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

Subject: File Reference No. 1102-100

Dear Ms. Bielstein:

The Financial Reporting Committee of the Institute of Management Accountants is pleased to provide comments on the Exposure Draft (ED), Share-Based Payment. We generally agree with the Board's tentative conclusions on the threshold issues that stock options should be charged to expense based on fair value estimated at the grant date using an option-pricing model. However, we do not support the ED as a whole because we strongly disagree with provisions in the ED related to accounting for income taxes, the guidance regarding how assumptions should be determined, the treatment of awards with graded vesting, as well as the proposed effective date and transition. In addition to those major objections, this letter describes our other suggestions for changes to improve the ED. If the Board modifies the ED as we suggest, we believe that the document would be greatly improved and we would therefore support its issuance as a final Statement. We are hopeful that this can be accomplished, as we believe it is time to bring the stock options debate to a final resolution.

Accounting for Income Taxes (Issue 11)

We disagree with the Board's conclusions related to accounting for the income tax effects of share-based payments. We also do not favor the approach prescribed by IFRS 2. We believe the tax benefit recognized in earnings for share-based payments should be reflective of the amount of compensation expense recognized, with any differences between that amount and the amount ultimately realized flowing to equity. We also believe the Board should adopt a portfolio

approach to tracking and accounting for the benefits realized upon exercise or settlement of share-based payments, as opposed to the individual employee approach in the ED.

We agree with the Board that the granting of an option by an employer and the exercise of that option by the employee represent two distinct transactions that should be accounted for as such. The granting of the option represents a compensation transaction paid by the company, whereas the exercise of the stock option represents an equity transaction by the option holder. Consistent with this view, we believe 1) the amount of income tax benefit recognized for the option grant should be reflective of the amount of the underlying compensation expense recognized in the income statement, and 2) any subsequent differences in realized tax benefits, both higher and lower, should be recognized in equity along with the effects of the option exercise.

We believe that the asymmetric approach in the ED (the benefit of actual tax deductions in excess of compensation expense credited to equity, and the effect of actual tax deductions less than compensation expense debited to earnings) is neither a fair portrayal of the economics of share-based payment transactions nor a useful approach for readers of financial statements. Further, it is not consistent with the Board's conclusion that the exercise of the option is an equity transaction. Even if the employer's tax deduction for a group of option grants equals or exceeds the amount of recognized compensation cost, certain options likely will be exercised before their individual recognized compensation cost is attained. This results in excess deferred tax assets for those options being charged to earnings, while the excess tax benefits for other options granted at the same time but exercised on different dates will be credited to equity.

Further, we believe the approach proposed in the ED is inconsistent with FASB Statement No. 109, Accounting for Income Taxes. The ED proposes to record a deferred tax asset as compensation expense is accrued for financial reporting purposes, as if a deductible temporary difference existed. The Committee cannot identify any deductible temporary difference in a share-based payment transaction. Additionally, the ED's requirement to charge an excess deferred tax asset to earnings seems directly contrary to paragraph 35 and 36 of Statement 109.

The Committee believes that the following approach, which achieves symmetry, is more consistent with Statement 109 than the approach proposed in the ED:

- The time value of an option, which is never deductible for income tax purposes, creates a taxable temporary difference. Notionally, the grant of an option creates an asset, prepaid compensation, representing the probable economic benefits of the expected employee services. That asset has no tax basis, so its recovery will generate future taxable income. The Committee understands that for a variety of reasons prepaid compensation is not recorded as an asset, just as a stock subscription receivable is not recorded as an asset, but notionally an asset, and a taxable temporary difference, exist.
- In accordance with Statement 109, a deferred tax liability should be recorded upon grant equal to the expected tax consequence of the time value, with a debit to equity. (If prepaid compensation were recorded as an asset, or as contra equity, the offset would be a credit to equity.)

- As compensation expense accrues for financial reporting purposes, the temporary difference decreases, and the deferred tax liability is reduced through the income tax provision.
- The actual tax benefit resulting from exercise of the stock option is recognized as a credit to equity.

The Committee also disagrees with the ED's proposed requirement that the tax effects be calculated at the individual employee level. The individual employee approach is inconsistent with the portfolio approach that is inherent in the valuation provisions of the ED (that is, the use of past experience for groups of employees to estimate the expected term of options and forfeitures) and that the Committee supports.

