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MP&T Director File Reference 1102-001 Financial Accounting Standards Board of the Financial Accounting Foundation 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Letter of Comment No: 247 File Reference: 1102-001 Date Received: /-3/-03

Dear Sir or Madam:

Thank you for your Invitation to Comment on the differences between certain U.S. accounting standards on stock-based compensation, principally FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and its related interpretations, and the Proposed International Financial Reporting Standard, *Share-based Payment* (Proposed IFRS.)

We understand that the Board is not seeking comments on certain issues such as:
(a) whether stock options granted to employees result in compensation expense for the issuing entity, (b) whether stock options issued to employees should be measured at something other than fair value, (c) whether the fair value of stock options can be reliably measured, and (d) the appropriate measurement date for measuring fair value of equity instruments to employees. However, given the FASB's objectives of improving U.S. financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, these issues are critically important to U.S. investors and reporting corporations.

The majority of reporting corporations in the United States continue to measure stock-based compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, due to the serious limitations of the fair value methods prescribed under Statement 123 and a fundamental disbelief that stock options represent a compensation cost to the issuing organization. The issuance of stock options does not result in a corporate level cost that impacts net income. To the extent options are actually issued, corporate assets are increased by the amount of cash that the employee must pay to exercise the option. The only cost of issuing employee stock options is borne by existing shareholders in the form of potential dilution.

We would like to reiterate that the definition of expenses in FASB Concepts Statement No. 6, *Elements of Financial Statements*, says that expenses result from outflows or using up of assets or incurring of liabilities. The issuance of stock options does not involve cash, or any other asset or the creation of a liability. There is no other income or expense item on the income statement that does not at some point in its life create a cash impact. Every significant accrual estimate that makes its way onto the

income statement involves making or receiving cash payments. The provision for loan loss is calculated based on the forgiveness of cash on principal and interest amounts owed and the receipt of cash on previously forgiven principal and interest amounts owed over the loan's life. Provisions for valuation allowances for deferred taxes are always ultimately offset by direct cash tax payments to or from taxing authorities. Pension and other post retirement benefit obligation expenses are always ultimately settled with cash payments to the beneficiaries. Depreciation expense is recorded as a result of the cash payment for an asset and the spreading of that expense over its estimated useful life. There is never a cash payment by the issuing corporation to a holder of a stock option during the life of the option and therefore no expense recognition can be justified. The only cash that changes hands is when the option holder is issued stock upon exercise and the corporation is paid for issuing that equity. This is, and should be, properly recorded as the issuance of equity as guided by APB No. 25.

While we recognize that the FASB does not consider economic arguments when it addresses accounting policy, we believe it would be imprudent not to look at the unintended consequences of its rule making. Stock options have been proven to transform industries and accelerate innovation and prosperity. They increase the ability of emerging companies to attract the talent they need to succeed and grow. It will limit entrepreneurial opportunities to advance new ideas and develop new technologies and will jeopardize our competitive edge as a nation. Mandatory expensing of stock options will depress U. S. stock prices, raise the cost of capital and reduce economic growth. At a time when the nation is posed for war and our economy is struggling, the impact of these rule changes could turn what is a cyclical downturn into a long-term decline.

The remaining portion of this comment letter addresses the specific issues you requested comments on in addressing the Proposed IFRS.

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

We concur with the IASB that, since in principle, the AICPA Statement of Position (SOP) 93-6, Employers' Accounting for Employee Stock Ownership Plans, already requires that compensation expense be recognized at fair value that a scope inclusion is appropriate.

We concur with Statement 123 that small discounts from market price for ESPPs are equivalent to (a) discounts routinely offered to stockholders and others or (b) avoided stock issuance costs incurred in a public offering. Therefore, the accounting treatment of these ESPPs should be different and the scope exclusion in Statement 123 is appropriate.

Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions.

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 fair value of employee stock options granted and why?

No, we do not believe that an accounting standard should mandate the use of an optionpricing model for measurement purposes. If mandatory expensing of compensation costs is required, then we believe that the accounting should be consistent with FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Here the issuing corporation would incur a compensation liability to be determined by the increase in the entity's stock price from the exercise price. The amount of the liability for such an award would be measured each period based on the current stock price. The effects of changes in the stock price during the service or vesting period would be recognized as compensation cost over the service period. Changes in the amount of the liability due to stock price changes after the service period are compensation cost of the period in which the changes occur. Use of this method would capture both the positive and negative changes in stock price and therefor compensation is valued by the market based on the value of the associate's services received during the current period. This method would also eliminate any excess tax benefit at exercise, as the income statement would have reported the appropriate cumulative compensation at the time of the exercise.

Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?

If mandatory expensing of stock options becomes required, the only amount the investor will be interested in is the compensation cost recorded on the income statements. How the organization arrived at those compensation costs will never be fully understood if multiple valuation methods are utilized by the industry to value stock options. If Black-Scholes or binomial options-pricing models are prescribed, then we believe that current disclosures required by Statement 123 provide the investor with the necessary information to make industry comparisons. If SAR accounting were the preferred method, then disclosures previously issued under those rules would be sufficient.

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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.

