CL 104

March 7, 2003

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Subject: Accounting for Share-Based Payments

We at Marsh & McLennan Companies, Inc. ("MMC") are keenly interested in the subject of accounting for share-based payments and appreciate this opportunity to provide you with a new perspective regarding this topic. While we recognize that the IASB in its exposure draft has concluded that expensing of stock options is appropriate, we hope that during the comment period you are still open to new ideas and an intellectually stimulating alternative solution.

The attached **Stock Option Share Equivalents** proposal provides an alternative approach to current accounting for stock options and could prove to be an effective "middle ground" between those who want to expense stock options and those who oppose recording such an expense. It recognizes that this is both a governance issue and an accounting issue and is responsive to both – options will no longer be perceived as "free" with unknown future dilution to shareholders. It goes beyond the argument that there is no cost to options – it requires that the estimated dilutive effect of options be recognized at the date of grant through an immediate increase in assumed shares outstanding.

We agree fair value, as measured at the grant date, is an appropriate valuation of what is being transferred to employees. However, we submit that dilution rather than expense should be recognized based on that value, and should be fully recognized at the grant date. In recognition of the fact that the future issuance of shares is a capital transaction, we believe it is more appropriate for the fair value amount to be divided by the company's share price on the grant date to arrive at a number of equivalent shares. These incremental shares would be added to diluted shares outstanding for purposes of calculating fully diluted earnings per share.

The attached Stock Option Share Equivalents alternative explains the proposed approach providing examples of its application, our basis for conclusions and the effects of implementation. The underlying principles of the Stock Option Share Equivalents proposal are as follows:

- When a company awards employee stock options it commits to issuing shares in the future. The company can satisfy this commitment, which is net of shares purchased with exercise proceeds, by issuing previously unissued shares.

- The number of shares ultimately issued is the true impact of the award to the company.

- The number of shares can be estimated at the time of grant and should be added to fully diluted shares outstanding creating an immediately dilutive impact on earnings per share.

- The number of shares, hereafter called **Stock Option Share Equivalents ("SOSE")**, is calculated by dividing the fair value of the grant by the company's share price on the date of grant.

- The **SOSE** balance is reduced as actual dilution is recorded through the treasury stock method.

- If actual dilution exceeds the **SOSE** estimate established at grant (the **SOSE** balance has been reduced to zero), dilution continues to be captured through the computation of common stock equivalents using the treasury stock method until the options are exercised, forfeited, cancelled or expire.

- If there is a remaining **SOSE** balance at the time the related options are no longer exercisable (actual dilution was less than estimated dilution), the **SOSE** balance is eliminated from the earnings per share calculation.

- At the end of the day, dilution is equal to the actual number of shares issued.

- If an option is issued at a discount, giving an employee a benefit that other shareholders will not enjoy, it creates an expense as well as increases the fair value of the grant. Similar to restricted stock, which is really just an option with a zero purchase price, expense should only be recognized for the intrinsic value of the grant. Future appreciation should not be recognized as expense as it is shared by all shareholders.

We believe the proposed accounting more appropriately addresses the many concerns of investors, analysts, compensation consultants, accountants and the companies who would be responsible for its implementation than expense recognition as suggested by IASB. Its theoretical underpinnings were examined and enhanced by NERA economic consultants, Mercer compensation consultants and Deloitte & Touche, MMC's independent auditors. Without exception, they feel the proposal has merit and deserves consideration. Also, it is currently under review by the Business Roundtable and the Financial Executives International.

We respectfully request that IASB consider this proposal. We would be happy to meet with the IASB board members and staff to discuss the proposal and its long-term implications and thank you in advance for giving it your attention and full consideration.

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Robert J. Rapport, Vice President and Controller

cc. Suzanne Q. Bielstein, FASB
Patricia Hanahan Engman, The Business Roundtable
Philip B. Livingston, Financial Executives International
William Freda, Deloitte & Touche

Stock Option Share Equivalents
A Potential Solution to Accounting for Employee Stock Options

Introduction

Over the past eight months we have been exploring the most appropriate recognition of employee stock options taking into consideration proper accounting treatment, corporate governance issues and the need for businesses to have flexible compensation structures to promote growth.

