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January 31, 2003

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

Dear Director:

WorldatWork is pleased to respond to the Nov. 18, 2002, Financial Accounting Standards Board Invitation to Comment No. 1102-001, *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*

WorldatWork is a not-for-profit educational association of 25,000 members who work in the fields of compensation, benefits and employee rewards. Eighty-eight percent of the *Fortune* 1000 is represented among the WorldatWork membership, as well as most of the leading universities and compensation and benefits consulting firms in North America. Our association is composed of individual members of the profession whose interest is to advance the state of the art of rewards management; we do not lobby.

Because our members either oversee or work directly in the compensation departments of North America's largest companies, many are responsible for the administration of stock compensation plans. As such, we believe WorldatWork is uniquely qualified to discuss both FAS 123 and the IASB Proposed IFRS from the perspective of compensation and rewards professionals.

Several of the profession's most respected practitioners and consultants have contributed to the attached document, and as such, we believe these comments bring both a diverse and balanced perspective of professionals in the field of compensation and employee rewards.

We appreciate your consideration of the comments contained in this letter and we thank you for the opportunity to comment. Of course, we would be pleased to respond to any further questions the FASB may have about any of our comments.

Regards,

A handwritten signature in black ink, appearing to read "Anne C. Ruddy".

Anne C. Ruddy, CPCU
Executive Director

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**Comments of WorldatWork Regarding
*A Comparison of FASB Statement 123, Accounting for Stock-Based Compensation,
and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment***

January 2003

WorldatWork is the world's leading not-for-profit educational association of compensation, benefits and employee rewards professionals. Founded in 1955, and with a membership today of more than 25,000 professionals around the world, WorldatWork focuses on the disciplines associated with attracting, retaining and motivating employees. Eighty-eight percent of the *Fortune* 1000 companies have at least one employee who is a WorldatWork member.

The following comments address a number of the items in the Nov. 18, 2002, FASB Invitation to Comment. On page 9, the FASB Invitation to Comment specifically asks for input regarding "proposed changes to U.S. accounting standards on stock-based compensation." Because this association is a collection of compensation and employee rewards professionals, not accountants or economists, we will leave discussions of accounting and economic theory to others, and will comment only upon those issues that are most relevant to our membership and the association's mission.

The Association's Overarching Views Regarding Stock-Based Compensation

As a fundamental premise, WorldatWork believes that stock options and other stock compensation plans are powerful employee rewards tools to 1) link the interests of employees with the interests of shareholders, and 2) maximize shareholder return.

As we have said in previous comments to the NYSE, NASDAQ and others, we believe that stock options are an extremely important employee rewards vehicle, and the resulting equity ownership can create a competitive advantage for certain organizations in attracting, retaining, and motivating key talent.

Stock option programs that include officers and outside directors contain specific provisions that make them different from other compensation arrangements. With the exception of broad-based plans and inducement options, these plans require shareholder approval, and the approval specifies the maximum number of shares that are authorized for stock options and the specific term of the options. Shareholders expect that the Board will allocate these shares to employees in a manner that will maximize future stock price. Shareholders also expect the Board to report the stock grant activity to shareholders each year and to monitor the overall operation of the plan. Since the shareholders eventually pay for these plans through ownership dilution and seek the reward through improved

management and stock performance, this is an appropriate trade off and protection for shareholders.

Historically, almost all public companies in the U.S. have offered stock option compensation plans for executives. Offering such options to the broader employee base is a more recent development, championed by high-tech companies during the past decade as a tool for talent attraction, motivation and retention.

Data from WorldatWork member surveys indicates that, indeed, during the last five years, companies have offered stock options deeper into the organization below the executive level. In 1997, 16 percent of 575 companies in North America responding to the WorldatWork *Salary Budget Survey* reported that stock options were offered to nonexempt hourly nonunion employees. In our most recent 29th Annual *Salary Budget Survey* (released July 2002), 26 percent of more than 2,000 companies reported similarly, a 10 percent increase in just five years.

