Esther Mills
First Vice President
Accounting Policy
(212) 449-2048

ML & Co., Inc.
4 World Financial Center
New York, New York 10080

March 7, 2003

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

Re: **Exposure Draft on the Proposed International Financial Reporting Standard, *Share-based Payment***

Dear Ms. Crook:

We appreciate the opportunity to provide our comments on the proposed International Financial Reporting Standard, *Share-based Payments* (the Proposal). We commend the Board's effort to develop accounting guidance that will lead to consistent reporting for share-based payments and to provide guidance on an issue that has been the subject of increased investor concern. As a leading underwriter and distributor of securities for our corporate clients, Merrill Lynch takes great interest in the international harmonization project. We fundamentally support this initiative, particularly given the global nature of the marketplace in which the financial services industry operates. However, we believe that in the context of share-based payments, U.S. accounting standard setters have already expended a considerable amount of time and effort deliberating this subject; they have thoroughly vetted the significant accounting issues and, in general, we believe they have developed a sound set of principles for determining and recognizing compensation expense for these awards in the income statement. As a result, we believe that the more appropriate solution to international convergence for stock-based compensation is one that is premised on the underlying principles of Statement of Financial Accounting Standards No.123 (SFAS 123), *Accounting for Stock-Based Compensation*.

The FASB's approach, similar to the International Accounting Standard Board's (IASB) Proposal, is based on the principle that stock options have value and that such value should be recognized in the income statement over the period that the related services are received. With a similar underlying principle, we do not believe it is necessary or is practicable from a cost benefit perspective to recreate a methodology for determining expense recognition, such as the unit-of-service attribution method suggested in the Proposal, when an acceptable methodology already exists. Although the FASB has not mandated expense recognition for stock options in the income statement, all companies that file with the Securities and Exchange Commission already calculate and disclose the pro forma earnings impact as if such awards had been expensed. We believe that the unit-of-service methodology is unduly burdensome and that a requirement to use this approach could involve significant costs for many issuers that are already complying with SFAS 123 without providing additional significant benefits. In summary, we do not believe that the changes that the Proposal introduces constitute an improvement that is sufficient to warrant development of an entirely new standard. *(Response to Question 9)*

Furthermore, we understand that the IASB originally considered the SFAS 123 model when developing their framework for share-based awards, but rejected it due to the election it provides between recognition and disclosure in the financial statements. We believe that, rather than revisit all of the accounting issues associated with share-based awards, a simple solution to this issue would be to eliminate the voluntary adoption provision in SFAS 123 and mandate expense recognition for share-based payments in the income statement. We believe that this presents a much more practical solution, given the host of other significant accounting issues on the IASB's agenda and the limited resources available. For these reasons, we would urge the IASB to reevaluate its decision to move forward with its proposed framework of accounting for share-based payments and instead reconsider an approach that uses the guiding principles of SFAS 123. Should the IASB decide to proceed with the Proposal, however, we offer the following comments for your consideration. *(Response to Question 24)*

Determination of Fair Value

Although we support a SFAS 123 based model over the current Proposal, we continue to believe that both models contain a significant flaw with regard to the fair value measurement of employee stock options, in that they result in overstatement of compensation expense in the income statement. We believe that option-pricing models that are used to value share-based awards were developed for market-traded options and do not accurately account for vesting or nontransferability of employee stock options. In particular, we do not believe that the use of expected life rather than the contractual term is a sufficient adjustment for nontransferability. This approach only reduces the value of an employee stock option for the remaining time value at the exercise date; however, no reduction in value is reflected for the inability to sell the option to a third party – a feature of a liquid option that enables the holder to realize both the intrinsic value and the remaining time value during the vesting period. We believe that strict adherence to a Black-Scholes or binomial pricing model is only appropriate for a highly liquid stock option that trades in the marketplace; we do not believe it results in an accurate valuation for an unvested share-based award.

As stated in paragraph 130 of the Basis of Conclusions, the IASB acknowledges that market prices provide the best evidence of the fair value of stock options. As a result, we believe it is critical to allow issuers flexibility in measuring share-based awards so as to arrive at a valuation that is most representative of what a non-transferable, non-exercisable stock option would trade for in the open marketplace. In paragraph 131, the IASB appears to recognize that flexibility is necessary in the determination of fair value in that it states that it is neither necessary nor appropriate to prescribe the precise formula or model to be used for option valuation. It also acknowledges that prescribing a particular model is not necessary, as there is a risk that any model specified might be superseded by improved methodologies in the future. However, in paragraphs 151 and 164, the IASB goes on to state that valuations derived from a Black-Scholes model should not include adjustments for either the lack of exercisability during the vesting period or lack of transferability of a stock option to an unrelated third party. While we commend the IASB for providing flexibility to issuers when choosing an option-pricing model, we believe that the detailed guidance in paragraphs 151 and 164 is inconsistent with a principles-based approach to standard setting. We believe that inputs to the models should be permitted to be adjusted as long as the outcome is a representationally faithful fair value that captures the true economics of a restricted, nontransferable stock option. *(Response to Questions 11, 12, 13 and 16)*