This proposal provides an alternative approach to current accounting for stock options and could prove to be an effective "middle ground" between those that want to expense stock options and those that oppose recording such an expense. Furthermore, the underpinnings of this proposal are well grounded in accounting theory. It sets forth an alternative solution that addresses the many concerns of investors, analysts, compensation consultants, accountants and the companies who would be responsible for its implementation.

The **Stock Option Share Equivalents** proposal:

- Recognizes that this is both a governance issue and an accounting issue and is responsive to both – options will no longer be perceived as "free" with unknown future dilution to shareholders.

- Goes beyond the argument that there is no cost to options – requires that the estimated dilutive effect of options be recognized at the date of grant (also ensures that the dilutive effect of "at the money" option grants is not double counted in the numerator and denominator of the EPS calculation).

- Takes into account the theoretical determination of the value of options (using those option pricing models expensing would require) and ultimate market experience – estimated value created at time of grant (recognized through the addition of **Stock Option Share Equivalents "SOSE's"** to fully diluted shares), is subsequently adjusted to reflect true value creation at time of exercise.

- Ensures EPS, especially when compared over time, will be a more accurate representation of a company's performance.

- Levels the playing field for all options – fixed, variable and performance-based options are accounted for in the same way.

- Allows investors to look at this issue consistently – all companies in different industries would account for option grants in the same way at the same time.

Stock Option Share Equivalents
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Background

The Business Roundtable and their compensation consultants, as well as the Financial Executives International are currently considering this proposal. Additionally, its theoretical underpinnings were examined and enhanced by economic consultants, whose expertise is option-pricing theory, and a global human resources-consulting firm who is expert in compensation and stock option related issues. Accounting review has involved "Big Four" accounting firms and a number of chief financial officers.

Proposal

- All future stock option grants must be made under shareholder-approved plans.

- If an option is granted with an exercise price that is less than the quoted market price of the stock on the date of grant, compensation expense must be recorded equal to the discount granted.

- As of the date of grant, the estimated future dilutive effect of new option grants must be reflected as a capital transaction and recorded as an increase in diluted weighted average shares outstanding, thereby decreasing earnings per share. The increase in diluted weighted average shares outstanding is defined as **Stock Option Share Equivalents.**

- The number of **Stock Option Share Equivalents** to be added to diluted weighted average shares outstanding is determined by dividing the options fair value on the date of grant, per an acceptable valuation method such as modified Black-Scholes etc., by the company's current share price.

- The **Stock Option Share Equivalents** must be separately identified in the company's reconciliation of diluted weighted average common shares outstanding and explained in the footnotes.

- The calculation of common stock equivalents using the treasury stock method continues.

- On a quarterly basis, the number of **Stock Option Share Equivalents** is reduced for any dilution that occurs under the treasury stock method.

- Even after the **Stock Option Share Equivalents** balance is reduced to zero, dilution continues to be captured through the computation of common stock equivalents under the treasury stock method until the options are exercised, forfeited, cancelled or expire.

- If there is a balance of **Stock Option Share Equivalents** at the time the related options are no longer exercisable (i.e., actual dilution was less than estimated dilution), they are removed from diluted weighted average shares outstanding.

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Effect of Implementation

- The abusive use of options, where grants were made without shareholder knowledge and consideration of future dilution, will be stemmed as shareholder approval will be required for all option plans and a current reduction of earnings per share will accompany each grant.
- No phase-in period is required. The **Stock Option Share Equivalents** for all prospective awards will be fully recognized on the date of grant.
- EPS, especially when compared over time, will be a more accurate representation of a company's performance.
- The granting of options, irrespective of the type (fixed, discounted, performance based, etc.) is immediately reflected in the calculation of earnings per share presented in each company's income statement.
- The dilutive impact of the grants will not be double counted in the numerator and denominator of the earnings per share calculation.
- Every company will recognize the dilutive impact of option grants upon award without respect to the vesting of the awards, which will allow for comparability of financial statements.
- The accounting treatment for performance-based options will be the same as fixed options allowing compensation strategies that will better enhance shareholder value.
- Net income will continue to closely match cash flow earnings allowing for better comparability between companies and transparency in financial reporting.
- Analysts will be able to track a company's "grant rate" (i.e., the percentage of fully diluted outstanding shares due to options granted in the year).
- Companies will be able to appropriately balance awards that deliver current incentive compensation with those that provide potential capital accumulation.
- In the US, fair value is currently being calculated for FAS 123 purposes. Therefore, implementation would be simple with no incremental cost to companies.

