June 29, 2004

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

Re: Exposure Draft – Share Based Payment:
An Amendment of FASB Statements No. 123 and 95

WorldatWork sincerely appreciates the opportunity to comment on the above-referenced Exposure Draft.

WorldatWork is the leading association of compensation professionals, representing 23,000 members from North America's largest companies. These professionals are charged with designing compensation strategies for their companies, which will be greatly affected by this proposal.

Our comment is organized into two sections: first, we respond to some of the issues posed by the Board in the Exposure Draft; second, we highlight the results from a recent survey of our members on how the proposal will affect employee compensation generally.

Responses to the Exposure Draft Issues

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13-C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

WorldatWork members generally agree that services rendered in exchange for equity instruments give rise to compensation costs, but not necessarily recognizable costs because the services are creative, difficult to measure and incremental; their value cannot be separately measured.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting has been used. For the reasons described in paragraphs C26-C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion?

We agree that pro forma disclosures are not an appropriate substitute for the recognition of compensation cost in the financial statements. However, we believe they provide adequate transparency to the exchange of services and allow investors to compare earnings with or without an expense for options. The focus should remain on dilution, not cost, which pro forma disclosures adequately address.

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13-B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

We do not believe that the guidance proposed to ensure the fair-value measurement objective is achieved on a consistent basis. On the contrary, the proposed guidance will lead to great inconsistency. First, we believe comparability between companies will be lost because each company could use a different valuation model. Second, the opportunity for companies to vary their assumptions also reduces consistency.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options?

We do not agree that the "fair value" methods proposed by FASB can reliably measure employee share options for the reasons we stated above. Further, we believe the open form lattice-based binomial models are still untested and cannot be adequately relied upon to provide a fair value measurement. For this reason, we recommend FASB delay the implementation unless or until the new standard is tested and problems are identified and resolved.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

WorldatWork members recommend a single approach of estimating volatility that would be used for all companies because our concern with consistency remains. Otherwise, comparisons between companies may become meaningless.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the non-transferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

We do not agree that the proposed methods give appropriate recognition to the unique characteristics of employee share options. We are concerned that the "fair value" methods to value employee options at the grant date may misrepresent their real value. Additionally, attempting to estimate the risk of forfeiture at the grant date brings too many subjective elements into the valuation, which ultimately reduces the value of comparisons of companies' financial results. Further, the proposed method does not take into account the risk of employee stock options going underwater and never being exercised.

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle?

WorldatWork members have strong reservations against this provision in the proposed Statement. Employee stock purchase plans (ESPPs) are designed to encourage ownership, align interests with shareholders and share the rewards of success. Requiring companies to expense ESPPs will have the effect of removing ownership incentives for rank-and-file employees. For public policy reasons, we recommend exempting ESPPs that provide a 15 percent discount (or less) from recognition in financial statements as compensation costs.

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment?

> **We believe the accounting treatment will be overly complicated for companies with monthly or daily vesting schedules. This is especially true for option grants as opposed to full value grants such as restricted stock or performance stock; each vesting period will require its own custom-developed grant date fair value calculation. We recommend allowing companies with graded-vesting grants to choose between straight-line accruals or front-loaded accruals, even though this may reduce consistency.**

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

> **We disagree with the transition provisions. Companies should be allowed to choose between retrospective restatement and the modified prospective transition method. If the retrospective restatement is not allowed, there runs the risk of noncomparability between 2004 and 2005 net income and earnings per share statements.**

Results of WorldatWork Survey

In May 2004, WorldatWork surveyed its members during a two-week period. The demographic profile of the survey's respondents is similar to the WorldatWork membership as a whole. The typical WorldatWork member works at the managerial level or higher in the headquarters of a large company in North America. Ninety-five percent of the *Fortune* 1000 companies employ a member of WorldatWork.

The survey asked members 14 questions, the last one requiring an open-ended response. The highlights of the survey are below. The full survey report may be obtained by contacting WorldatWork.

The survey revealed the impact the proposed Statement would have on North America's largest companies:

- 81 percent of companies would see a shift in their compensation strategies due to the effect of the proposed Statement.
- 68 percent of companies will incur a significant or moderate administrative cost and burden to comply with the mandates under the proposed Statement.
- 58 percent said their companies would see either a moderate decrease or a great decrease in their companies' earnings due to the new accounting standard.

Regarding the members viewpoints towards the proposed Statement:

- 48 percent of respondents felt the requirement to treat stock options as a compensation expense is either a "bad idea" or "somewhat of a bad idea." Only 8 percent of respondents feel that it is a "great idea."
- Only 31 percent of respondents indicated that the proposed Statement would NOT result in a change to their employee stock purchase plans (ESPP). The largest group of respondents, 46 percent, did not know how their ESPP would be affected.
- 79 percent indicated that the proposed valuation methodology was either "highly complicated" (45 percent) or "moderately complicated" (34 percent). Two percent said the methodology was "quite impossible." The rest were unsure.

Sincerely,

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