Basis of Measurement/Accounting for Forfeitures

We also disagree with the framework outlined in the Proposal that seems to suggest that the measurement of share-based payments should be based on the value of services received, rather than the value of equity instruments issued. A basic principle of accounting in the U.S. has been that exchange transactions should be measured by looking at whichever asset is more objective and is more readily determinable. In the case of services received in exchange for share-based payments, we believe that the value of the share-based payment, while subject to some estimation, is clearly more readily determinable than the value of the services rendered. Paragraph 63 of the Proposal acknowledges this point, and therefore recommends that the value of equity instruments given be used as a proxy. We believe that the Proposal's stated requirement to measure the transaction based on the value of services received represents a significant change from the current U.S. conceptual framework and is particularly problematic given that the IASB agrees that the value of the equity issued is more clearly evident. As a result, we would encourage the IASB to adopt an approach that would require measurement to be based on the value of the equity instruments issued. *(Response to Question 7)*

We believe that the problems associated with measuring share-based payments based on services received is brought to the fore when considering the proposed accounting for stock forfeitures. As mentioned above, for exchange transactions, we support a measurement approach based on the value of the asset that is more clearly evident. For example, in the case where an employer pays cash for services received, the cash amount would serve as the basis of measurement for the transaction. The same should hold true for share-based payments. Thus, in the case of stock forfeitures, although a company may have received services, it has not provided any consideration of value to the holder. For example, if a company grants 100 stock options to an employee that cliff vest in three years, and the employee leaves the firm in year two, in essence the company has received the employee services for free. We can equate this situation to a scenario where a company offers a "stay bonus" to an employee that agrees to remain with the firm and provide services prior to a termination date. If the employee leaves prior to the termination date, although the employee has provided certain services, he/she has not fulfilled his/her obligation, the company will not pay any consideration, and no charge is required to be recognized in the income statement. We do not believe that the fact that an award will be settled in shares rather than cash should result in a substantially different accounting answer. As a result, we believe it would be inappropriate to recognize a charge for forfeited shares in the income statement. *(Response to Questions 7 and 9)*

In addition, we believe that the requirement to estimate forfeitures at the grant date without the ability to adjust such estimates for actual results contradicts the conceptual framework on which existing accounting principles are predicated. IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies,* states that "the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability…The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:
(a) the period of the change, if the change affects the period only; or
(b) the period of the change and future periods, if the change affects both". [1]

In practice, estimates have always been an inherent part of the financial statements, as, for example, in the context of the collectibility of doubtful accounts, litigation reserves, and pension benefits. In each of these cases, estimates are reconciled with actual outcomes in order to provide users of financial statements information that is both reliable and transparent. As a result, we would encourage the IASB to abandon the unit-of service methodology and adopt a SFAS 123 model for expense recognition of share-based payments, which would result in an earnings impact for only those awards that ultimately vest. *(Response to Question 10)*

Deferred Taxes

A major concern that we have with the Proposal is the requirement that all tax benefits related to share-based payments be recorded in the income statement. We strongly believe that any changes in the value of stock-based awards after the grant date accrue to holders of the award in their capacity as equity participants, and therefore believe that the

[1] Similarly, U.S. Accounting Principle Board Opinion No. 20, *Accounting Changes*, states that "estimates are a necessary part of the financial statements since future events and their effects cannot be predicted with certainty. However, estimates will change as new events occur, as more experience is acquired, or as additional information is received."

associated tax effects should appropriately be classified within equity. We find the IASB's rationale for recognition of all tax benefits in the income statement inconsistent. While we believe that the initial tax benefit measured at the grant date should be recorded in earnings since the associated compensation expense is recognized in income, we believe that the additional tax benefit received upon exercise appropriately belongs in equity. This is because the tax benefit realized upon exercise is not reflective of an expense that has been recognized in earnings, but is instead based on the increase in value of an option between the grant date and exercise date.

Furthermore, we believe that including the tax impact of stock-based awards in the income statement and remeasuring that impact each reporting period will lead to financial information that is confusing to financial statement readers, as remeasurement will cause distortion in the effective tax rate and net income as the stock price fluctuates. In the case of a rising stock price, application of the Proposal's methodology could result in a company recording income related to deferred taxes in excess of the cumulative compensation expense measured at the grant date.

For example, assume a company with a 35% tax rate grants 100 stock options at $6 a share, which vest over three years. The company would record $200 of pre-tax expense during each of the three years. Assume at the end of year three, the stock price has risen from $6 to $30. Although the pre-tax expense recognized over the three years would remain constant at $600, the tax benefit at the end of year three would be $840 (($30-$6)*100*35%), which on an after-tax basis, would result in net income of $240. We fail to see how the remeasurement approach provides more meaningful information to users of financial statements since the ultimate tax deduction that a company will realize is based on the intrinsic value of the award at the exercise date and not the value at any interim date. The requirement to constantly remeasure the expected tax impact and record changes in the expected tax impact in income leads to a situation whereby companies will report unrealized gains and losses in income which they do not have the ability to realize at the reporting date. This is because the realization of a tax deduction is outside the company's control and is wholly dependent on a holder's decision to exercise an option. Thus, although we believe remeasurement is inappropriate, should the IASB require this approach, we believe that the effects of remeasurement should be reported in equity, similar to other unrealized gains and losses for which a company does not have the intent and ability to immediately realize. *(Response to Question 23)*

*   *   *   *

Once again, we thank you for allowing us to provide feedback on the share-based payment Proposal, and we hope you will strongly consider our recommendations as you move forward with the issuance of a final standard. If you have any questions regarding the content of this letter, please do not hesitate to call me at 212.449.2048.

Sincerely,

/s/ Esther Mills

Esther Mills
First Vice President

cc: Michael Tovey (FASB)