From a practical perspective, accounting for the deferred tax consequences at an individual employee level will require significant effort and resources to build and maintain systems capable of tracking the tax effects at that level. Companies maintain systems and information necessary to capture and measure their tax deductions. However, those systems generally are not designed to capture the level of detail needed to comply with the ED and often are not integrated into financial reporting systems. The Committee does not believe that there is any benefit to tracking tax benefits by individual employee given the inconsistency with the valuation approach, but even if there were, the costs of capturing the information would exceed the benefits.

Assumptions Used in Determining Fair Value

The guidance in this ED takes a much more prescriptive approach in how constituents should go about developing their assumptions and whether or not those assumptions are regarded as reasonable for purposes of being used in the valuation model. Paragraph 275 of Statement 123 says that there will nearly always be a reasonable range of assumptions and that it is appropriate to use the low end of the range when no amount within the range is a better estimate than any other. However, Paragraph B14 of the ED states that when there is a range you have to use the "average" of the range, which is referred to parenthetically as its expected value. Although it is not clear from the wording of the requirement, we understand that the expectation by some members of the Board is that probabilities will be applied to the each of the various assumptions within the range.

We believe that the proposed requirement is sufficiently unclear that many constituents may not realize that this is the Board's intention. We are confident that once made aware of this, many constituents would strongly object to the idea of making assumptions about the probability of an assumption coming to pass. Further, we envision that most companies will encounter a fairly wide range of assumptions, particularly with respect to expected volatilities, and believe the ED would require a level of estimation effort that is beyond the capabilities of companies to comply. Nor do we believe that efforts to apply probabilities will improve the relevance of the assumptions to a degree that warrants the significant costs this would impose.

Awards with Graded Vesting (Issue 9)

We believe the Board should preserve the choice contained in FASB Statement No. 123, Accounting for Stock-Based Compensation, which allows either the attribution method contained

in the ED or a straight-line attribution method for awards with graded vesting. While we understand how the Board reached its conclusion that an award with graded vesting represents separate awards (each with a different fair value measurement and requisite service period, requiring that they be accounted for separately), the Committee believes that both employers and employees view a share-based award with a graded vesting schedule as a single award – particularly as it relates to the services provided in exchange for the award.

We believe that measuring share-based payment transactions based on the fair value of the instruments issued reflects the reality that such instruments can be measured more reliably than the value of the services provided by the employees. We do not believe that measuring the transaction using the fair value of the instruments issued should lead to an attribution method that is inconsistent with the pattern of the services consumed (or the pattern of benefits received) by the employer. Given the fact that employees' services are rendered evenly over the vesting period regardless of vesting terms, we believe that the ratable attribution pattern allowed under Statement 123 is an equally appropriate approach for plans with a graded vesting schedule. Ratable attribution also represents a much simpler method.

Effective Date

The Committee recommends a one-year delay in the effective date for public companies to fiscal years beginning after December 15, 2005, at the earliest. Under the most optimistic timetable, the final Statement won't be issued until late in 2004. We believe that it is unreasonable to expect public companies to immediately adopt a newly issued standard of this type. Even if the board adopts our recommended changes to the document, there are a number of other operational issues that would warrant a longer implementation period. While companies have been measuring the fair value of option grants since the effective date of Statement 123, the ED proposes some significant changes that will require systems modifications—for example, tracking income tax benefits by individual grant and using accelerated attribution for awards with graded vesting. Many employers will want to implement, or at least explore, lattice valuation models, and likely will need to engage valuation specialists. Finally, with recognition in the income statement rather than in pro forma disclosures, some employers may want to explore changing the terms of their share-based awards. In particular, equity plans with features (for example, performance conditions or indexed exercise prices) that would have caused variable accounting under APB Opinion No. 25, Accounting for Stock Issued to Employees, become relatively more attractive under the ED. Plan design issues may involve engaging specialists, as well as discussions by boards of directors. While companies could do some of this work in the second half of 2004, they are rightly reluctant to incur costs related to provisions in the ED that may change in the final Statement.

