Letter of Comment No: 4795 File Reference: 1102-100



June 23, 2004

Director of Major Projects and Technical Activities Financial Accounting Standards Board

File Reference No. 1102-100

Dear Sir or Madam:

The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide our perspective on the Exposure Draft of a Proposed Statement of Financial Accounting Standards, Share-Based Payment: An Amendment of FASB Statements No. 123 and 95. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which the members are associated.

The Committee agrees with the major conclusions of the Exposure Draft. In particular:

- The exchange of an equity instrument gives rise to compensation cost.
- That cost should be recognized in the financial statements.
- That cost can generally be measured with sufficient reliability.

Because of the large number of issues identified in the Exposure Draft, we have limited the content of this letter to those issues where we disagree with the Exposure Draft or wish to expand upon it. We agree with the Exposure Draft's conclusions with respect to Issues 1, 2, 3, 4(b,c), 6, 7, 9. We believe the guidance in the Exposure Draft is sufficient with respect to issues (4a), 8. We believe the proposed standard is understandable to a reasonably educated financial or business person (Issue 18).

Following are our specific comments on the remaining Issues:

Issue 4(d):

The proposed standard would require that option values take into account post-vesting early exercise and forfeiture. Pre-vesting forfeitures are dealt with by estimating the portion that will vest (with a subsequent "truing-up" for actual pre-vesting forfeitures). As a result, only options that ultimately vest are ever expensed.

This approach effectively assumes that forfeitures during the pre-vesting period are independent of the stock price performance during that period. We do not believe this to be the case. Options are most (least) likely to be forfeited when they are least (most) valuable. Options that are in the money are undoubtedly less susceptible to forfeiture in the pre-vesting period than are out-of-the money options. By ignoring this relationship, the proposed standard would tend to undervalue the economic cost of options. The "truing up" called for in the standard does not solve this problem. Even when the proper number of options (the number that vest) is ultimately expensed, the cost per option is misstated.

Addressing our concern would require use of a lattice model that would consider forfeiture behavior in both the pre-vesting and post-vesting periods. We believe it is currently feasible to apply a lattice model, so this problem can be remedied. Although it appears the Board does not plan to require use of a lattice model, we believe this issue should still be addressed in the final standard and that those firms using a lattice model should be permitted to consider pre-vesting forfeiture behavior in their option value computations.

Issue 5:

In situations where fair value cannot be measured, the proposal calls for use of the intrinsic value method, with re-measurement through the settlement date. Although we agree with the Exposure Draft in principle, we believe the standard should indicate there is a very strong presumption that fair value can be estimated and that this provision only becomes operative if that presumption is overcome by substantial facts to the contrary. It is difficult to conceive of many situations where a company would include as part of its compensation package, a component that it cannot reasonably value.

The only exception we believe it is reasonable to carve out is for companies where the value of the underlying stock is not readily determinable. We believe the language in Paragraph 3(a) of Statement No. 115 would be a reasonable way to determine whether a security's price is readily determinable.

Issue 10:

The proposed standard contains principles regarding modifications and settlements. In general, for modifications of vested awards, the incremental value provided to employees (fair value of new instrument less fair value of old instrument, both measured at date of modification) is treated as compensation expense. For modifications of unvested awards, the incremental value provided, together with the remaining unamortized cost of the original award, is amortized over the remaining vesting period.

With respect to vested awards, we agree with the conclusions in the Exposure Draft. However, with respect to unvested awards, we believe there should be an immediate write-off of the difference between the unamortized original value and the fair value immediately before the modification. Otherwise, after the modification is made, the unamortized cost exceeds the fair value of the new instrument. Consider the following example:

- Original grant is worth \$14.70 per option and vests over three years.
- After one year, the fair value of the original grant is \$5.36 per option due to a stock price decline. The options are repriced and the fair value of the new options are \$8.59 each.

Under the proposed standard, the following would happen:

Grant date:

Determine grant is worth \$14.70. Set up amortization at \$4.90 per year.

End of Year 1:

Charge \$4.90 to compensation expense. \$9.80 remains unamortized. The additional value provided by the repricing (\$3.23 = \$8.59-\$5.36) is added to the unamortized original cost of \$9.80. The total of \$13.03 is amortized over the remaining vesting period of two years.

At the end of year 1, the options are worth only \$8.59, but the cost still to be amortized is \$13.03. Therefore, the unamortized cost is overstated by \$4.44. We believe that \$4.44 should be immediately taken to compensation expense at the time of the repricing. Then, only \$8.59 would remain to be expensed over the remaining vesting period, and the unamortized cost when the options are granted would be equal to their fair value, as would be the case if this were an original issuance of the options.

Issue 11:

We believe that deviations between recognized compensation expense and the ultimate tax deduction due to deviations in stock prices are equity transactions regardless of the direction of the change. If the ultimate tax deduction is small (or zero) because a stock performed poorly, that difference should be an adjustment to paid-in capital, just as it would be if the value of the tax deduction exceeded the amount originally charged to a deferred tax asset. We do not believe the asymmetric treatment of income taxes is appropriate.

