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ED2 Share-Based Payment

Pfizer welcomes the opportunity to comment on the above-noted invitation.

Pfizer is a research-based health care company with global operations in over 140 countries. The Company's 2002 sales were approximately \$32.4 billion and assets are approximately \$46.4 billion under accounting principles generally accepted in the United States of America.

As we have expressed in a number of forums, until an option-pricing model is identified which encompasses the variables inherent in determining the fair value of a stock option held by an employee, we remain concerned about the IASB allowing companies to report fair valuation amounts. Our concern results from the fact that the absence of a reliable method of accounting for the "value" of an employee stock-based payment effectively forces an inaccurate valuation to be reflected in the financial statements. Further, users of financials, who do not generally have backgrounds in option valuations, may be misled into believing that the valuation is absolute in its accuracy and appropriateness. While estimates and judgments are used in financials on a regular basis, they are formulated based on a reasonable and realistic assessment of various factors. We believe this is missing in the current pricing models. Moreover, the current guidance to fair value a stock option can result in very different values and result in a significant lack of future comparability between financial statements of similarly situated companies. We have seen evidence of this within the recent announcements of the companies who have announced that they will recognize stock options as compensation expense. Such models are dependent on highly subjective future-oriented assumptions which may also invite opportunities for abuse.

We would like to see the IASB defer the issuance of an accounting standard until all of the very significant issues associated with valuing employee stock options are resolved.

However, in the spirit of working with the IASB, we have offered a number of suggestions that might mitigate the serious reporting and disclosure issues in the interim until a satisfactory model can be found.

Our detailed comments are attached and we would be happy to discuss any of our views.

Very truly yours,

Loretta V. Cangialosi

Loretta V. Cangialosi
Vice President and Controller
Attachment

cc:

Mr. D. L. Shedlarz, Executive Vice President and Chief Financial Officer
Mr. A. G. Levin, Vice President - Finance

I. Summary

Generally, we do not agree with the IASB proposed recognition of the value of employee stock options because the value determined is unreliable and the accounting theory has some weaknesses.

The traded option-pricing model does not contemplate the inherent restrictions associated with employee stock options. In addition, we are apprehensive about the IASB adjustment that seeks to reflect those restrictions on employee stock options as a reduction in value as we do not believe that it accomplishes its mission.

In contrast, we are not aware of a practice of similar restrictions in the exchange of stock options in non-employees. While we understand the IASB's concern to group like-items in the same standard, we don't see options granted to employees and options exchanged for goods or non-employee services as like-items and, therefore, can foresee different accounting.

Upon reading the IASB ED2, we have similar concerns as we did upon reading the U.S. equivalent, SFAS 123. Accordingly, we now also disapprove of the disclosure of the option valuation and related assumptions because we believe that the value to be determined under the ED will be unreliable and misleading.

II. Objection to the IASB proposed recognition of the value of employee stock options

A. The traded option-pricing model value is unreliable

We do not believe an accounting standard can mandate the use of an option-pricing model for measurement purposes because no option-pricing model adequately values employee stock options since the **trading** option-pricing model:

- Does not consider non-traded options;
- Does not adequately consider restrictions on trading, transferability and the ability to forfeit the options before expiry; and,
- Is dependent on highly subjective future-oriented assumptions.

However, notwithstanding the above, we recognize that a viable valuation model for determining the fair value of employee stock options needs to be agreed upon or developed. Without guidance from the IASB as to an appropriate and reasonable fair valuation model, the method of valuing these employee stock options will be left to the wide discretion of management which, in turn, decreases the future comparability between financial statements of similarly situated companies and increases the opportunity for abuse.

Until an option-pricing model is identified which encompasses the variables inherent in determining the fair value of a stock option held by an employee, we remain concerned about the IASB allowing companies to report fair valuation amounts. Our concern results

from the fact that the absence of a reliable method of accounting or disclosing the “value” of an employee stock option effectively forces an inaccurate and inappropriate valuation to be reflected in the financial statements.

Below we have provided expanded comments on our objection to the use of a trading option-pricing model.

