>4</sup> This brings us back to the benefits of a disclosure system where information and employee stock option assumptions are available for those financial statement users that find the information to be valuable. Disclosure will enable users to understand how the valuation was determined. In short, the lack of precision in compensation measurement may lead to greater controversy and confusion at a time when a financial accounting has come under a good deal of criticism.

### **Forfeiture Should Be Separately Estimated and Not Part of the Option Pricing Valuation**

As the Invitation for Comment discusses, the IASB proposal would incorporate a stock option forfeiture assumption into the fair value at grant date calculation. Statement 123 does not include a forfeiture assumption in the option valuation at grant date calculation but financial statement preparers are directed to account for the forfeiture assumption separately, outside of the valuation model, by adjusting the number of options issued. Initial estimates, especially for options with long vesting periods, are likely to need adjustments to reflect reality. Should the Statement 123 methodology remain in effect, we believe that the separate determination and adjustment based on actual experience is the preferable approach. Inclusion in the model would further complicate a complex model that already includes a number of arbitrary assumptions.

### **Volatility Should Be Excluded From the Calculation of Stock Options of Nonpublic Entities**

The Invitation for Comment asks about the treatment of stock options for nonpublic entity or entities whose stock trades infrequently. Statement 123 correctly concludes that direct estimate of the expected volatility is not feasible and thus gives companies with nonpublic or infrequently traded equity securities the alternatives of using a calculation of volatility or the minimum value. By contrast, the IASB is recommending methods to estimate volatility based on share price volatility of comparable companies. We believe that this approach is unnecessary, hypothetical and of little benefit to financial users as the calculation is not based on the company's history and experience. A minimum value that excludes a volatility factor is appropriate treatment as it better reflects the value of the option of the nonpublic entity.

### **Disclosure Should Focus on the Dilution of Existing Shareholders**

Any changes on footnote disclosure should concentrate on providing financial statement users with information on the dilutive impact of exercising stock options. An example would be an earnings per share calculation in which earnings per share is adjusted for the cash flow associated with the exercise of the option and the number of outstanding shares are increased by the options issued and exercised. The current information disclosed on option valuation assumptions is reasonable, although we reiterate our concern with option pricing model valuation assumptions in general.

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<sup>4</sup> Jude Rich of the Sibson Consulting, division of the Segal Company reported that his analysis calculated a range of option values from \$10 to \$97 depending on the model used for one option granted at \$100. (Forbes.com, January 22, 2003)

### **Economic Value of Stock Options**

As FASB considers the employee stock option accounting approach, the benefits to the economy of stock options in furthering the objective of aligning the interest of management and shareholders cannot be ignored. Properly structured, employee stock options are a powerful incentive for management to productively invest corporate resources consistent with shareholders' interests. To the extent that there are examples of the issuance of stock options encouraging reckless behavior by management in the recent past, such examples reflect improper incentives in the compensation structure that encourages short-term stock price appreciation rather than long term performance. Stock option incentive compensation is best practiced when it reaches beyond the executive level to establish incentives for other levels of management and staff through broad based plans. Research such as Blasi, Kruse and Bernstein's book, *In the Company of Owners: The Truth about Stock Options (And Why Every Employee Should Have Them)* has shown that firms with broad stock option plans are more productive.

In conclusion, we believe that the current practice of Treasury Method accounting treatment combined with Statement 123 disclosures works well. We agree that stock options as a form of compensation have value but, even when exercised, the stock option is not a surrender of cash or other resources. Rather, it dilutes the value of the equity ownership interests of the existing shareholders. Should FASB and the IASB continue to require an option pricing model calculated fair value, we urge an adjustment to account for the overvaluation problem.

We appreciate having this opportunity to present our views to FASB. Please contact Steve Davidson at 202-857-3158 or [sdavidson@acbankers.org](mailto:sdavidson@acbankers.org) regarding questions or clarification of our views.

Sincerely,



Robert Davis  
Managing Director of Government Relations