## Procter&Gamble

MP&T Director – file Reference 1101-001 Financial Accounting Standards Board 401 Merrit 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116 Letter of Comment No:  $7^{\circ}$  File Reference: 1101-001/Date Received:  $11/(\gamma / 0.2 - 1.00)$ 

Re: Proposed Statement of Financial Accounting Standards, Accounting for Stock-Based
Compensation - Transition and Disclosure, an Amendment of FASB Statement No. 123

We are pleased to have the opportunity to respond to the FASB's proposed SFAS on Accounting for Stock-Based Compensation – Transition and Disclosure, an Amendment of FASB Statement No. 123 (SFAS 123). We commend the Board on its decision to proceed with this project and the pace at which it has proceeded. However, we caution the Board, as it proceeds to accelerate its processes, to ensure adequate time for public review and comment.

Overall, we are supportive of the proposal. We believe that amending paragraph 52 of SFAS 123 to provide for the three alternative adoption methods (as provided in paragraph 2(a) of this proposal) is an improvement over the previous requirement for prospective adoption only. The option to allow retroactive adoption of SFAS 123 will eliminate the issues associated with the ramp-up in option-related expense and provide for better comparability of period-to-period expenses upon adoption.

However, we believe the Board should reconsider the requirements of paragraph 2(b), specifically with respect to a company that elects to adopt SFAS 123 using the full retroactive transition alternative in paragraph 2(a)(c). We do not believe that an adjustment to retained earnings and additional paid-in capital for unvested options as of the beginning of the first year restated is meaningful or relevant, particularly in light of the associated effort to compile the information.

The Notice for Recipients asks whether other disclosures would be useful, such as where expense is classified in the income statement. We would not support such a requirement, primarily due to its potential impact on disclosure overload, the lack of perceived relevance, and the non-cash nature of the charge. This treatment would also be inconsistent with other types of compensation-related expenses, (i.e., salaries/benefits, pension/postretirement benefits) and other types of costs (i.e., occupancy, depreciation), where no such disclosure is required.

While you have not sought comment on other aspects of SFAS 123, we would encourage the FASB to quickly pursue the topic of measurement. We realize that valuation may be partially addressed in the IASB's current project on stock-based compensation plans and that the FASB is pursuing convergence opportunities. However, we believe that the increasing adoption of the fair value method of accounting for stock options among U.S. companies warrants more immediate attention to this topic by the FASB. This is especially relevant in light of the expected increased scrutiny of actual compensation costs recognized under the fair value method of SFAS 123 vs. pro forma costs under the intrinsic method. We agree with the widely-held consensus that the Black-Scholes and binomial option-pricing models recommended in SFAS 123 over value stock options, primarily because the formulas are not adjusted to account for the restrictions inherent in employee options, such as vesting patterns and lack of transferability. Thus, we believe the amount of compensation

costs recognized under current guidance will generally be overstated. In addition, under current guidelines, we see the potential for criticism on the range of acceptable assumptions a company could potentially use, and the resultant range of acceptable compensation costs.

We believe one way the Board could address the valuation concern is by simply acknowledging that Black Scholes and binomial models fail to reflect the true value of employee stock options due to the vesting patterns and lack of transferability. Accordingly, a reasonable discount should be applied to resulting valuations. Of course, study would be needed to arrive at appropriate discount rates, but we believe this could be accomplished, if the FASB merely acknowledges the appropriateness of this approach.

Alternatively, the Board could consider the use of SAR-type accounting for options that, importantly, limits the mark-to-market adjustments to the vesting period. For example, assume an option with a \$100 strike price and 3-year vesting. If at the end of year 1, the underlying stock is trading at \$109, the company would record \$3 of compensation (1/3 of the value). If at the end of year 2, the stock trades at \$112, an additional \$5 of cost would be recorded, bringing total recognized cost to \$8, or 2/3 of the intrinsic value at that date. At the end of year 3, the final mark-to-market adjustment is recorded. This model has the benefit of recording compensation costs for appreciation in the option value attributable to the employees' required holding period. Appreciation realized by employees subsequent to the vesting period, which is the result of their decision to hold the fully exercisable option, is a shareholder decision and should not be reflected as compensation.

A third alternative would be to consider commissioning a study to develop a more reliable stock option pricing model.

A fourth alternative, and one which we would favor least as it would be more rule based, would be to provide more specific guidance around the assumptions used in applying option-pricing models. It can be argued that comparability would be enhanced by replacing SFAS 123's lists of factors to be considered in arriving at the various estimates for useful lives, volatility, etc., with more prescriptive guidance. While we realize this may be inconsistent with a desire to move more towards principle-based standards, we believe it could be justified in this case due to the lack of reliable employee stock option-pricing models. Although we believe it is preferable to address the pricing models as noted in the preceding paragraphs, we recognize the need for improved reliability and comparability of this financial statement element, and therefore, could accept even this more prescriptive approach

If you have any questions on this comment letter or would like to discuss any of our views further, please feel free to contact me at 513-983-3874.

Regards,

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