One of the most attractive features of stock option plans is the flexibility with which they can be implemented. Traditionally, companies have been able to determine participation and award sizes based on market forces and business needs, rather than rules and complex tests. WorldatWork believes that stock compensation is an important part of fair, flexible and creative compensation designs for both the employer and employee.

Comment Regarding 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 the fair value of employee stock options granted and why?

We believe movement toward a single mandated stock option-pricing accounting standard is an extraordinarily difficult goal. The difficulty lies in both the fundamental nature and volatility of markets, and the shortcomings of the option pricing models that have been developed to date.

Although stock options undoubtedly have some value when issued — indeed, that is why they are issued in the first place — predicting the future value of those options is a fundamental problem. For the millions of employees who today hold underwater options, the value of the options they hold is essentially zero. The options granted just a few years ago with the intention of rewarding, motivating and retaining key employees have essentially no value.

Virtually all publicly traded option-pricing models were developed for short-lived transferable options that trade in the public markets. Thus, their accuracy can be verified and modifications made. This is not the case, however, with employee stock options that have different characteristics than public options. To our knowledge, there exists no option-pricing model for employee stock options that recognizes these differences.

Both the IASB and FASB propose using option-pricing models developed for publicly-traded options to estimate the “fair value” at grant of employee options for expense recognition purposes with only two modifications to reflect the special characteristics of employee options: adjustments for forfeiture, and use of “expected” option term, to recognize non-transferability.

These adjustments do not fully reflect the negative characteristics of employee options, which include:

1. Option is forfeitable until vested (recognized in adjustment 1 above).
2. Option is not exercisable until vested (recognized in European option models like Black-Scholes).
3. Option is non-transferable, and once exercised, dies (addressed by adjustment 2 above, but insufficiently; see later discussion).
4. Option term is truncated if employee terminates after vesting (addressed by adjustment 2 above).
5. Miscellaneous such as blackout periods, stock holding requirements, non-compete and forfeiture requirements.

Option-pricing models do not purport to measure the cost to the company of granting options to employees because there is no “cost,” per se, that can be measured. Nor do they purport to measure the value of the options to the recipient. Accounting professionals seem to imply that this is irrelevant for accounting purposes.

Rather, option-pricing models purport to measure the amount of cash forgone to the company by granting options to employees rather than selling them in the market. This forgone cash, then, becomes the “expense” recognized for the option in the income statement. Yet there is no evidence offered that option-pricing models, as adjusted, measure what investors (or employees) would be willing to pay for options with characteristics similar to employee stock options.

We believe option-pricing models, as adjusted, overstate the “fair value” of employee options and, thus, the amount of cash forgone by not selling them in the market. “Fair,” as in fair value, means fair to both the buyer and seller. “Value,” as in fair value, means a price at which numerous willing sellers and buyers would agree to trade similar instruments. Since a buyer will not pay more than the perceived value to him or her, investors’ (or employees’) perception of the value to the employee is indeed relevant to the issue of “fair value.”

In addition to the special characteristics of employee options enumerated above that reduce their value versus traded options, employees themselves bring certain attributes to the value exchange that result in a further lowering of the “fair value” of employee options:

- Employees tend to be risk averse
- They are already over-concentrated in their employer's stock
- They cannot hedge their option position
- They tend not to be sophisticated investors able to pick "highs" in their stock.

Thus, volatility is of less value to employees than public investors. (See "Stock Options for Undiversified Executives" by Brian J. Hall and Kevin J. Murphy.)

It is true that compensation professionals apply option-pricing models to employee options in their work. But this is primarily for the purpose of comparing options granted in one company to a group of peers or the market as a whole, not for determining the real value to employees. In fact, when converting option values to real compensation, it is reasonably common to apply a significant haircut to option values determined using option-pricing models.

The major difference between employee options and traded options is that employee options are non-transferable. Except in the case of death, only the employee may exercise employee options; they may not be sold to someone else. And once exercised, they terminate.