1. The traded option-pricing model does not consider non-traded options

Traded option-pricing models build on binomial share pricing, then constructing a portfolio of shares and options such that the cash flows associated with buying shares and writing call options equate to a guaranteed amount. Under a traded option-pricing model, the production of the value that is guaranteed, whatever the individual values of the components, must involve the buying and selling of the other so that their individual movements can offset (hedge) each other. The sum of the present value of the hypothetical instruments in the “hedge portfolio” produces the present value of the options. In contrast, employees usually cannot and do not write stock options on their company’s stock.

Also, a traded option-pricing model provides an optimal value, assuming traders are rational individuals that seek and can optimize their portfolio. In contrast, employees may not seek to optimize their portfolios. Further, employees cannot optimize their portfolios because of trading, transfer and forfeiture restrictions. If options are a “fairly bargained transaction” (ED2 BC197), why should one assume that the employee could achieve an optimal value? Moreover, if options are a fairly bargained transaction, one proof of an IASB-determined employee stock option value would be that such value would equal the mean of the optimal company value and the optimal employee value—and yet this avenue has apparently not been explored by the IASB.

In addition, a traded option-pricing model assumes no transaction costs. Such costs would increase the cost to exercise an option and decrease the option value and there may be transaction costs. There are brokerage, processing and regulatory fees for so-called “cashless” exercises where stock acquired with, effectively, a temporary loan is immediately exchanged for cash. Moreover, the vesting requirements conceptually constitute a cost to exercise, economically akin to the opportunity cost incurred in waiting on a line for a commodity that will be sold to anyone at the same price on a first-come, first-served basis.

Further, stock price appreciation and dividends represent the total rate of return on investment. Generally, when dividends are paid, share price falls. To reflect this in a traded option-pricing model, dividends must be excluded; they decrease the option value. The dividend assumption employed in a traded option-pricing model does not consider the dividend effect in relation to vesting requirements. If it did, it would have to acknowledge that there is no possibility of obtaining the dividend in the vesting period.

Lastly, a traded option-pricing model does not directly consider the impact of:

- The different tax consequences on Incentive Stock Options and Non-Qualified Stock Options under the U.S. Internal Revenue Service Code; and, to a lesser extent,
- The ability to elect “tax holidays”;
- Graduated income tax rates; and,
- Intended and announced treasury stock buybacks.

In the U.S., certain (Incentive Stock Options (ISOs)) options present a tax advantage to the holder when the stock acquired upon exercise is held more than a year and then sold. The advantage is that rather than being taxed at ordinary income tax rates, the security sale is taxed at lower capital gains rates. Obtaining a tax advantage or a treasury stock buyback may be seen as theoretically the same as obtaining a dividend, and consequently decreasing the option value. At best, the ED2 suggests that the average exercise period may be shorter, but that is not on point in a traded option-pricing model.

We are uncertain how the “binomial model and the inability to exercise an option during the vesting period can be taken into account in applying such a model” (ED2 BC150).

The Black-Scholes model does not assume “that the options cannot be exercised during that period” (ED2 (22 b) and (BC148)). The Black-Scholes model assumes that options can be traded during the period; that the option being valued will be exercised at a specific date. As we recall, during the FASB public meeting with academics on valuing employee stock options, under inquiry about whether he would use the Black-Scholes formula for valuing employee stock options, Dr. Myron Scholes said he hadn’t thought about it being used that way-- and he didn’t say much more.

2. The option-pricing model does not adequately consider restrictions on trading, transferability and the ability to forfeit the options before expiry

Many (of the few) academic published researchers interested in SFAS 123 employee stock option valuation (Rubinstein, Carr, and Linetsky) have concluded that the SFAS 123 valuation that depends upon expected term to factor out the restrictions on employee stock options significantly overstates the value of the SFAS 123 option or, that the factors involved in predicting exercise are complex (Huddart). We have problems with their parsing out certain effects, but we do agree that they have at least contemplated most of the factors that the FASB did not.

We suspect that other factors important to employee exercise behavior include:

- Age (including retirement eligible status);
- Company policy that may require holding stock upon option exercise;
- Current and expected future taxation;
- Financial savvy (including industry employee character);
- Personal wealth (liquidity needs);
- The relationship of stock price to the general stock market prices (“beta” and alternative investments);

- The degree of risk diversification (including the effect of previous grant “overhang” and alternative employment).