The Board also should consider the current financial reporting environment. If the final Statement is issued late in 2004, the proposed implementation in the first quarter of 2005 will coincide with year-end 2004 closing under newly accelerated filing deadlines and with first time compliance with Section 404 of the Sarbanes-Oxley Act.

Transition (Issue 13)

The Committee believes that the Board should permit public companies to choose retrospective adoption, by restating prior years to reflect the compensation cost previously reported on a pro forma basis under Statement 123. While we would not mandate that presentation because of the costs involved, we believe that it provides greater comparability between past and future years. Therefore, we believe it is inappropriate for the Board to prohibit a transition method that many would consider superior. Further, the results of operations in 2005 and future years will be identical under the modified prospective and retrospective methods.

The Committee also believes that those companies who voluntarily adopted the fair value method of accounting for stock options using the prospective approach, as permitted under the provisions of FASB Statement No. 148, Accounting for Stock-Based Compensation — Transition and Disclosure, should be permitted to continue applying the prospective method. We believe that many companies adopted the preferable accounting method with a reasonable expectation that the FASB would not reverse the transition decisions in Statement 148 when it issued the expected Statement on share-based payment. That view was based, in part, on the reasoning in paragraph A12 of Statement 148, which states:

"...the Board believes that the new disclosures required by this Statement mitigate those [comparability] concerns by providing information that enables users of financial statements to make comparisons."

We agree with the Board's view that the disclosures required by Statement 148 are sufficient to allow meaningful comparisons among entities despite differences related to transition methods.

We believe it is inappropriate for the Board to require those companies that voluntarily adopted the fair value method prospectively, to have to readopt under the new Statement. A prospective approach to applying the provisions of the new standard is the fairest way to deal with those companies that already adopted using that method. The Committee notes that this is a closed set of companies; Statement 148 does not permit the prospective method for accounting changes after 2003.

Comments and recommendations on other issues follow.

Grant Date Measurement (Issue 3)

The Committee strongly agrees with the conclusion that the fair value of equity instruments should be measured at grant date.

Some Committee members believe that it is unclear in the ED that share-settled stock appreciation rights are equity instruments. We recommend making this more explicit in the final Statement, perhaps by including an example of such an instrument.

Fair Value Measurement (Issues 4a and 4b)

While the Committee generally agrees with the Board's observations about the advantages of lattice valuation models over closed-form valuation models, the Committee would not designate

lattice models as preferable and strongly recommends against requiring such a model to the exclusion of all others. There are many option-pricing models in existence today, and it is reasonable to expect that even better models will be developed in the future. Requiring the use of a lattice model or designating lattice models as preferable might deter the development of superior valuation models in the future or preventing companies from adopting such models until the Board has amended its standard to permit the use of superior alternatives.

Some Committee members believe that the ED is unclear about whether employers who have sufficient information to apply lattice models are required to do so. Because lattice models are more costly to implement than closed-form models, the Committee believes that employers are in the best position to decide whether the advantages of lattice models outweigh the costs. Accordingly, the Committee does not believe that lattice models should be required in any circumstances. Several Committee members who have experience with lattice models noted that the results of lattice and closed-form models are similar if an employer applies comparable effort in developing assumptions. Therefore, the Committee believes there would be little downside (in terms of lost comparability) associated with a standard that specifies, at a minimum, the factors that should be considered in measuring the fair value of stock option but does not require the use of any specific valuation model.

Expected Volatility (Issue 4c)

The Committee agrees that the Board should not prescribe methods of estimating expected volatility or prescribe a uniform volatility assumption for public companies. However, many Committee members believe that the Board should provide more robust guidance concerning factors that younger or smaller companies should consider in making their volatility estimates.

Inability to Estimate Fair Value at Grant Date (Issue 5)

The Committee disagrees with the Board's tentative conclusion on accounting for awards for which it is impossible to reasonably estimate fair value at grant date. We believe that the Board should retain the approach in Statement 123—use intrinsic value until it is possible to reasonably estimate fair value. That approach is closer to the overall grant date, fair value model in the ED. The proposed exercise/settlement date, intrinsic value approach in the ED has no conceptual merit. The Board's stated reason for selecting this approach has no conceptual basis; it is predicated on avoiding abuse. We do not believe that abuse avoidance is an appropriate conceptual basis for selecting an accounting principle. Further, these types of awards are so rare that we doubt the Board has any empirical evidence that abuses have occurred under Statement 123.

