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FIAC

Financial Institutions Accounting Committee

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RE: Accounting for Stock-Based Compensation

Dear Ms. Bielstein:

The Financial Institutions Accounting Committee (FIAC) is pleased to have the opportunity to follow-up on our meeting with the FASB Board and staff on Friday, August 2nd.

FIAC is a group of 13 financial professionals working in executive level positions in the banking and thrift industries and is a standing committee of the Financial Managers Society. FIAC's primary responsibility is to evaluate those accounting and regulatory matters that affect financial institutions. The comments within this letter are representative of the FIAC as a whole and do not necessarily reflect individual views of the institutions represented on the Committee.

Summary

During our meeting on August 2, 2002, and also in our letter of December 23, 1993, in response to your request for comments on the *Accounting for Stock-Based Compensation Exposure Draft*, FIAC concluded, "In general, FIAC believes that stock options granted to employees by employers constitute value given for services rendered, or to be rendered, and represent a form of compensation. We must therefore conclude that income statement recognition is appropriate."

Given recent events, we believe it is appropriate to reaffirm and redocument our support for income statement recognition of this type of stock-based compensation. We believe that this action will bring further credibility to corporate financial statements.

The International Accounting Standards Board

In their meeting of May 2002, the International Accounting Standards Board (IASB) reached a tentative conclusion that options granted as part of an employee share purchase plan should be recognized as an expense.

August 16, 2002 Ms. Bielstein Page 2

The next step in the IASB's deliberative process is to document this tentative conclusion in an exposure draft and to issue it for public comment. It is expected that this exposure draft will be issued sometime in the fourth quarter of 2002, with a final version of the International Financial Reporting Standard to be issued in 2003.

If we assume that the final version of the International Financial Reporting Standard (IFRS) does not significantly modify the IASB's tentative conclusion with regard to the recognition of compensation expense at the grant date, than an inconsistency would exist between the IFRS and Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. We believe that the FASB should address this inconsistency by conforming SFAS No. 123 to the conclusions reached in the IFRS.

Inconsistent Treatment of Options for tax purposes

Stock option plans can be either an incentive stock option plan or a nonqualified stock option plan. The distinction between an incentive and a nonqualified stock option plan is based on the IRS Code, and relates to the tax treatment afforded the plan. Because companies are able to record tax benefits without regarding a corresponding compensation expense for nonqualified stock options, they have become the predominate form of employee option.

FIAC proposes that the advantage provided to nonqualified stock options be eliminated, by recognizing a compensation expense on the grant date for both nonqualified and incentive stock options. This accounting treatment would prevent a double standard, and insure that companies were not allowed to record tax benefits for compensation expenses that were never reported as compensation expense in their financial statements. The tax treatment of stock options is a complex topic and FIAC members are willing to discuss the tax implications of amending SFAS No. 123 with FASB staff when it is appropriate to do so.

Opposition

At the time of the issuance of SFAS No. 123, the Board commented that, "the debate on accounting for stock-based compensation unfortunately became so divisive that it threatened the Board's future working relationship with some of its constituents. Eventually, the nature of the debate threatened the future of accounting standards setting in the private sector."

There is still substantial opposition to the issuance of a standard calling for the expensing of stock options. Much of this opposition emanates from the high-tech industry. This industry has alleged that the expensing of stock options will result in the end of the free enterprise system as we know it today.

The FASB and FIAC have heard these same arguments used against the issuance of SFAS No. 141 Business Combinations. However, we have not witnessed the deleterious affect on the free enterprise system that was alleged to result from the issuance of SFAS No. 141. We are therefore not persuaded that expensing of stock options would result in any misallocation of resources to the high-tech sector.

In fact, a 2001 Merrill Lynch study on the impact of stock options indicated that it is the largest companies that benefit the most from the current accounting treatment. Merrill Lynch studied 32 highAugust 16, 2002 Ms. Bielstein Page 3

tech companies. Expensing options would have reduced net income by 67% among the 32 companies studied.

Support

Although there is substantial opposition, there is increasing support for a reexamination of this issue. In fact, economists such as Alan Greenspan and Paul Volker, and Chief Executive Officers such as Warren Buffett believe that investment resources would be allocated more efficiently if options were expensed. They believe that standardized treatment of stock options would provide better, more comparable information to investors.

A September 2001 survey by the Association for Investment Management and Research found that 80 percent of the financial analysts and portfolio managers believe that options should be recognized as an income statement expense.