3. The option-pricing model is dependent on highly subjective future-oriented assumptions

The IASB use of a traded option-pricing model requires predicting the exercise date of an option. Exercise is a function of many things, all of which are future events that are not controllable, e.g., stock prices.

The IASB use of a traded option-pricing model requires that a company predict future stock price volatility. Such a feature is not objectively verified.

The IASB use of a traded option-pricing model requires predicting future long-dated dividends. Dividends are a function of many things, all of which are future events that are not necessarily controllable, e.g., net income.

We encourage the IASB to consider the approach used by the FASB, which uses historical exercise patterns and historical volatility.

Also, we encourage the IASB to discuss the valuation of traded options with option traders to understand that such valuations are somewhat recursive, with values constantly being adjusted to reflect other’s valuations. In particular, we encourage the IASB to discuss the valuation of traded options with option traders just when the market becomes volatile. We believe these discussions will prove valuable in understanding that option-pricing model values are simply a starting point and not a definitive value.

Finally, we ask the IASB to identify why a log normal distribution is appropriate for long-term expected equity securities prices.

B. Accounting theory weaknesses

Within the IASB’s Framework for Preparation and Presentation of Financial Statements “an item that meets the definition of an element should be recognized if:

- a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and [emphasis added]
- b) the item has a cost or value that can be measured with reliability. [emphasis added]”

The second criteria indicates that the recognition of an item that possesses a cost or value must be measured with reliability. We do not believe that the results of the currently proposed option pricing model are free from material error and bias nor do we believe that the results can be depended upon by users to represent faithfully that which it

purports to represent or could reasonably be expected to represent. We believe that paragraph 32 of the aforementioned framework applies in this case; that is, information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading.

Furthermore, there is no cost to the company granting options because no cash or other assets are given up by the company. We believe expenses are cash or cash equivalent outlays. Further, this is consistent with the bulk of accounting for other expenses.

We believe accounting should reflect actual and probable cash flows, not possible cash flows. This is what financial statement users understand. As you well know, the U.S. financial markets have been jolted by recent problems involving the valuing of long-dated financial instruments that could not be demonstrated by actual cash flows. Indeed, our own FASB staff's view in the November 21, 2001 minutes to the EITF 02-3, *Issues Involved In Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*, is requiring the rejection of valuations of long-dated derivatives that are not based on observable market inputs.

In addition, the ED2 accounting that requires crediting paid-in capital as employee services are expected to be delivered is a point of disharmonization with our conceptual view on equity. We work with the idea that equity is a residual amount, the net of assets and liabilities. The fact that the ED2 required accounting concurrently increases equity – paid-in-capital, and then decreases equity - retained earnings indicates that there is no substance to this equity treatment.

We see the accounting theory employed by ED2 suggests that the using up of resources reflects compensation expense. However, there is another view that sees the granting of options as a risk-sharing mechanism by the company with its employees. That is, if share prices increase, employees are permitted to become part owners of the company mostly through “sweat equity” and a (perhaps, relatively small) cash contribution. On the other hand, if share prices decrease, employees are not permitted to become part owners of the company.

We take exception to the idea that services are assets when received (ED2 BC42). We work with the idea that an asset is a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events. An “entity’s own shares are not an asset to an entity” (ED2 BC68) and neither are the services they encourage.

III. Adjustments to the option-pricing model value

A. Adjustments to the traded option-pricing model

Pfizer Inc comments on ED2 Share-Based Payment

We believe that no currently existing option-pricing model adequately values an employee stock option; therefore, we are concerned about ascribing these dubious values in externally reported financial statements.

However, if the IASB proceeds with the use of a traded option-pricing model, we believe other modifications should be made to improve the consistency and reliability of option valuations to reflect the restrictions on the exercise or transfer of employee stock options. We believe the use of the expected term to exercise the option does not adequately reflect the decrease in option value consequent to the restrictions.

We recognize that many people have noted this issue about the overstatement in value required by the FASB both during and after the development of SFAS 123. The problem appears to be unresolvable in practice because unlike the Black-Scholes model that has been validated against actual traded stock options by the authors (specifically **excluding** options with restrictions on trading) and others, the diminution in employee stock option value can not be validated against actual traded stock options. Perforce, the value can only be determined theoretically.