The FASB's and IASB's answer to this difference is to allow use of "expected" life, rather than contractual life, of the option in measuring "fair value." But this does not adequately account for the loss of remaining time value when the employee option is exercised before its end, as is often the case. It measures the difference in time value between expected and contractual life when the option is granted. But this is far less than the forgone time value at the point of exercise when the option is exercised early.

Given the pervasive view that option-pricing models, as adjusted, overestimate the "fair value" of employee options, we see the FASB as having three choices:

1. Sponsor development of an option-pricing model to more accurately determine the "fair value" of employee options
2. Permit further modifications to option pricing models for employee options to reduce the "value gap" (see our response to Issue 2(d) next)
3. Abandon the goal of measuring the "fair value" of employee options as unachievable in the absence of a public market for employee options. Instead, default to the "minimum option value method" (MOVM), which clearly and simply measures the value of allowing the employee to delay payment of the option's exercise price.

We believe that the problem with the fair value approach proposal by both the FASB and the IASB is that it does not result in a "fair value" for an employee option at grant. Thus, the objective of "leveling the playing field" between fixed-price options and other forms of equity incentive will not be achieved. The unintended consequence may be a bias

against the use of stock options because few companies will be willing to incur an expense for a form of compensation significantly greater than the value perceived by recipients.

Comment Regarding 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.

Several adjustments can be made to option pricing models, or to their outcomes, to “improve the consistency and reliability of measurement.”

- Adjustments must be made to ensure that an option-pricing model developed for shorter-term trade-able options appropriately reflects the fact that employee options are non-transferable, with a vesting schedule and an employment-based exercise term.
- To appropriately recognize all miscellaneous negative characteristics of employee options versus traded options, further reduce “fair value” outcomes by some arbitrary but reasonable amount, perhaps 25 percent.
- The fact that an employee option has no liquidity value until the vesting date should be incorporated into any option-pricing model. Vesting date might be used as the expected option term.
- Measure “fair value” using maximum contractual term, but then allow an adjustment to income at option exercise or expiration for the “fair value” of the option at that point, less intrinsic value (i.e., option gain realized), if any.

Comment Regarding Issue #3: Do you believe that employee and non-employee 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 believe that there is no reason to differentiate employee and non-employee transactions. As the work force model has, in the recent past and will continue to increasingly be, redefined by contract employees, temporary assignments, etc., there is no need for such a distinction.

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

Yes, actual outcomes of performance-based equity grants should affect total compensation expense. Specifically, an estimate of the probability of meeting any performance vesting conditions should be incorporated into the value determination at grant, just like forfeiture estimates for continued-employment conditions. Then, these grant-value estimates per share should not be “trued up” based on actual outcomes. However, there should be an adjustment at vesting for the actual number of shares earned (or forfeited) based on the performance outcomes.

Many plans have earn-out ranges of 0 percent to 200 percent of the initial shares grant. And some company’s boards use discretion to determine the extent to which performance goals are met. Without a requirement to reconcile actual shares issued to prior accruals, we could have the unintended outcome of employees receiving far more or far fewer shares than had been recorded as expense. The result would be to exacerbate swings in operating earnings and to reduce the reliability of reported earnings. An analogy to the IASB’s approach would be to require that accruals of target bonus amounts not be reconciled to actual bonuses paid because the company got the services from the employees anyway.

Comment Regarding Issue #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 those expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not?

Additional IFRS disclosure requirements (paragraph 83) might be useful in preventing companies from “gaming” their parameter estimates in the option pricing model. We generally believe that disclosure is important to the market’s clear understanding of option valuation assumptions and methods. However, we also believe the other disclosures suggested in paragraphs 84-86 would be interesting but not particularly useful.

Simplified information that might be useful to investors is 1) options/SARs granted each year as a percentage of average shares and share equivalents outstanding during the year (“run rate”), (2) options/SARs outstanding at year end as a percentage of total shares plus options outstanding (“overhang”), and 3) the dilutive effect of equity incentives on Basic EPS (dollar amount per share and percentage).

We appreciate this opportunity to comment to the FASB and stand ready to respond to questions regarding any of the above commentary.