In 1996, a group of 57 analysts, academics, accountants, regulators and FASB staff members participated in an American Accounting Association/FASB survey of the best and worst accounting standards. The worst three were determined to be SFAS No. 13, Accounting for Leases, Opinion 16 Business Combinations and SFAS No. 123, Accounting for Stock-Based Compensation. A reexamination of SFAS No. 123, which we are pleased to see the Board has begun, would permit the FASB to correct the perceived inadequacies of this standard.

Conclusion

While the expensing of stock options would not have prevented the alleged deceptive accounting practices at Enron, WorldCom, Global Crossing, Adelphia, Tyco, Xerox, Sunbeam, Waste Management, etc., it would have reduced the number of stock options granted and thus reduced the incentive to manipulate earnings.

Should the IASB adopt a standard requiring the expensing of stock options, we urge the FASB to do so also and to adopt a standard that would restore usefulness and integrity to the income statement and consistency with international standards. FIAC does not believe that disclosure of compensation expense is a substitute for recognition.

Sincerely, Joe Perillo

Joseph Perillo Chairman

cc: Ron Lott, Financial Accounting Standards Board Jeff Mahoney, Financial Accounting Standards Board Sydney Garmong, American Institute of Certified Public Accountants Jenifer Minke-Girard, Securities and Exchange Commission

Financial Institutions Accounting Committee

December 23, 1993

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Re: Exposure Draft: Accounting for Stock-Based Compensation

Dear Mr. Lucas:

The Financial Institutions Accounting Committee (FIAC), is pleased to provide the following comments on the Accounting for Stock-Based Compensation Exposure Draft (ED). FIAC is a group of sixteen financial professionals working in executive level positions in the thrift and banking industries and is affiliated with the Financial Managers Society. FIAC's primary responsibility is to evaluate accounting and regulatory matters which may impact our businesses. The comments within this letter are representative of FIAC as a whole and do necessarily reflect the individual views of institutions represented on the Committee. Our views are summarized below.

In general, FIAC believes that stock options granted to employees by employers constitute value given for services rendered, or to be rendered and represent a form of compensation. We must therefore conclude that income statement recognition is appropriate.

We do, however, have concerns over the very complex measurement techniques recommended in the ED. The use of sophisticated mathematical models is not well understood by most financial statement preparers or accounting practitioners. The theoretical correctness of recognizing compensation expense may be overshadowed by the possible misunderstood results which would not provide a meaningful improvement in financial reporting.



Comments to specific issues in the ED follow:

Issue 1: Should the issuance of fixed stock options, like the issuance of other equity instruments, result in recognition of the consideration received and the subsequent cost incurred as the consideration - employee services - is used in the entity's operations?

We concur that the value of stock options issued to employees is compensation and that compensation is a cost that should be recognized in the income statement.

Issue 2: This proposed Statement would apply the same basic accounting provisions to all stock-based plans, including broad-based stock option and discounted stock purchase plans that are considered noncompensatory under Opinion No. 25. Should there be exceptions to the basic recognition provisions for certain awards?

Once we accept the basic premise that all rights granted to employees are compensation, whether those rights are to options or to a discounted purchase plan, it follows that recognition is required. The standard should be straightforward and not try to address any and all permutations that the right to acquire stock for services rendered may take now or in the future. If compensation is inherent in the award it is compensation.

Issue 3: This proposed Statement would require restricted stock, stock options, and other equity instruments issued to employees as compensation, and the related compensation cost, to be measured based on the stock price at the date an award is granted. Should the stock price at another date, such as the vesting date or exercise date, be used to measure compensation cost?

Strong arguments can be made for each of the dates discussed: grant date, vesting date, service date, service expiration date and exercise date. From the employee's perspective exercise date is when compensation is recognized. However, as stated in the ED, grant date is the date at which the employer and employee agree to the terms of the award. The fact that the final compensation realized by the employee would be different is not relevant to the discussion as subsequent changes in the value of an equity instrument are not recognizable. Using any future date is fraught with difficulties.

Issue 4: This proposed Statement would require fair value as the basic method for measuring awards of equity instruments, including stock options, to employees. The fair value of employee stock options would be estimated using an option-pricing model. Should fair value be the basic measurement method?

The Board has embraced fair value accounting in all recent standards. Contrary to protestations otherwise, we can only conclude that fair value financial statements are being imposed in a piecemeal approach. We consider it foolish to swim upstream against the tide, therefore, we do concur that fair value is the appropriate measurement tool. Fair value, as defined in the ED, goes beyond "the amounts at which a financial instrument could be exchanged in a current transaction between willing parties based on the quoted market price, if one is available" (with which we are familiar) to include, "or on a valuation technique". Paragraph 25 of Statement of Financial Accounting Standards No. 107 also states that using option pricing models to estimate the fair value of "custom-tailored" financial instruments is appropriate.