Illustrations

The **Stock Option Share Equivalents** approach to accounting for stock options calls for an increase in the calculation of diluted shares outstanding at the time of grant reflecting the estimated dilutive effect of options granted.

By using the **Stock Option Share Equivalents** approach, the effect of stock option grants will be reflected as a capital transaction and stock option grants will have an immediately dilutive impact on EPS.

The proposal calls for **Stock Option Share Equivalents** to be added to diluted shares outstanding at the time of grant. The number of **Stock Option Share Equivalents** is calculated by dividing the fair value of the grant per an acceptable valuation method (with inputs for relevant items such as the risk free rate, current stock price, exercise price, stock price volatility, stated maturity, expected life, vesting period and liquidity), by the company's current share price.

On the following page is a simple illustration of the concept. The **Stock Option Share Equivalents** balance is established at grant. When the stock price rises value is created for option holders. This value is captured in the current fully diluted calculation through application of the treasury stock method. The **Stock Option Share Equivalents** balance is reduced by the number of common stock equivalents as determined by the treasury stock method. However, total diluted weighted average shares outstanding do not change.

Stock Option Share Equivalents
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Options Granted – Base Case

Assumptions	
Market price on grant date (12/31/02) (A)	$50.00
Stock Option Exercise Price	$50.00
Stock Option Fair Market Value per share	$15.00
2002 Stock Options Granted	10.0
Fair Market Value of 2002 Options (B)	$150
Stock Option Share Equivalents (B/A)	3.0

	For the Five Years Ended December 31,					
	2002	**2003**	**2004**	**2005**	**2006**	
Net Income						
Net Income Before Option Expense	1,100	1,265	1,455	1,673	1,924	
Option expense	-	-	-	-	-	
Tax benefit on option expense (40% tax rate)	-	-	-	-	-	
Net Income After Option Expense	1,100	1,265	1,455	1,673	1,924	
Outstanding Shares						
Basic weighted average common shares outstanding	500.0	500.0	500.0	500.0	500.0	
Stock option share equivalents - 2002 Options	***3.0***	***3.0***	***3.0***	***3.0***	***1.3***	*
CSE's per Treasury Stock Method	-	-	-	-	***1.7***	
Diluted weighted average shares outstanding	503.0	503.0	503.0	503.0	503.0	
EPS						
Basic Earnings Per Share	$2.20	$2.53	$2.91	$3.35	$3.85	
Diluted Earnings Per Share	$2.19	$2.51	$2.89	$3.33	$3.83	
Ending share price	***$50.00***	***$50.00***	***$50.00***	***$50.00***	***$60.00***	

* will be reversed when no longer exercisable.

Now let's assume the options were issued at a discount. Expense, as well as dilution, will be recognized for options issued at a discount (those where the exercise price is less than the quoted market price of the stock on the date of grant). Consistent with accounting for restricted stock under FAS 123; expense is recognized for the intrinsic value of the grant, which excludes any estimate of future appreciation.

Options Granted at Discount

Assumptions (changes from base in bold italics)	
Market price on grant date (12/31/02) (A)	$50.00
Stock Option Exercise Price	***$45.00***
Stock Option Fair Market Value per share ($15 + $2)	$17.00
2002 Stock Options Granted	10.0
Fair Market Value of 2002 Options (B)	$170
Stock Option Share Equivalents (B/A)	3.4

