

ICI Comments on FASB Stock Option Proposal, June 2004

June 29, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Share-Based Payment File Reference No. 1102-100

Dear Ms. Bielstein:

The Investment Company Institute ¹ is pleased to respond to the Board's request for comment on proposed amendments to FASB Statement No. 123, Accounting for Stock-Based Compensation. As investors in approximately \$4.4 trillion in securities (both equity and fixed-income) issued by U.S. corporations – on behalf of millions of individual investors – mutual funds believe it is imperative that the accounting principles that govern corporate financial statements ensure full and fair disclosure of earnings, cash flows, and financial condition.

As you know, FASB Statement No. 123 currently encourages (but does not require) corporations to reflect the fair value of options granted to employees as compensation expense in the income statement. Since mid-2002, approximately 500 U.S. corporations have voluntarily decided to treat the fair value of options granted to employees as compensation expense. ² Those corporations that do not elect to treat the fair value of options granted to employees as expense must disclose the pro forma effects of expensing stock options on income and earnings per share in footnotes to their financial statements.

The Board's proposal would require an entity's financial statements to recognize as compensation expense the value of employee services received in exchange for all types of share-based payments. In particular, the proposal would require employee services received in exchange for stock options issued to employees to be measured based on the grant-date fair value of those options. The fair value of options granted would be recognized as expense over the requisite service period (typically the vesting period). The grant-date fair value of stock options issued to employees would be estimated using option-pricing models. ³ Footnotes to the financial statements would be required to disclose: a) the nature and terms of share-based payments during the period; b) their effect on compensation expense and income; c) the method and assumptions used to estimate the fair value of options granted; and d) the cash flow effects of share-based payment arrangements.

The Institute previously urged the Board to propose and adopt accounting standards requiring the fair value of stock options granted to employees to be expensed. ⁴ We believe rigorous accounting and disclosure standards, including expensing of stock options, are necessary to ensure investor confidence in the Nation's capital markets. The Institute supports the Board's proposal for the following reasons:

- Including the effect of stock options in financial statements, rather than in footnotes, will ensure that commonly reported items, such as earnings per share, have the same meaning for all companies. While mutual fund managers and other institutional investors can adjust their valuation models (whether option information is provided in the financial statements or in the footnotes), it is not clear that less sophisticated investors can do so. We believe including the effect of stock options in the financial statements will improve comparability and increase transparency to the benefit of all investors.
- Current accounting principles favor stock options over other forms of compensation. Properly constructed stock option plans can be highly effective in aligning the interests of corporate officers with those of shareholders. Nevertheless, accounting principles should be neutral. That is, they should not favor (or disfavor) stock options relative to other forms of compensation. All forms of compensation should be reflected as expense in order to ensure accuracy of reported earnings.
- Recently adopted international accounting standards mandate expense recognition for employee services received in exchange

for equity instruments, including stock options, beginning in 2005.⁵ The proposal will promote comparability between issuers following United States generally accepted accounting principles and those following international accounting standards.

In finalizing the proposal, we urge the Board to minimize alternatives for measuring the fair value of share-based compensation in order to promote comparability across issuers. If the final standard provides alternatives, financial statement footnotes should disclose the method and assumptions used to estimate fair value.

We appreciate the Board's consideration of our comments. If you have any questions, please contact the undersigned at 202/326-5851.

Sincerely,

Gregory M. Smith
Director – Operations/Compliance & Fund Accounting

cc: Paul F. Roye, Director
Division of Investment Management

Donald T. Nicolaisen, Chief Accountant
Office of the Chief Accountant

ENDNOTES

¹The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,633 open-end investment companies ("mutual funds"), 622 closed-end investment companies, 126 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.393 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

²See David Reilly, "Foreign Firms to Expense Options," Wall Street Journal, February 19, 2004, p. A2.

³The option pricing model must incorporate the following factors: 1) the exercise price; 2) the expected term of the option; 3) the current share price; 4) the expected volatility of the share price; 5) expected dividends; and 6) the risk-free interest rate. A lattice model (e.g., a binomial model) and a closed-form model (e.g., the Black-Scholes model) satisfy these criteria.

⁴See [Letter from Matthew P. Fink](#), President, Investment Company Institute, to Robert H. Herz, Chairman, FASB, dated August 21, 2002.

⁵International Financial Reporting Standard No. 2, Share-based Payment.