EMPLOYMENT POLICY
FOUNDATION

CL 37

March 3, 2003

Via UPS and E-Mail

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

Re: Comments on Draft ED2 Share-Based Payment Guidelines

Dear Ms. Crook:

The Employment Policy Foundation (EPF) appreciates the opportunity to submit these comments to the International Accounting Standards Board (IASB) on the draft share-based payment guidelines, dated November 2002.

EPF is a non-partisan economic policy research and education organization that focuses on the consequences of workplace policies and trends affecting American companies and workers. Through policy analysis, economic studies, and policy forums and briefings, EPF seeks to encourage an employment policy framework that will facilitate economic growth, job creation, job security, and a rising standard of living for a growing population. Employee stock option grants are an innovative compensation approach that encourages efficiency and productivity growth.

The comments of the Employment Policy Foundation focus on issues presented in paragraphs 17 through 23 of the draft guidelines. These paragraphs address with unexercised equity options, issued to employees.

Overview

The goal of ensuring accurate, reliable, transparent, and meaningful information should guide the design and implementation of accounting standards. Unfortunately, the proposed guidelines relating to the mandatory expensing of unexercised employee stock options may have the opposite effect–making accounting statements unreliable and misleading. As discussed below, the recommended methods within the proposed guidelines for establishing the value of unexercised employee stock options will not improve understanding of the financial health a company. Additionally, it may create a disincentive for companies to use employee stock options to increase productivity and to ensure that employees' interests are closely aligned with company performance.

The issue of reporting employee stock options on financial statements is only a question of how best to report the existence of option obligations. In the United States, employee stock options are already fully reported in financial statement notes. Furthermore, the actual cost of employee stock options is already accounted for and disclosed to investors through diluted earnings per share. Changing the format of reporting to an estimated expense at the time of the stock option grant would only create confusion and actually make accounting statements less representative of actual firm performance.

Because Employee Stock Options Differ from Other Options, Placing a Value on Them at the Time of Issue is Speculative

The draft guidelines propose that, in the absence of an established market price for options, a firm should estimate the fair value of options granted by applying an option-pricing model that takes into account various factors. The problem with such a guideline is that employee stock options typically differ from other options in three important ways, each of which negatively impacts the accuracy of the proposed methods of option valuation.

First, most employee stock options are not transferable. Typical options written in the context commodity and stock markets are bearer contracts. In contrast, employee stock options can only be exercised by the individual who is originally granted the options. The lack of transferability reduces the value of employee stock options and makes any forecast of value less precise.

Second, employee stock options have longer time constraints than market-traded options. Typical options expire in one to six months. Employee stock options often expire in four to six years after being granted. The time considerations associated with employee stock options make their value at grant highly speculative and difficult to estimate.

Lastly, employee stock options typically have no intrinsic worth at issue. The intrinsic worth of a stock option is the difference between the market price of the stock at the time of the option grant and the strike price. Employee stock options are usually issued at or above the market price at the time of the grant. Even if their value were not constrained by vesting periods that prevent exercise until a later date, the intrinsic value at grant would be zero. Stock options only become valuable if they translate into increased earnings and competitive success.

For these reasons, present methods of modeling other option prices are unsatisfactory for producing accurate or meaningful estimates of the value of employee stock options that might be exercised over long periods. Black-Scholes estimation can hypothetically calculate values for tradable stock options. However, the Black-Scholes method does not provide accurate forecasts of the market value of employee stock options because of previously mentioned differences between non-tradable employee stock options and other option contracts. Other methods involve pure guesswork by so-called market experts and subjective appraisers.

Recognizing the inherent difficulties of valuing employee stock options, the Internal Revenue Service of the United States allows corporations to deduct the net cost of stock options from corporate income taxes only after an option is exercised. Moreover, the deduction is from the taxable income in the year when the contract is exercised. This practice reflects the reality that proper valuation of an employee stock option is not certain until it is exercised.

Companies routinely undertake a variety of option contract obligations. All options create potential impacts on the financial status of a company. Because of these impacts, it has long been standard accounting practice to disclose details of option transaction obligations in corporate annual financial reports. Disclosure in notes, rather than in direct adjustments to the income statement or the balance sheet is most appropriate when the exact timing and amount of the impact cannot be estimated with certainty.

The IASB Should Move Cautiously When Establishing Guidelines for Stock Options Because of the Potential Adverse Consequences on Productivity and Employee Income

Paragraphs 1 through 3 of the draft guidelines issued in November 2002 establish the scope of guidelines, including accounting for unexercised employee stock options. EPF believes that caution is necessary in designing guidelines regarding the recognition of unexercised employee stock options. Changes to current accounting guidelines could create disincentives to use a compensation innovation that has been shown to improve worker performance, increase productivity growth, and raise the value of stockholder equity.

Between 8 and 10 million employees held unexercised options in 2000. According to the National Center for Employee Ownership's *Current Practices in Stock Options Plan and Design* (2001), since 1992, the number of employees holding stock options has increased 10-fold. Undoubtedly, the prevalence and extent of broad based employee stock options would decline if companies were compelled by new guidelines to account for employee options, which cannot be accurately valued.

If stock options were eliminated entirely, EPF's *Policy Backgrounder–The Economic Impact of Expensing Stock Options* (http://www.epf.org/research/newsletters/2002/pb20020916.pdf) estimates the total productivity growth in affected firms would be reduced by 16 to 19 percent over a 10-year span. This estimate is based upon the National Center for Employee Ownership's most comprehensive study (*Public Companies with Broad-based Stock Options: Corporate Performance from 1991-1997* (2002) by Joseph Blasi, Douglas Kruse, James Sesil, and Mayo Kroumova) to date comparing companies that offer broad based stock option programs with those that do not.

Based upon recent growth in the use of stock option compensation programs, the current number of employee option holders could grow to 30 million employees over the next ten years in the United States. Employees and stockholders would be directly affected by the proposed changes to accounting guidelines. If stock options were eliminated, each employee could cumulatively lose between $63,900 and $77,300 in income over the decade. Similarly, stockholders would lose value due to lower profits and less productivity growth. Even if implementation of the proposed guidelines did not lead to complete elimination of employee stock option grants by firms, they could greatly reduce use of a valuable tool for spurring productivity growth.

Conclusion

Stock options have become an important part of employee compensation. However, unexercised stock options possess unique characteristics, which require special treatment in accounting for their value. The current practice of disclosure of option grants in the notes of the financial report adequately informs the public, shareholders, and prospective investors. The proposed IASB guideline to recognize unexercised options through speculative expense deductions in financial statements will require amended financial statements after the employee options have been exercised. Moreover, it could result serious negative consequences for private sector productivity growth, employee welfare, and stockholder wealth.

Sincerely yours,

Edward E. Potter

Edward E. Potter
President