Employee Stock Purchase Plans (Issue 6)

The Committee disagrees with the Board's tentative conclusion on accounting for employee stock purchase plans (ESPPs). We believe that the Board should retain an approach similar to Statement 123. We believe that the right benchmark for determining whether an award is compensatory is whether the employer receives proceeds from employees commensurate with the proceeds it would receive from a sale of the same instruments to independent investors. We believe that the 5% "safe harbor" in Statement 123 is appropriate, because our experience is that 5% is a practical minimum level of transaction costs in equity offerings. However, we would not

object to eliminating the 5% "safe harbor" and referring solely to whether the proceeds received from employees are commensurate with the proceeds the employer would receive from an offering of the same instruments.

Requisite Service Period (Issue 7)

The Committee disagrees with the proposed attribution for situations in which the employee begins providing services before an award is approved. We believe that there should be no accounting recognition—neither an accrual of compensation expense nor a credit to equity—for awards that have not been approved, unless approval is a formality (perfunctory). We believe that it is inappropriate to give accounting recognition to unauthorized transactions. It sets a terrible precedent, it is inconsistent with the Board's recent decisions in other projects (for example, definition of assets held for sale in FASB Statement No. 144 and conditions for determining that a liability exists in FASB Statement No. 146) and it will encourage some to analogize to this guidance inappropriately to resolve recognition timing issues related to other transactions or events.

Disclosures (Issue 12)

Given that the focus of this project was to require recognition and measurement of the cost of stock options in financial statements, the Committee expected that less disclosure in financial statements would be necessary than under Statement 123. Instead, the ED appears to expand significantly on those disclosures. For example, paragraph 191(h) requires disclosure of the total unrecognized compensation cost and the weighted average period over which it is expected to be recognized in earnings. This amount will not usually provide a useful forecast of compensation expense that will actually be recognized in future years, because of changes in the composition of options outstanding, including: forfeitures, cancellations, new grants, etc. The ED also requires an exhaustive list of disclosures about the intrinsic values of options, disclosures that seem odd for a proposed standard that requires recognition of options at fair value. It was understandable that Statement 123 required disclosures about the preferable fair value method in the financial statements of employers who continued to apply the intrinsic value method. We do not understand why the ED requires disclosures intrinsic value in the financial statements of employers who apply the preferable fair value method.

We believe that the level of disclosure far exceeds the needs of investors and other financial statement users. It also is unclear to what use these new disclosures will be put – the basis for conclusions provides little direct insight or support. We believe that if the disclosures proposed cannot be persuasively supported as fulfilling a specifically identified user need, they should be deleted.

Nonpublic Entities (Issues 14a and 14b)

The Committee supports the Board's desire to reduce implementation costs for nonpublic entities. In that regard, we support the provisions to delay the effective date for nonpublic entities and to require them to apply the prospective transition method. However, the Committee does not support the permitted alternative of measuring compensation based on intrinsic value at the settlement date. We believe that method is neither appropriate in concept nor less costly. For equity awards, the FASB believes, and the Committee concurs, that fair value at grant date is the

appropriate measure of compensation cost. The proposed private company alternative, by comparison, uses an inferior method (intrinsic value) on an inferior date (settlement). We believe it would be more logical for the lower cost alternative to retain the preferred date (grant)

For a nonpublic entity that makes relatively infrequent option grants, the Board's alternative would not even result in lower cost. The settlement date method requires annual valuations of the company's shares. Some companies may have no other reason to perform annual valuations, and those annual valuations may be more costly than running an option-pricing model once, at grant date.

and adjust the model to be less costly. Our first preference would be to retain the minimum value alternative of Statement 123. That alternative comes closer to the preferred grant date fair value method, giving private companies specific relief on the most difficult assumption—expected volatility. If the Board finds zero volatility unpalatable, then another approach would be to

We appreciate your consideration of our comments. Please feel free to contact me at (203) 373-3563 if you have any questions regarding the issues discussed in this letter.

Sincerely,

Mitchell A. Danaher

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Chair, Financial Reporting Committee Institute of Management Accountants

specify a standardized volatility for nonpublic entities.