The failure of a pricing model to adequately factor in a reduction in value to reflect the restrictions that are inherent in employee stock options would actually result in the IFRS value not being a fair market value—the stated principle behind ED2.

We have three suggestions, which represent alternatives distinguished by different hypotheses on what point in time there is a willing “buyer” and a willing “seller” for the exchange of “fair value”, tempered by operational (objective) criteria.

Alternative #1

We suggest the value of an option can be calculated as the net of the:

- IASB traded option-pricing model value (adjusted for transaction costs under IIA-1) using an expected exercise date, less the
- IASB traded option-pricing model value (adjusted for transaction costs under II-A-1) and, excluding predicted dividends and, including the effect of taxes and intended treasury stock buybacks (see previous discussion under II-A-1).

The difference between the two option-pricing model values represents the value of an option when it can be exercised **through** its exercise date. In essence, this method hypothesizes that an option has no value during the vesting period when it can be forfeited or it cannot be traded or transferred. The point in time where there is a willing buyer and seller is between the vesting date and the expected exercise date.

The advantages of this method are that:

- It better reflects the reduction in value for the restrictions, and the
- The vesting date is an objectively determined factor.

This method also addresses the anomaly that options with restrictions requiring a minimum holding period, i.e., vesting period, have a value greater than options that are not vested.

The disadvantage of this method is that there is no direct method to distinguish the reduction in the value of the option due to the restrictions.

Alternative #2

We suggest the value of an option can be calculated as the:

- IASB traded option-pricing model value (adjusted for transaction costs and, excluding predicted dividends under II- A-1) using the vesting date exercise date, less the
- Predicted expected value of the stock price depreciation.

In essence, this method hypothesizes that an option has no value after it is vested and, that the economic cost associated with when an employee stock option can be forfeited or cannot be traded or transferred is reflected by the probable loss incurred by the required holding of the stock.

Hypothesizing that an option has no value after it is vested reflects the company's point of view on the option; once the option is in the money, it is no longer optional. In a business exchange transaction, a fairly bargained transaction (ED2 BC197), both parties come to the negotiating table with an idea of the marginal utility of the transaction and settle on a price that meets both of their expectations. Usually, but not always, the exchange transaction involves no ongoing relationship after the exchange or if it did the relationship is built into the exchange price, e.g., a company offers a lower price because it wants the counterparty to come back to buy additional items later. Such is not the case with employee stock options where the value of the option is not the only issue on the table. There are multiple deliverables at issue, some with uncertain values. The company must be profitable; the employee must not get fired, etc. The uncertainty in the value of certain deliverables leads to some fundamentally different views between the company and the employee.

One way of looking at the probable loss incurred by the required holding of the stock is to look at the hypothetical penalty imposed on an option holder who is unable to trade or transfer the options. This penalty is the probability of a loss in the stock price; the inability to exit the investment before it declines in value. Assuming a normal distribution of stock prices, the stock price volatility (the standard deviation of prices) half the time the price will be above the mean stock price and half the time it will be below the mean stock price. Apply one half the stock price volatility to the stock option exercise price granted at-the-money and reduce the value of the option by that amount.

This reduction for the probable loss incurred by the required holding of the stock is necessary because the typical option valuation mathematically operates in the First Quadrant, where all determined values are positive numbers; the squaring in the

derivations of the standard deviation gets rid of any negative values. The Black-Scholes model does not reflect the penalty imposed on an option holder who is unable to transfer the options.

This method also addresses the anomaly that options with restrictions requiring a minimum holding period, i.e., vesting period, have a value greater than options that are not vested.

The advantages of this method are that:

- It better reflects the reduction in value for the restriction, and the
- The vesting date is an objectively determined factor;
- There is a direct method to distinguish the reduction in the value of the option due to the restrictions.
- The shorter expected term increases the likelihood of better predictions of stock price volatility and dividend rates.

The disadvantage of this method is that it depends solely on the company (seller) point of view; the employee (buyer) point of view, that it can exercise at vesting date or later, is not accommodated.