Arriving at fair value is the most difficult element in the ED. We acknowledge that option pricing models, such as Black-Scholes, are used in the pricing of equity instruments by those who specialize in such activities. But we also know that use of the models is not just a "fill-in-the-blanks" exercise. The ED makes a compelling argument for the inclusion of volatility value which adds further complexity. Adjusting for vesting requirements and the nontransferability of the option we agree are important indicators of value.

What are we left with to consider?

- (1) Fair value is the appropriate measurement.
- (2) Fair value of equity instruments is
- determined by use of option-pricing models.
- (3) Stock compensation in equity instruments has very different and unique characteristics that require unique expertise.

We do not want the Board to draw the conclusion that "if it's easy we are for it, if it's hard we are against it". Most likely many comment letters will have that flavor. However, we must honestly report that we are troubled by the complexities inherent in the ED which many, or most, companies are not equipped to handle. Will the resultant information be reliable and verifiable? More importantly, will it be meaningful to more than just the most sophisticated users?

Issue 5: This proposed Statement would permit nonpublic entities to use the minimum value method, which does not consider volatility, to estimate the value of their options because a nonpublic entity usually has no trading history on which to base an estimate of expected volatility. Are the provisions for nonpublic entities appropriate?

Use of minimum value method for a nonpublic entity with no trading history makes sense.

Issue 6: This proposed Statement would require that in estimating the fair value of an option, the actual life, rather than its maximum term, would be used to reflect the nontransferability of employee stock options. Is there an alternative nonarbitrary way to reduce the value of an employee stock option to reflect its nontransferability?

Using grant date measurement there seems to be no nonarbitrary way of estimating the actual life of an option. The nontransferability feature of employee stock options is certainly part of the fair value determination. It has already been decided that fair value must be based on a "valuation technique" and such technique must need to address nontransferability. We favor the Board's recommendation of making a fair value measurement at grant date based on the expected life of the option. However, going back at a later date to adjust for the actual life is a an unnecessary complication. Let's remember we are dealing with an arbitrary valuation technique, not a guoted market price to begin with.

Issue 7: This proposed Statement would require compensation cost to be attributed over the period that the related employee services are rendered, usually the period from the grant date to the vesting date. Should the attribution period for employee stock options instead be over the period from the grant date to the date that all service-related restrictions expire?

An attribution period from grant date to vesting date is appropriate and uncomplicated.

Issue 8: Please comment on the extent to which disclosure of significant assumptions is necessary and which assumptions should be specified. For example, this proposed Statement would not require that the expected lives of stock options be disclosed. Is knowledge of expected lives of stock options essential in comparing the fair values estimated by different entities?

Disclosures should include the basic assumptions used in determining fair value and a brief description of the valuation technique employed. Disclosures required by Opinion 25 should be supplemented by the risk-free interest rate, volatility and dividend yield used in the model. Volatility and dividend yield would probably be derived from publicly-available historical information and would not present a confidentiality problem. Disclosure of expected lives of stock options should be optional. Expected lives of stock options would probably be disclosed as part of the basic assumptions whether required or not.

Issue 9: The Board received several proposals for extensive disclosures about stock options in lieu of recognizing the related cost in the financial statements. Should some of the specific items in Appendix E be required to be disclosed, even though compensation cost is recognized? For example, are there additional disclosure items that should be required to help evaluate the potential dilution stemming from employee stock options?

FIAC is proceeding on the assumption that the final statement will require recognition. We are conceptually in agreement with that assumption. Therefore, none of the additional disclosures in Appendix E are required.

Issue 10: Is the proposed three-year period of pro forma disclosures before the recognition provisions of the Statement are required to be adopted appropriate? Do the effective dates provide sufficient time for preparers to apply the provisions of the proposed Statement?

For many preparers, users and independent accountants, this ED represents a steep learning curve. We would feel more comfortable with a five-year period of pro-forma disclosures before recognition is required. No doubt a cottage industry of experts seeking to sell their expertise for measurement and recognition will spring up during the proposed disclosure period. Time must be provided to sort through the complexities of this difficult issue.

Once again FIAC thanks the Board for this opportunity to comment. We always stand ready to provide any assistance you may need.

Sincerely,

Roberta Yassin

Chairman