Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

October 3, 2001

International Accounting Standards Board
Reopens Controversial Stock Option Accounting Project

The IASB announced on September 20 its intent to develop a new global accounting standard for employee stock options and other equity-based grants. It did so by reissuing a call for public comment on a controversial discussion paper, "Accounting for Share-based Payment," published in July 2000 by its predecessor organization, the International Accounting Standards Committee. The comment period will be open until December 15, 2001.

The discussion paper on which the IASB is inviting comment is actually an advocacy paper that makes the presumptive case that there *should* be a P&L charge for the "fair value" of employee stock options. This value should be estimated on the grant date by an option-pricing model, such as Black-Scholes or the binomial model, and then accrued over the vesting period, with the final value and cost measured as of the vesting date. In contrast to this "vesting date/fair value" standard for stock options, U.S. GAAP currently permits "grant date/intrinsic value" accounting for employee stock options (APB No. 25) but requires disclosure of what the expense would be under a "grant date/fair value" standard (SFAS 123) and what the pro forma effect would be on net income and EPS. A "vesting date/fair value" charge for stock options is only required under U.S. GAAP for options granted to outside consultants and others who provide goods or services in exchange for stock options[1].

The IASB plans to use the July 2000 discussion paper and related public comments to develop an exposure draft for release in mid-2002. Comments then will be invited on the exposure draft, following which the IASB will finalize a new global accounting standard for stock options. This new standard then would need to be adopted by the accounting standards-setting body of each member nation[2]. Adoption is voluntary, but all member nations' accounting standards-setting bodies have pledged to support the IASB in its effort to promulgate common global accounting standards for important business transactions.

All IASB member nations now permit "grant date/intrinsic value" accounting for stock options granted to employees and directors. Thus, international accounting standards are in harmony. The IASB reports, however, that many investors are dissatisfied with this standard, and would prefer a "fair value" standard whereby the "value" of options is a charge against operating

---

1 See EITF Issue 96-18

2 IASB member nations include Australia, Canada, France, Germany, Japan, New Zealand, the UK, and the U.S.

earnings. In its new request for comment, the IASB asked that particular focus be given to the question of *how* to measure the value of stock options, not *whether* the value of options should be a P&L expense. Apparently, the IASB believes that the issue of whether or not the value of options should be a required expense to the issuing company is no longer debatable, despite the fact that the value of options is based on a mathematical model developed for the short term trading of derivatives.

In response to the first call for comment on the July 2000 discussion paper, the UK's Accounting Standards Board received over 100 responses. About half favored an expense to the P&L for "share-based payment transactions" and half did not. Substantial support for a required expense came from the investment community. The proposal to fix the expense at the vesting date, however, was controversial, with only a minority of respondents in support. Most favored the date of grant as the measurement date.

We believe that adoption of this "fair value/vesting date" accounting standard for stock options and other equity awards would have an extremely negative effect on the development of employee equity incentives, would not improve financial reporting of operating results, and ultimately, would not be in the long-term interests of shareholders.

If the IASB approves an accounting standard for stock options which is different from current U.S. GAAP, which is likely, then the FASB will have to decide whether or not to restart the arduous and contentious effort of changing stock option accounting standards. European nations have indicated they will not adopt a new "fair value" expense standard for stock options unless the U.S. does. To do so would place them at a competitive disadvantage in competing for people and capital in the global marketplace. Thus, if a new standard is proposed, the FASB will be under considerable pressure to adopt it. For the present, the FASB's position is that it "has no plans to reconsider its existing standards in that area." Financial Executives International ("FEI") is launching an effort to have the IASB either drop the project or align any new global accounting standard for employee stock options with current US GAAP.

Our firm responded to the first request for comments with a letter dated November 6, 2000, available on our website at www.fwcook.com in the "Opinion Pieces" section under "Publications," and we plan to do so again. The subject is too important for companies and other interested parties not to make their views firmly known. The July 2000 discussion paper, "Accounting for Share-based Payment" is available for purchase from the IASB via email (publications@iasb.org.uk). Comments on the paper should be sent to the IASB's email address (commentletters@iasb.org.uk) by December 15, 2001. We suggest a copy be sent to the Chair of the FASB (eljenkins@fasb.org).

* * *

This letter is intended to alert compensation professionals to a development that could affect their companies. General questions on the IASB stock option project may be addressed to Fred Cook at (212) 986-6330. This letter and other materials by our firm are available at www.fwcook.com.