Alternative #3

We suggest the value of an option can be calculated as the:

- IASB option-pricing model value (adjusted for transaction costs and excluding predicted dividends under II-A-1) using the vesting date, less the
- Average change in value for similar SIC industry stocks when such stocks begin to trade, which is calculated by relating the traded value of stock X to the value of non-traded Stock X analogized to a traded stock, scaled to similar net assets and/or or net income.

In essence, this method hypothesizes that an option has no value after it is vested and, that the economic cost associated with when an employee stock option can be forfeited or cannot be traded or transferred is reflected by the average change in value of analogous stock prices once the restrictions are lifted.

The advantages of this method are that:

- It better reflects the reduction in value for the restrictions, and the
- The vesting date is an objectively determined factor.

This method also addresses the anomaly that options with restrictions requiring a minimum holding period, i.e., vesting period, have a value greater than options that are not vested.

The disadvantages of this method are that there is no direct method to distinguish the reduction in the value of the option due to the company-specific restrictions.

The failure of the IASB to adequately factor in a reduction in value for employee stock option restrictions into the employee stock option valuation results in the IASB ED2 value not being a fair market value—the stated principle behind IASB ED2.

B. Additional guidance for determining the amount of the option-pricing model factors

We believe the IASB ED2 approach will require additional guidance for **determining the amount of** the factors because the amounts cannot be validated by observable experience and different reasonable people have different views on determining the amounts. If the basis for determining the amount of a factor were better defined, it would facilitate comparability among companies.

Specifically, the predicted exercise term should be the average historical exercise term equal to the term of the grant being valued, unless the exercise term will be truncated, e.g., planned divestiture and accompanying contractual term limit on the options. Anything else is not objectively determinable.

The predicted dividend rate should be the average historical dividend rate of increase or decrease applied to the expected term, unless the predicted dividend will be changed. In this case, the known changes would be factored into the average historical dividend rate. Anything else is not objectively determinable.

We suggest using historical data for the predicted exercise term and dividend rate, and because that is likely what the company has in mind when the grant is made.

The predicted volatility rate should be the traded volatility rate even though traded volatility represents a period shorter than the predicted exercise term. Anything else is not objectively determinable.

We suggest using market data for the predicted volatility because that is, again, likely what the company has in mind when the grant is made.

We also think that there should be no differentiation among classes of employees, e.g., executives and non-executives. Such distinction leads to the odd conclusion that the same option has different values to different sets of people.

C. “Truing-up” for all forfeitures

We appreciate that the IASB, in contrast to the FASB, contemplates **some** of the effect of forfeitures in the valuation of the employee option. In this fashion, the IASB is factoring in the so-called “bargained value” one of the unique (and common) aspects of an employee stock option that makes it different from a traded stock option—the employee can forfeit the option. However, the IASB valuation does not contemplate the effect of

forfeitures after the vesting date. We believe the IASB valuation should reflect an estimate of all possible forfeitures.

Further, if companies are issuing share options to pay employees (ED2 BC1), then share options are substitutes for cash. Since an option may expire out-of-the money or be forfeited, an employee may actually lose compensation. Like many other estimates in accounting, an estimate should be “trued-up” for actual events. This follows from the common-sense idea that if the option never is in-the-money, no value was ever exchanged. Accordingly, we suggest the only way to reflect this compensation loss is to reverse any previous charges when an option is forfeited.

We understand that the alternative view is that the employees effectively donate their services. We fail to understand the logic behind this view.

We disagree that “irrespective of whether the option expires worthless or the employee makes a large gain on exercise, that outcome does not mean that the grant date estimate of the fair value of the options was unreliable or wrong” (ED2 BC135). It may be right or it may be wrong. Only a “true up” in the charge can rectify that. We understand that the traded binomial pricing models do not predict stock prices, but we also know that it contemplates the amount and degree that the option is in-the-money as a function of expected stock prices.

BC 282 states the FASB’s objections to the truing up of an option valuation, but we are uncertain of the IASB’s objections. In terms of the FASB’s objections, we argue that estimates involving cash flows are, in fact, “trued up.”

