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From: REEVES, MARK [MREEVES@ACBANKERS.ORG]
Sent: Friday, July 02, 2004 12:15 PM
To: Director - FASB
Subject: File Reference No. 1102-100 - correct version

Letter of Comment No: 6384
File Reference: 1102-100



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The following comment letter was filed today on behalf of
America's Community Bankers:

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June 30, 2004

Director of Major Projects – File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
Via email to director@fasb.org

Re: Exposure Draft: Share-Based Payment
File Reference No. 1102-100

Dear Director:

America's Community Bankers ("ACB")¹ is pleased to comment on the exposure draft ("ED") issued by the Financial Accounting Standards Board ("FASB") containing proposed amendments to the accounting for employee stock options and other share-based payment arrangements for employees.²

FASB's ED would require public companies to expense employee stock options and other share-based employee payments. The proposal requires these stock options to be recorded as an expense on the income statement, and mandates that public companies use only a fair value based accounting method to estimate the value of the options as of the grant date. The proposal allows private companies to use an intrinsic value method, with remeasurement required at each reporting date until settlement. The ED does not permit nonpublic companies to recognize the cost of employee stock options using the "minimum value approach," as currently allowed under Statement 123.

ACB Position

ACB supports the continuation of current Statement 123, as amended by Statement 148, which permits but does not require the expensing of stock options on the income statement. Despite being subject to the fair value measurement flaws associated with option-pricing models, the

¹ ACB represents the nation's community banks. ACB members, whose aggregate assets total more than \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

² Exposure Draft: Share-Based Payment, an amendment of FASB Statements No. 123 and 95.

current mandatory footnote disclosure provides prominent information on the fair value impact of stock options in the footnotes to the financial statements. These disclosures have proven to be useful for the users of these statements. Under the current structure, an estimate of possible shareholder dilution is reflected in the difference between basic earnings per share and diluted earnings per share, resulting from the issuance and exercise of employee stock options. As lenders, our members would not find borrower financial statements with stock option expensing particularly useful because of the distortion of financial condition that can result from applying potentially unreliable pricing models to the options and running the expense through the income statement.

ACB agrees with FASB that the most widely used fair value measurement techniques for stock options, including Black-Scholes and other closed-form pricing models, are not appropriate for employee stock option valuation. Such methodologies tend to significantly overstate the value of employee stock options. However, in the ED, FASB suggests that binomial (lattice) models are superior and are the preferred methods for measuring the fair value of stock options. ACB believes that these binomial models are also inherently flawed. The data required for binomial (lattice) models are simply not readily available, incorporating much uncertainty into the assumptions used in these models, inevitably jeopardizing the reliability of these numbers in the financial statements.

Background

The issue of how to account for employee stock options has gained a significant amount of attention for many years. APB Opinion No. 25, *Accounting for Stock Issued to Employees*, issued in 1972, required that employee stock options be measured at their intrinsic value, most often at the grant date. This generally resulted in little or no compensation cost being recognized. In 1995, FASB issued Statement 123, which established a fair value-based method of accounting for share-based compensation to employees that companies were encouraged to adopt. Companies, however, were permitted to continue accounting for share-based compensation using APB 25. Statement 123, however, required certain *pro forma* information to be provided on an annual basis to reflect the impact of outstanding stock options on net income and earnings per share.

The current ED would require all public companies to expense the fair value of outstanding employee stock options, and *pro forma* disclosure would no longer be an acceptable alternative. Observable market prices of identical or similar equity or liability instruments would be considered the best evidence of fair value and would have to be used if available. Since observable market prices are usually not available, the options would have to be measured using complex option-pricing models.

In the ED, FASB agrees with the critics who say that the Black-Scholes formula and similar closed-form models do not produce reasonable estimates of fair value because they do not adequately take into account the unique characteristics of employee stock options. FASB believes that binomial (lattice) models are preferable because of their greater flexibility and would encourage their use, but would not require it at this time.

Lender's Perspective of Proposal

Before addressing the specific details of the ED, we note that lenders who are the users of financial statements have concerns in addition to those they might have as companies that use stock options as compensation. When making credit decisions, lenders use corporate customers' financial statements to evaluate the financial condition of the borrowers. If employee stock options are expensed, it will distort the true financial condition of the company and will not accurately reflect the ability of the company to make payments on a loan. Lenders are concerned that they may have to work with *pro forma* statements that negate the impact of the stock option expense. Under the current approach, the lender can rely on the financial statements as an accurate reflection of the condition of the company and, if necessary, obtain information about the impact of stock options by reviewing disclosures made pursuant to current accounting standards.

ACB Opposes Mandatory Expensing of Employee Stock Options

ACB's policy position on the issue of stock option accounting is to

“[S]upport an approach for the accounting of stock options that provides for equitable accounting treatment across industries, ensures accurate measurement of the value of stock options, encourages compensation policies that align management's interest with the long-term interest of stockholders, and provides useful information to investors. ACB opposes a mandatory requirement to expense stock options as inconsistent with these objectives.”

