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Letter of Comment No: 62 File Reference: 1102-001

Date Received:

February 6, 2003 Via mail and email

Ms. Suzanne O. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

> Re: File Reference No. 1102-001 – Invitation to Comment

> > 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 Ms Bielstein:

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with over \$300 billion in assets providing banking, insurance, investments, mortgage and consumer finance. We appreciate the opportunity to comment on the issues being considered by the Board in determining whether to revise U.S. accounting standards on stock-based compensation.

Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, established a fair value based accounting method for recording the cost of stock options. However, SFAS No. 123 also permits companies to continue to apply the intrinsic value based accounting method, presented in Accounting Principles Bulletin (APB) Opinion No. 25, Accounting for Stock Issued to Employees. The proposed International Financial Reporting Standard (IFRS), Share-based Payments, would mandate the use of only a fair value based accounting method, without permitting the application of the alternative intrinsic value based accounting method.

Wells Fargo does not believe that the grant of a stock option meets the definition of an expense. Paragraph 80 of FASB Statement of Concepts No. 6, Elements of Financial Statements, defines expenses as follows: "Expenses are outflows or other using up of assets or incurrences of liability (or a combination of both) from delivering or producing goods, rendering services. carrying out other activities that constitute the entity's ongoing major or central operations."

Because there are no outflows, using up of assets, or incurrences of liabilities associated with stock options, we don't believe stock options grants should be classified as an expense. Mandating the fair value method requires an earnings charge even though there is no cash outflow and, in fact, there is a cash inflow associated with the exercise of the option. In addition, stock options have been a valuable tool to start-up companies, particularly U.S. technology companies, allowing them to attract talent and create innovative products that are the envy of the world. They have helped entrepreneurs and product innovators thrive — while preserving valuable cash, obtaining new cash, and avoiding prohibitively costly terms for raising funds in the capital markets.

Wells Fargo believes the intrinsic value method is the preferable method of accounting for stock options. The intrinsic value method measures the economic impact of a stock option grant on earnings per share in terms of potential dilution to existing stockholders. By giving the grantee a right to buy shares at a predetermined price, a stock option grant has the potential to transfer to the grantee some of the claims of existing stockholders to the Company's future earnings. In effect, the impact of a stock option grant to existing stockholders is the possibility that their slice of the corporate earnings pie will be smaller if the option is exercised. Under the intrinsic value method, an estimate of this possibility is reflected in the difference between basic earnings per share and diluted earnings per share, the latter calculated based on assumptions about the exercise of outstanding in-the-money stock options. Under the fair value method, however, because the estimated fair value of an option grant must be expensed, the economic impact of a stock option grant is reflected twice, not only in terms of the potential dilution to existing stockholders but also in the form of a charge to earnings. That's double counting the economic impact. That doesn't make sense to us. Therefore, we disagree with this accounting treatment.

Although we do not believe the grant of stock options meets the definition of an expense, if the expensing of options is mandated by the Board, we have significant concerns with the reliability of any model used to estimate the fair value of stock options. The most commonly used methods to calculate the value of the option grant (e.g., the Black-Scholes model or the binomial model) utilize at least five faulty assumptions in the calculation of the fair value of the option grant (as further detailed below). In addition, the fair value method actually provides less information to evaluate the Company's earnings. Net income and earnings per share would be calculated and presented under a single method. There is no alternative footnote disclosure to present the impact of stock options "as if" the intrinsic value method had been used. By contrast, Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, not only permits, but requires, prominent quarterly disclosure of the fair value impact of stock options in the footnotes to the financial statements. Moreover, the footnote disclosure provides information about the assumptions used to calculate fair value, such as the weighted average exercise price of outstanding stock options and the expected dividend yield, stock price volatility and option duration. As such, expensing a stock option grant in the income statement would not add any information not already collectively provided in the financial statements and notes to the financial statements.

We believe that the valuation assumptions inherent in any option-pricing model, including the Black-Scholes Model (BSM), are flawed. The specific assumptions inherent in the BSM that are not applicable to employee stock options, and thus invalidate the use of the model, are as follows:

- 1. Transferability. The Black-Scholes Model calculates a fair value for stock options assuming the option holder has the ability to transfer options to an independent third party. Employee stock options differ from other options in that they can only be exercised and not transferred, thus significantly reducing the true value of an employee stock option compared to the BSM calculated value. The FASB attempted to address this deficiency by mandating the use of the option's expected life, rather than the option's maximum term. We are not convinced that the FASB's modification generates a value that is representative of the option's true fair value.
- 2. Black-out periods. The BSM calculation of fair value assumes there are no time periods during which the option holder is unable to exercise his options. Mandatory black-out periods required by both Sarbanes-Oxley legislation and SEC regulations prevent certain employees from exercising options during certain periods of the quarter and other time periods, significantly reducing the true value of the employee stock option.
- 3. Short-term vs. long-term nature of options. The BSM is used primarily by traders to value short-term options (30-90 days) actively traded on national exchanges. In contrast, employee stock options are long-term (10 years). BSM relies on an assumption that the current interest rate, dividend rate and volatility will essentially remain constant during the duration of the option's life. While this assumption is valid for short-term options, the forecast accuracy of the model declines significantly as the option's duration lengthens.
- 4. Nonexercisability during vesting period. The BSM calculation assumes that all options are immediately vested on grant date. Because employee options generally vest over a 1-3 year time period, the imposition of vesting restrictions significantly reduces the true value of employee stock options. Again, the FASB recognized the BSM's deficiency and attempted to address this concern by mandating the use of the option's expected life, rather than the option's maximum term. Again, we are not convinced that the FASB's modification generates a value that is representative of the option's true fair value.
- 5. Termination restrictions. The BSM calculation assumes that an option holder will not be forced to exercise his option during adverse national economic conditions but will be able to retain the option until the option's expiration date. Because most employee stock options have to be exercised within three month's of an option holder's termination, the risk of required exercise during adverse economic conditions is increased and the value of the employee stock options is significantly reduced.

Based on the foregoing, we do not support changes to FASB Statement 123 that would (1) eliminate an enterprise's ability to account for stock options under APB Opinion No. 25, and (2) mandate the use of a specific option-pricing model that we believe to be unreliable in determining an option's fair value.

We appreciate the opportunity to comment on the issues contained in the Board's invitation. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy Senior Vice President & Controller