The use of Black-Sholes or other options pricing models generates large differences in the compensation expense recorded depending on the inputs used. The volatility assumption creates the greatest disparity in the comparability of compensation expense from one period to the next. This volatility measure assumes that future price moves in a company's stock will follow historical price move patterns. Given the significant

volatility in stock prices during the 1990's and a reversion to a more normal stock market pattern, this volatility assumption overstates the likely value of a option in today's environment. Therefore, stock price volatility should be set to either .001 or capped to level the playing field for all reporting corporations. Without this, current models create a favorable bias for companies in non-volatile industries and a negative bias in highly volatile industries. For example, if the stock price and other terms were the same, the stock price is declining in the volatile market, and staying constant in the non-volatile market, the option value will be significantly higher for the company in the volatile market. Interest rates, dividends and employee behavior are much more stable and predictable and have less of an impact on option valuation.

Issue 2(e): Do you believe that additional guidance for selecting factors used in options-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?

Other than the volatility assumption discussed above, the current guidance provided by the FASB is very useful in applying this standard.

Issue 3: 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? If so, why? If not, why not?

We concur with the Proposed IFRS that there is no conceptual difference between employee and nonemployee transactions. However, we do not agree with the IASB's use of grant date measurement because service and performance conditions significantly affect the value of the economic benefit. We are proponents of the use of Stock Appreciation Rights approach to measurement and recognition for this class of awards as well. Calculation of compensation cost would again be done at each reporting date prior to reaching a final measurement date.

Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not?

No, for the reasons stated in Issue 3 above.

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Issue 5: Do you believe the notion of issuance is of conceptual importance in the design of a standard on stock-based compensation? If so, why? If not, why not?

We concur with the FASB that equity instruments subject to service or performance conditions are granted and not issued because they represent a conditional obligation to issue equity instruments in exchange for valuable consideration at a later date. We believe that it is essential to provide this as a conceptual basis for the accounting treatment of forfeitures.

Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined in Statement 123, at the grant date? If so, why? If not, why not?

No, we do not agree that an equity instrument is issued at grant date if there are vesting or other performance requirements. We concur with FASB's use of the modified grant-date method for determining when an equity instrument has been issued.

Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimated fair value per equity instrument (IASB approach)? If so, why? If not, why not?

No we do not agree with estimating the effect of forfeitures at grant date and being unable to modify that estimate to reflect the actual forfeitures realized. We believe that the FASB's method of adjusting for actual forfeitures in future periods is a closer approximation of true compensation cost than using a static assumption.

Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that reward? If so, why? If not, why not?

Yes, since the purpose of recording the compensation cost to begin with is to reflect the value obtained by the corporation from the services provided by the option holder. If the option holder is no longer there to provide that value or fails to perform the conditions for which the reward has been promised then it should reduce the compensation cost previously recorded.

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 fair value than minimum value? If so, why? If not, why not?

No, as previously stated, we believe that the volatility assumption in options-pricing models should be eliminated because it produces misleading and sometimes meaningless values. We believe all entities should be able to use minimum value in options-pricing valuation.

Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why?

Because we disagree with the IASB's use of grant date measurement and assumption driven forfeiture schedules, we prefer the FASB's modified grant-date approach over the vesting period with actual forfeiture adjustments. If the units-of-service approach was modified to allow for actual forfeitures in the reporting period it would generally yield the same results as the FASB's approach.

Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not?

We understand the logic in the IASB's approach to attribution given their theory that the organization receives the value of the employee's service prior to forfeiture. However, as with any incentive compensation, the employee must be here to receive the compensation or the corporation doesn't pay it. For example, annual bonuses are paid for the work performed by an employee in the previous year, but if they leave prior to the actual bonus payout they do not receive the bonus and the corporation does not record a compensation cost. The FASB's attribution approach is much more consistent with business practice.

Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by the enterprise? If so, why? If not, why not?

Yes, we believe this is true for all applications of stock-based accounting, not just performance awards. The compensation cost for a performance award should be adjusted for changes in the expected or actual outcome of the performance condition. We concur with the issuance concept established by Statement 123, since the equity instruments are not issued, changes in the actual outcome that impact the fair value should be recognized. We disagree with the IASB's inclusion of an assumption of forfeitures rather than the actual value of forfeitures.

Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not?

We do not believe that option-pricing model's should be used to determine the fair value of the option. If the Stock Appreciation Rights accounting were to be used, the time value of the option would be represented in the current market price of the stock. However, if mandatory expensing of stock options is required to be determined using an option-pricing model then we believe that using the expected option life and attributing the compensation cost over the vesting period is appropriate.

Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not?

Yes

Issue 15: Do you believe that all tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not?

We concur with the Proposed IFRS that all tax effects related to equity instruments granted be recognized in the income statement. If we are required to record compensation for equity instruments that are issued in exchange for services received, this is an income statement item. Consequently, tax benefits received relate to an item recorded on the income statement not the balance sheet. Additionally, if the Stock Appreciate Rights accounting is utilized, there would be no excess tax benefit to recognize since the cumulative compensation expense at the time of the exercise would already have been recorded on the income statement.

Item 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 the expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?)

We believe that the explanation of any difference between historical volatility and expected volatility would be useful information to the investor. Decomposition of the impact of vesting schedules would be complex and confusing to the average investor. Since we do not concur with the use of grant-date methodology, the disclosure related to expected vesting at grant date would be unnecessary. Actual option life versus expected option life offers no additional information to the investor since compensation cost will always be calculated off of the expected option life.

Conclusion

We appreciate the opportunity to provide you with our views on this subject. We hope the information we have provided will prove useful to you in your deliberations.

Respectfully submitted,

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