ACB strongly favors the proper disclosure of the impact of outstanding stock options on a company as a better alternative to an expensing requirement. The greatest real-world impact of stock options is on shareholder dilution. This dilution is properly reflected by disclosing information about outstanding stock options, including diluted earnings per share. While there may be a potential cost associated with the granting of stock options, any such cost is absorbed by the shareholders through a change in their share of ownership.³ Additionally, ACB members remain concerned that a requirement to expense stock options, while continuing to reflect their impact in diluted earnings per share calculations, may result in an inappropriate double counting of the impact of the options.

Valuation Issues

The biggest challenge in trying to measure the fair value of stock options is that there is no agreement on the proper methodology, and all option-pricing models have their drawbacks. While ACB appreciates FASB's efforts in developing the proposed approach and extensive implementation guidelines, we believe that the approach will add to more uncertainty and will distort the real financial condition of most companies that use employee stock options. While

³ Under newly revised listing standards adopted by the national stock exchanges, shareholders must be given the opportunity to vote on stock option programs and can decide whether the programs are in the best interest of the company and whether the impact is justified.

management is left with the flexibility to develop appropriate assumptions, the wide variations in calculated values that will result among companies will not allow for accurate comparisons across industries and companies.

The models require a great deal of assumptions that are difficult to make with any sense of certainty. For example, volatility has to be projected as far as ten years into the future. Expectations about future volatility cannot be based solely on past experience, and a company must project how the future is expected to differ from the past. That same assumption is also required when reviewing historical averages of share option lives and historical dividends. Furthermore, the proposal requires the aggregation of individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors, with the fair value of the options granted to each group estimated separately. While there are a variety of categories into which a company could group employees, no indication of acceptable categories is provided by the proposal.

No model can take into account all of the substantive characteristics of an employee stock option. For example, the models do not take into account the fact that an option cannot be transferred, hedged, pledged or sold. Thus, ACB does not believe that any option pricing model adequately produces a reliable measurement of fair value for use in the primary financial statements.

At a minimum, prior to imposing this proposal on all companies, ACB urges FASB to conduct impact studies to test the proposed models and implementation guidelines to see if the results do reflect fair value. If, as we believe, the value of the options would be overstated, adjustments should be made to reach a more accurate result. Possible adjustments include assigning zero volatility, placing a cap on volatility, and valuing the option up until the vesting date when the option can be exercised.

Complexity of Proposal

We are particularly concerned about the impact of the complexity of the proposal on our members, which are community banks, comprising both public and private institutions. The effort involved in performing a lattice calculation, as proposed by the ED, can be significant. These calculations would involve collecting and analyzing significant amounts of employee exercise data prior to award expiration. Many of FASB's examples in the implementation guidelines assume that a company grants stock options to a limited number of executives. However, many companies have broad-based plans and will find the accounting difficult and costly. As a practical matter, many ACB members do not have the resources internally to develop the assumptions and perform the complex calculations without the assistance of valuation specialists. The alternative afforded to private companies of using intrinsic value, rather than fair value, is helpful but not sufficient, since the numbers will be subject to re-valuation at each reporting date. Again, this will be a significant burden to our smaller members, who are still not convinced that the end result is more reliable due to the potential double counting of the cost of the options.

We believe that these significant burdens associated with the mandatory expensing of stock options will cause smaller companies like many ACB members to either terminate their stock

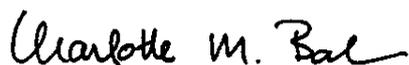
option programs or limit the programs to a small number of executive officers. Therefore, the people that will be most negatively impacted are the rank-and-file employees who are awarded options as an incentive to help the financial institution meet its performance objectives. In contemplating this result, we urge FASB to consider the benefits to the economy of stock options in furthering the objective of aligning the interest of management and shareholders. Properly structured, employee stock options are a powerful incentive for management to productively invest corporate resources consistent with shareholders' interests. Research such as that conducted by Blasi, Kruse and Bernstein's and discussed in the book, *In the Company of Owners: The Truth about Stock Options (And Why Every Employee Should Have Them)*, shows that firms with broad-based stock option plans are more productive. Potential abuses associated with the issuance of options would be better addressed by holding directors accountable for compensation paid to corporate executives, rather than through adjustments to the accounting treatment.

Conclusion

In conclusion, ACB believes that the current practice of allowing disclosure as an alternative to expensing employee stock options works well. Those companies that want to voluntarily expense their employee stock options should be permitted to do so and FASB should adopt uniform standards for those companies to follow. Any cost associated with the granting of employee stock options is clearly reflected in shareholder dilution. Additionally, using option-pricing models that do not accurately consider the unique characteristics of employee stock options will inevitably produce unreliable data and potentially distort the financial condition of companies as reflected in the primary financial statements. Lastly, requiring smaller companies to follow complex implementation guidelines to arrive at figures that are not reliable would be unduly burdensome. If FASB decides to move forward with the adoption of a fair-value expensing requirement in line with the proposal, we encourage FASB to provide appropriate adjustments to mitigate the overvaluation problems.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org, or Dennis Hild at (202) 857-3158 or via e-mail at dhild@acbankers.org.

Sincerely,



Charlotte M. Bahin
Senior Vice President, Regulatory Affairs