The proposed standard does not discuss the difference between qualified and non-qualified options. It should be made clear that the tax-related provisions of the standard apply to non-qualified options (which generate a tax deduction upon exercise) and a portion of qualified options. The portion of the qualified options is the estimated percentage of options that would be subject to disqualifying dispositions (sale of stock received within one year), which triggers a tax deduction as well.

Issue 12:

The new disclosure requirements appear to exclude the disclosure of information about outstanding options at the balance sheet date. This is a key disclosure in that it is essential to an analyst who is estimating the value of the firm's equity – the current fair value of employee stock options must be subtracted, and this disclosure is the only source

of information available to make that estimate. Recognition of compensation expense does not eliminate the need for this disclosure.

Issue 13:

In response to an exposure draft that ultimately became Statement No. 148, we argued for mandating retroactive restatement. We stated:

The Committee believes retroactive restatement should be the only permissible transition method for firms now adopting the recognition provisions SFAS No. 123. Retroactive restatement provides the greatest comparability and eliminates the need for confusing pro forma disclosures. Because firms have already been compiling the required data and making the necessary computations, there is very little cost associated with this transition method.

After arguing against prospective application, we also argued against the modified prospective method (the same one currently proposed) as follows:

The Committee also opposes prospective recognition for unvested awards and new awards. This method would also require pro forma disclosure, albeit for fewer years than the ramp-up method. Like the ramp-up method, this would lead to non-comparability across years. We see no benefit to this transition method

We believe the arguments in support of retroactive application and against the modified prospective method continue to apply. Retroactive application is the only transition method that will immediately eliminate the need for confusing pro forma disclosures and reconciliations, and it would be inexpensive to apply.

The current Exposure Draft states that retroactive application is not practicable because the current proposal contains additional guidance that might result in some firms changing the way they estimate fair value. We do not find this to be a compelling argument. First, it is not clear the difference between the measurements of fair value under the old guidance and the new guidance would be materially different. Second, even if the difference were material, it is certainly possible to permit the retroactive application to be based on measurements previously used for pro forma disclosures for existing options. That is, the new guidance does not represent a different accounting method from Statement No.123, but a different method for estimating the value of an element of that accounting.

Under retroactive application, there would be no need to recompute the values of previously issued options. The benefits of retroactive application would be achieved with very little cost. The large additional cost of remeasuring the values of previously-issued options, which would provide relatively little benefit, would be avoided.

Issue 14(a):

We agree that while the fair value method is preferable, non-public entities should be permitted to continue to use the intrinsic value method. We would also note that if such exemption is not provided to non-public entities, it would be incumbent on the Board to issue guidance to such firms on determining the values of the underlying stock.

Issue 14(b):

We agree that extending the effective date for non-public firms is appropriate. However, we do not believe the selection of a transition method for all firms should be based on the need to mitigate compliance costs for non-public firms. Just as the proposed statement allows non-public firms to continue to use the intrinsic value method, it could allow non-public firms that do not continue to use the intrinsic value method to use a different transition method.

Issue 15:

We see no reason to exempt small business issuers from the provisions of the standard as long as they have publicly held stock with readily determinable market prices. As we stated under Issue 5, we believe the language in Paragraph 3(a) of Statement 115 is a useful way to determine whether the value of the underlying stock is readily determinable.

In our committee's deliberations, a question was raised as to whether the stock valuation made each year for purposes of an ESOP contribution constitutes a readily determinable market price. We believe that this should not constitute a readily determinable market price (and it would not under Statements 115's guidance), but the standard should address this issue.

Issue 16:

The proposed standard would treat excess tax benefits as a financing cash flow rather than a reduction of income taxes paid. We agree in part. However, consistent with our position on Issue 11, we believe that when the actual tax savings deviates from the previously-established deferred tax asset, that difference should be reflected as a financing cash flow, regardless of the direction of the deviation. For example, if a deferred tax asset of \$400 were established when compensation expense was recognized, and the actual tax benefit was only \$300, the cash flow statement should reflect the \$300 cash inflow as \$400 from the change in the deferred tax asset and -\$100 as a financing flow from ESO tax benefits being less than the original estimate.

Issue 17:

We do not believe the international standard is superior with regard to the specific issues mentioned. We also believe the standard should be based on the Board's best judgment and that it should not relegate its standard setting power to the international board.

Additional Issue:

Because the proposed standard would supersede Opinion No. 25, it would also nullify EITF No. 87-23 regarding book value purchase plans. The Committee believes the Board should consider providing guidance for accounting for such plans under the proposed standard.

The members of the Accounting Principles Committee of the Illinois CPA Society thank you for the opportunity to respond to this proposal. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

James L. Fuehrmeyer, Jr., Chair Accounting Principles Committee

APPENDIX A

ILLINOIS CPA SOCIETY ACCOUNTING PRINCIPLES COMMITTEE ORGANIZATION AND OPERATING PROCEDURES 2004 - 2005

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education, government and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

Current members of the Committee and their business affiliations are as follows:

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