Even pensions, if not trued up, are continuously adjusted to estimate the impact of a “true-up;” pension liabilities are not “set in stone” (as would be the case in an incorrect valuation of employee stock options). Moreover, in U.S. practice there has been a fundamental shift in pension plans away from defined benefit plans to defined contributions plans, e.g., “cash balance” plans, that has resulted in a large number of pension plan settlements, which perforce, required “truing-up” the pension liability. It is also important to note that U.S. GAAP for pension liabilities does not purport to be a fair valuation of such liabilities (SFAS 87 Employer’s Accounting for Pensions - Summary).

Please be aware that our suggestion for “truing-up” for all forfeitures is not exercise date accounting.

IV. Conclusion

We think the introduction of a charge for employee stock options will also introduce unreliability and inconsistency into the financial statements. This impact will be solely due to the lack of an adequate measure of the inherent restrictions associated with employee stock options.

We would like to see the IASB delay the issuance of any standard requiring the recording or disclosure of a value for employee stock options until all of the very significant issues associated with those valuations are satisfactorily resolved.

Responses to specific questions follow:

Question 1

Paragraphs 1- 3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS.

Is the proposed scope appropriate? If not, which transactions should be excluded and why?

We believe that accounting for employee stock options should be excluded from the IFRS because no option-pricing model adequately values employee stock options and the accounting theory has some weaknesses. See our cover letter II-A.

Question 2

Paragraphs 4- 6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed. Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

No. We believe expenses are cash or cash equivalent outlays. When the shares granted can be immediately exchanged for cash, then we would recognize compensation expense.

Question 3

For an equity-settled share -based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7). There are no exemptions to the requirement to measure share -based payment transactions at fair value. For example, there are no exemptions for unlisted entities.

Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

No. It is not appropriate for employee stock options. See our cover letter II-B

Question 4

If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

Not for employee stock options. See our cover letter II-B.

Question 5

If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

No for employee stock options. See our cover letter II-B.

Question 8

Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest.

Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

No. We do not understand why the compensation cost is attributed to the vesting period when the expected option term is based on an expected exercise term. To receive the benefit of an option that is in-the-money, an employee must work through the date of exercise, not simply through the date they vest.

Question 9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received,

by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

No. It is impossible to predict future services. See our response to Issue 9.

Question 10

In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognising a transfer within equity, ie a transfer from one component of equity to another.

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

No. See our cover letter III-C.

Question 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk-free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends.

Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be

inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

No. See our cover letter Sections II-A and III-A.

Question 12

If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22).

Do you agree that replacing an option's contracted life with its expected life? when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non- transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

No. See our cover letter Section III-A.

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

Yes. See our cover letter Sections III-A and III-C.

Question 14

For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25).

Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

No. A reload performance requires one to estimate several sets of investor and market behavior. We think there are enough problems in evaluating just one fixed grant. We have read the IASB cited paper on reloading options and have not found it persuasive. At the least, the paper does not adequately discuss the problems identified by other academics and non-academics in valuing employee stock options.

If the IASB elects to distinguish reload grants as requiring a higher value than a fixed grant, the FASB should make the standard operational by providing specific valuation guidance.

Question 15

The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21- 25).

Are there other common features of employee share options for which the IFRS should specify requirements?

Yes. Another common and crucial feature is the inability to trade the options.

Question 16

The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies.

Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

No. This accounting requires a rules-based approach in identifying the use of a FASB created option-pricing model and in identifying the supplemental guidance for use in selecting those assumptions employed in the model. Without such guidance, people can come to different values-- just as the IASB and the FASB have done.

See our cover letter III-B.

We are apprehensive about an accounting standard setting body requiring fair value accounting for stock options when there are so many seemingly intractable problems with determining fair value for stock options.

Question 21

The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

- (a) the nature and extent of share - based payment arrangements that existed during the period,**
- (b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and**
- (c) the effect of expenses arising from share - based payment transactions on the entity's profit or loss.**

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

Our general goal is to reduce disclosures to allow investors to focus on the most critical issues and aspects of our business. Thus, we suggest the elimination of several irrelevant disclosures assuming the IASB goes forward with its proposal. They are as follow:

- We are uncertain why the date an option is granted (ED2 46 (a) ii)) is relevant to audited financial statement users, unless you want them to recreate the same value. Practically, there may be many grant dates; we have seen some companies give the same grant each quarter or upon hiring.
- We see no economic difference between a forfeited and an expired option [ED2 46 (b) iii and v)]. We are uncertain why a company should distinguish between a forfeited and an expired option.
- To ensure comparability, we suggest that the standard require the use of historical volatility in valuing options and disclose that historical volatility was used, then departures be explained (ED2 48 (ii)).