	For the Five Years Ended December 31,					
	2002	**2003**	**2004**	**2005**	**2006**	
Net Income						
Net Income Before Option Expense	1,100	1,265	1,455	1,673	1,924	
Option expense ($5 discount x 10 million shares)	***(50)***	-	-	-	-	
Tax benefit on option expense (40% tax rate)	***20***	-	-	-	-	
Net Income After Option Expense	1,070	1,265	1,455	1,673	1,924	
Outstanding Shares						
Basic weighted average common shares outstanding	500.0	500.0	500.0	500.0	500.0	
Stock option share equivalents - 2002 Options	***2.4***	***2.4***	***2.4***	***2.4***	***0.9***	*
CSE's per Treasury Stock Method	***1.0***	***1.0***	***1.0***	***1.0***	***2.5***	
Diluted weighted average shares outstanding	503.4	503.4	503.4	503.4	503.4	
EPS						
Basic Earnings Per Share	$2.14	$2.53	$2.91	$3.35	$3.85	
Diluted Earnings Per Share	$2.13	$2.51	$2.89	$3.32	$3.82	
Ending share price	***$50.00***	***$50.00***	***$50.00***	***$50.00***	***$60.00***	

* will be reversed when no longer exercisable.

Stock Option Share Equivalents
A Potential Solution to Accounting for Employee Stock Options

If dilution under the treasury stock method exceeds the **Stock Option Share Equivalents** established at grant (the **Stock Option Share Equivalents** balance has been reduced to zero), dilution continues to be captured through the computation of common stock equivalents until the options are exercised, forfeited, cancelled or expire.

Additional Dilution Recognized

Assumptions (no change, only higher ending share prices)	
Market price on grant date (12/31/02) (A)	$50.00
Stock Option Grant Price	$50.00
Stock Option Fair Market Value per share	$15.00
2002 Stock Options Granted	10.0
Fair Market Value of 2002 Options (B)	$150
Stock Option Share Equivalents (B/A)	3.0

	For the Five Years Ended December 31,				
	2002	**2003**	**2004**	**2005**	**2006**
Net Income					
Net Income Before Option Expense	1,100	1,265	1,455	1,673	1,924
Option expense	-	-	-	-	-
Tax benefit on option expense (40% tax rate)	-	-	-	-	-
Net Income After Option Expense	1,100	1,265	1,455	1,673	1,924
Outstanding Shares					
Basic weighted average common shares outstanding	500.0	500.0	500.0	500.0	500.0
Stock option share equivalents - 2002 Options	***3.0***	***1.6***	***0.7***	-	-
CSE's per Treasury Stock Method	-	***1.4***	***2.3***	***3.3***	***3.9***
Diluted weighted average shares outstanding	503.0	503.0	503.0	503.3	503.9
EPS					
Basic Earnings Per Share	$2.20	$2.53	$2.91	$3.35	$3.85
Diluted Earnings Per Share	$2.19	$2.51	$2.89	$3.32	$3.82
Ending share price	***$50.00***	***$58.00***	***$65.00***	***$75.00***	***$82.00***

If there is a remaining balance at the time the related options are no longer exercisable, (i.e., actual dilution was less than estimated dilution), the **Stock Option Share Equivalents** balance is eliminated from the earnings per share calculation.

Basis for Conclusions

Purpose of an employee stock option

- The purpose of an employee stock option is to align the interests of the option holder with those of shareholders. Stock options are issued to drive employee performance over a long period of time.

Value of an employee stock option

- Unlike freely traded options, there is no market for employee stock options.
- Their value can only be realized from exercise of the option.
- The option cannot be sold or pledged as security and furthermore the employee must vest in the award.
- If employee stock options are granted at fair market value, only future appreciation will create value that can be realized upon exercise. All shareholders enjoy this future appreciation.
- If employee stock options are granted at a discount, the stock does not have to appreciate for value to be realized by the option holder.
- If the share price remains below the exercise price for the term of the option, the options expire worthless.
- "The value of stock options is directly related to the growth and growth potential of the employer stock" quoted from the Deloitte & Touche Executive Compensation Catalog.
- Employees are awarded a right to a future ownership position in the company.
- For all of the above reasons it is difficult to estimate the value of an employee stock option, but it is possible.

Accounting for the discount element in an employee stock option

- Any discount given, calculated by subtracting the exercise price from the fair market value of the employer stock on the date of grant, should be expensed.

