The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
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Comment Letter on Changes to Procedures for Accounting for Stock Options, February 2003

February 3, 2003

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

Re: Accounting for Stock Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-Based Payment

File Reference No. 1102-001

Dear Ms. Bielstein:

The Investment Company Institute[1] is pleased to respond to the Board's Invitation to Comment comparing FASB Statement No. 123, Accounting for Stock-Based Compensation and the proposed IASB standard, Share-Based Payment. The Invitation to Comment explains the similarities of and differences between the proposed guidance on accounting for stock-based compensation included in the recently issued IASB proposal and FASB Statement No. 123. We understand that, after considering the responses to the Invitation to Comment, the Board plans to make a decision about whether it should undertake a more comprehensive reconsideration of accounting for stock options. As part of that reconsideration, the FASB may revisit its 1995 decision permitting companies to disclose the pro forma effects of expensing stock options in financial statement footnotes, rather than requiring all companies to recognize the fair value of employee stock options granted as an expense in the income statement.

The Institute urges the Board to move forward with a reconsideration of Statement No. 123 as soon as practicable. We continue to believe that accounting standards should (1) require issuers to treat the fair value of stock options granted to employees to be recognized as expense in the income statement and (2) ensure uniformity in how stock options are valued for this purpose.[2] Mandatory expense treatment is necessary to ensure full and fair disclosure of issuers' results of operations and financial position. We are pleased to see that the IASB proposal will require issuers following International Accounting Standards to expense the fair value of stock options granted to employees.

Issue No. 7 in the Invitation to Comment requests comment on whether the effect of forfeitures should be incorporated into the estimate of the fair value of options granted. Forfeitures occur when employees do not attain service requirements or performance conditions necessary for the options to vest. Statement No. 123 does not permit an entity to consider the effect of forfeitures when estimating the fair value of options granted. Instead, entities must either recognize forfeitures as they occur (by reducing compensation expense) or estimate the quantity of options to be forfeited and true up that estimate based on actual forfeitures. These two methods result in the same aggregate amount of compensation expense, but the amounts recognized in any single period may differ.

The IASB proposal requires issuers to consider the effects of forfeitures in estimating the fair value of options granted to employees. This means that the entity must incorporate forfeitures into the option-pricing model or adjust the model's output when estimating the fair value of each option at grant date. When options are forfeited as a result of the employee's failure to achieve vesting conditions, compensation expense recognized by the entity is not reversed. Essentially, the IASB proposal treats the services received related to forfeited options as a "contribution" by the employee.

The Institute believes that Statement No. 123's approach, which excludes forfeitures from the estimate of the fair value of options granted is the most preferable approach. Requiring issuers to estimate future forfeitures and to incorporate that estimate into the option pricing model would enable them to “manage” the fair value of options granted and related compensation expense by adjusting their estimates. In addition, the IASB approach would not seem to allow issuers to adjust compensation expense for any variance between estimated and actual forfeitures. For these reasons, we believe excluding the effects of forfeitures from the estimate of the fair value of options granted combined with adjustment of compensation expense based on actual forfeitures yields the most accurate results. We also believe that analysts and investors are familiar with the Statement No. 123 approach and that adoption of the IASB approach may complicate their ability to estimate compensation expense and future earnings.

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

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,938 open-end investment companies (“mutual funds”), 535 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

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