As directed by the IASB (ED2 BC275), we have read the Barth, Clinch and Shibano paper that suggests that the market perceives a difference between recognition in the income statement and footnote disclosure. We have several concerns with the research, which starts with the researchers admission that “findings from two-stage estimation of the system of equations reveals that after controlling for endogeneity bias, unrecognized stock-based compensation expense is negatively associated with share prices, as predicted, but the relationship is not significant” (3).

Other researchers would have stopped there, but they proceeded to try to explain the insignificance by seeking to test three hypotheses. After seeking to parse out expected future benefits from the stock prices, the researchers show a statistically significant correlation. However, the correlations are not overwhelming; they are not as persuasive as the Black-Scholes model .91 correlations for very short-term traded options!

We suggest the explanatory power of correlations depends on a quality sample, the design structure and the underlying finance theory. We are uncertain why the sample did

not include large cap companies. We are uncertain if analyst forecasts for mid and small cap companies are good proxies for possible expected benefits embedded in prices. We are uncertain if the statistical significance necessarily means, as asserted, that the valuation is reliable. Further, the researchers references cited do not cluster around the ideas presented; the research appears genuinely new. We are hesitant to place much store in this relatively new research.

That is not to say that we disagree with the hypothesis that recognition is more relevant than footnote disclosure. We recognize the value in disclosing certain reliable possibilities that do not merit balance sheet or income statement recognition, which is embedded in many aspects of current US GAAP as well as IASB concepts.

Lastly, implicit in the traditional application of the Black-Scholes formula is that the value determined is based on assuming that 68% of the observations fall within one standard deviation of the expected value when drawn from a normal distribution. Given the importance of this assumption, it should be noted to the average financial statement user. However, we believe this assumption is so fragile that income statement recognition is not appropriate.

Question 24

In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 *Accounting for Stock- Based Compensation* , as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences.

The main differences include the following.

(a) Apart from transactions within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share - based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;**

- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (paragraphs BC70- BC74 in the Basis for Conclusions give an explanation of intrinsic value); and**

- unlisted (non- public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the**

effects of expected share price volatility (paragraphs BC75- BC78 in the Basis for Conclusions give an explanation of minimum value).

(b) For transactions in which equity instruments are granted to employees, both SFAS 123 and the draft IFRS have a measurement method that is based on the fair value of those equity instruments at grant date. However:

- under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.

- under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore the amount of compensation expense measured at grant date but not yet recognised is recognised immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity should continue to recognise the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96- 18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

(e) SFAS 123 requires liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70- BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

(f) For a share-based payment transaction in which equity instruments are granted, SFAS 123 requires realised tax benefits to be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognised in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) *Income Taxes*, proposes that all tax effects of share-based payment transactions should be recognised in profit or loss, as part of tax expense.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment.

(Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

Please see of our attached copy of our response to the FASB Invitation to Comment.

Question 25

Do you have any other comments on the Exposure Draft?

Practically, we are uncertain how one prices a SAR under a Black-Scholes pricing model (ED2 34). If we set the exercise price at zero, we get no value.

We are uncertain why the repurchase of company stock in excess of fair value is reported as an expense (ED2 29 (b)), when the event is the same as purchasing company stock at fair value. Perhaps, the resolution of the issue revolves around the meaning of the term "fair value." If the meaning is the average fair value in the market, then we see the requirement as seeking to ferret out the some unstated right. However, we then do not understand why a gain can not be determined if the purchase price is less than the average price as that suggests the sale of some unstated right with no cost basis. If the meaning is what a willing buyer and seller in the same circumstances would do then that requires factoring in things like "control premiums." Chances are a willing buyer in the same circumstances would pay the same premium. If the IASB is not willing to define fair value in a treasury stock transaction, we suggest no expense recognition under any circumstance.