Association for Financial Professionals

March 7, 2003

CL 120

Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Exposure Draft, ED 2, *Share-Based Payment*

Dear Ms. Crook:

The Association for Financial Professionals (AFP) welcomes the opportunity to respond to the Exposure Draft *Share-Based Payment*. As corporate finance and treasury professionals, our members will likely be called upon for information necessary to formulate the economic assumptions inherent in options-pricing models that are used for estimating employee stock option expense.

AFP continues to oppose any requirement that companies record as an expense the fair value of stock options issued to employees. Employee stock options (ESOs) have value to employees and are a cost borne by shareholders, not the company. The cost of stock options is reflected in fully diluted earnings-per-share, under current accounting rules of the Financial Accounting Standards Board (FASB). However, if the International Accounting Standards Board (IASB) requires the expensing of ESOs, it is imperative that IASB address significant issues related to accurately, reliably and consistently measuring the estimated cost.

The membership of AFP includes approximately 14,000 financial executives employed by over 5,000 corporations and other organizations. Our members represent a broad spectrum of financial disciplines; their organizations are drawn generally from the Fortune 1000 and middle-market companies in a wide variety of industries, including manufacturing, retail, energy, financial services, and technology. AFP supports members throughout their careers with research, continuing education, career development, professional certifications, publications, representation to key legislators and regulators, and the development of industry standards.

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Key Requirements of Exposure Draft

The purpose of the Exposure Draft is to ensure that an entity recognizes all stock-based payment transactions in its financial statements, at fair value, including stock options granted to employees. In keeping with a principles-based approach to standard setting, there are no exceptions to this draft International Financial Reporting Standard (IFRS).

The draft IFRS requires companies to estimate the cost of an ESO using an options-pricing model such as the Black-Scholes or binomial models. The model must take into account the exercise price, the expected life of the option, current price of underlying stock, estimated volatility of stock price, estimated dividends, and the risk-free interest rate for the expected life of the option.

Companies must estimate the total ESO cost by multiplying an estimated "deemed fair value per unit of service" by the number of actual "units of service" received. The "deemed fair value" is the fair value adjusted for forfeitures. Units of service are actual employee years, in the IASB illustrations. For example, 100 employees with ESOs would generate 100 units of service for the year. The total fair value of the ESOs would be 100 times the "deemed fair value per unit."

AFP's Views on Key Exposure Draft Requirements

AFP strongly opposes the requirement to expense the estimated cost of ESOs. However, if the IASB requires expensing, then it must provide additional guidance for companies to use in estimating the cost. There are significant measurement issues associated with the model most widely used for estimating the cost of employee stock options, the Black-Scholes option-pricing model. IASB should recognize that there may be additional methods of estimating the cost of ESOs, other than options-pricing models. In addition, the IASB should not require the "unit of service" approach for estimating the cost of ESOs.

AFP believes that additional research must be done to identify acceptable modifications that address the well-known shortcomings of the Black-Scholes options-pricing model. These shortcomings result in overstating estimated costs of ESOs. A modification is needed to account for the non-transferability of most ESOs, which exposes employees to additional risks and lowers the value of ESOs. In addition, some ESO plans have "blackout" periods, which prohibit executives and directors from selling stock acquired through option exercise. Blackout periods expose employees to additional risks and therefore must be considered. ESOs do not have the same exercise pattern as marketable options. Marketable options tend not to be exercised prior to the option's expiration because of the value embedded in the remaining time period. Employees may exercise ESOs early for a variety of reasons.

AFP opposes the proposed requirement that companies use the "unit of service" method of accounting for the estimated cost. Conceptually, that method focuses on measuring the fair value of *services received*. AFP supports the concept of measuring the value of *issued* equity instruments; i.e., those ESOs that are vested. The IASB proposal recognizes a service cost for ESOs that do not vest. The units of service method introduces additional estimates when dealing with options that vest based on performance criteria. In such cases, companies must estimate, at the grant date, the likelihood that the performance criteria will be attained and the estimated impact. This could result in extremely complex and possibly arbitrary estimates.

Because of the stake that our members have in the outcome of FASB and IASB deliberations on employee stock options, AFP is currently exploring the possibility of performing research on ESO valuation methodologies. AFP would be pleased to share with the IASB the results of any research performed.

Recommendations

As the voice of 14,000 corporate finance, treasury, and accounting professionals in all industries, AFP is concerned about accounting for stock options. AFP members have a direct interest in the debate and may be called upon for economic analyses necessary to help implement any new corporate accounting policies related to stock options.

AFP recommends that the IASB consider the option of enhanced disclosure, rather than expensing, of the cost of employee stock options in financial statements.

If the IASB does not allow a disclosure option, then AFP recommends that IASB encourage the development of modifications to Black-Scholes and accept a range of alternatives for valuing employee stock options.

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On behalf of our 14,000 members, AFP appreciates the opportunity to comment on the FASB proposal. If you have any questions, please contact Gregory Fletcher, AFP's Director of Financial Accounting and Reporting, at 1 (301) 961-8869.
Sincerely,

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