- This expense treatment is consistent with the treatment of restricted stock. In fact, restricted stock is simply an option with a zero exercise price. It is a full value award and the full value on the date of grant is expensed. If the market value of a share of stock were $50 on the date of grant, a grant of a share of restricted stock would generate an expense of $50.

$50	Fair market value
-$0	Exercise price
$50	Expense

- When restricted shares are granted only the intrinsic value is expensed, there is no attempt to estimate and expense the future appreciation in the stock.

- Other examples of share payments where expense is limited to the intrinsic value of the shares on the measurement date include shares used for pension payments and charitable contributions.

- Given the same $50 fair market value on the date of grant, a grant of an option to buy a share at $10 should generate an expense of $40.

$50	Fair market value
-$10	Exercise price
$40	Expense

- It then follows that a grant of an option to buy a share at $50 should generate an expense of $0. There is no expense unless there is a discount.

$50	Fair market value
-$50	Exercise price
$0	Expense

Accounting for dilution

- The actual dilution that will occur from a particular stock option is not known until the option is exercised and the increase in the company's share price is known. At that time, the exercise price is paid in cash and the company issues the stock but is able to buy back a portion of the shares using the exercise proceeds. The net increase in shares thus dilutes existing shareholders. For example, if an employee exercises 1,000 options at $50 when the share price has increased to $62.50 the net exercise proceeds of $50,000 could be used to buy back 800 shares ($50,000/$62.50) and shares outstanding would increase by 200 (1000-800).

- The dilution from stock options granted can be estimated by dividing the fair value of the option by the fair market value of the stock on the date of grant.

- Using the above example, if at the time 1,000 options were granted at an exercise price of $50 (equal to current market) they had an estimated fair value of $12,500 (1,000 x $12.50 per share) the $12,500 would have been divided by the current share price of $50 and 250 **Stock Option Share Equivalents** would have been added to diluted shares outstanding. This treatment would result in an immediate dilutive effect on EPS.

- As noted in their discussions with the IASB, compensation consultants have historically used variations of mathematical models (such as Black Scholes) in helping employers decide how many options should be granted to employees and what dilution they cause.

FASB and IASC standards regarding earnings per share calculations are maintained

- The treasury stock method as prescribed in FAS 128 and IASC 33 is maintained. As actual dilution is captured under the treasury stock method, the company's estimate of dilution (as recorded on the grant date), the **Stock Option Share Equivalents** balance, is reduced.

- A fundamental assumption made with **Stock Option Share Equivalents** is that a company will not buy back its stock prior to the options being exercised, possibly incurring debt or using excess cash, which would impact operations. We assume, consistent with the treasury stock method, that upon exercise funds obtained by issuers from the exercise of options are used to buy back stock which offsets shares issued. We recognize that funds could be used in many ways with a wide variety of results that cannot be anticipated. This method represents a practical approach to reflecting the net dilutive effect of the option grants and increases transparency and comparability.

- As noted by the Ontario Teacher's Pension Plan Board in their December 7, 2001 comment letter (CL 26) to the IASB, "Institutional investors are most concerned that they possess adequate information to properly assess the present and future economic impact of such equity transactions. We stress the need for transparency with regards to these accounting principles".

- Outstanding stock options are not revalued each reporting period in keeping with the conclusion in FAS 128 that to do so would be inconsistent with FAS 123, which has valuation only at the grant date.

Consistent accounting treatment

- The **Stock Option Share Equivalents** approach to accounting for stock options presents an opportunity to eliminate the "uneven playing field" for reporting different forms of compensation (fixed, variable and performance-based options) with a resulting improvement in the quality of financial statements.

- Supporting this is a comment letter (CL 94) to the IASB, "All preparers and users of financial statements would benefit from a level playing field between performance-vesting and time-vesting grants and between fixed-priced options and variable-priced options".

- Footnote disclosure is not a substitute for recognition. Financial statement users are asking that amounts be measured and recognized on a reasonable and consistent basis that takes into account detailed information generally only available to the entity.

- Investors want to know the impact on EPS of transactions the company has entered into. They recognize not all transactions will impact the E in EPS.