

Peter J. Mariani  
Vice President, Corporate Controller

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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

File Reference No. 1102-100  
Proposed SFAS, Share -Based Payment, an Amendment of FASB Statements No. 123 and 95

On behalf the 12,000 employee-owners of Guidant Corporation, I am pleased to provide comment regarding the Board's Exposure Draft on share-based payments. In an industry that is characterized by rapid innovation, our shareholders have been well served by a culture that fully aligns the long-term best interests of our employee-owners with those of our shareholders. Stock options have been an integral part of this alignment as approximately 90% of Guidant Corporation stock options have been granted to employee-owners other than our senior leadership team. Although the exposure draft in its current form would certainly discourage future broad-based stock grants, the focus of our comment letter will be on the technical accounting merits of the Exposure Draft.

We have significant concerns with the Exposure Draft that we believe the Board should address prior to issuing the final standard. We have arranged our response into three sections. This first section serves as an executive summary of our primary concerns. The second section contains the technical references and supporting arguments for our primary concerns, and in the third section we discuss our position on certain other issues raised by the Board for comment in the Exposure Draft.

## Section 1 - Executive Summary

Our primary concerns can be summarized as follows:

- We cannot accept the Board's overall conclusion around the expensing of share-based payments as it continues to contain significant unresolved conflicts with the existing conceptual framework. (*Issues 1 and 2*)
- The reliability of the current valuation methods is insufficient for financial statement recognition. (*Issues 3 and 4*)
- The Board's conclusions regarding the accounting for the income tax effects of share-based payments are not operational. (*Issue 11*)

- The required transition method is inconsistent with established accounting principles. **(Issue 13)**
- The proposed Q1 2005 effective date is inappropriate given the overall complexity of the standard (specifically around the valuation methodologies and income tax treatment), together with the Sarbanes Oxley attestation and the accelerated SEC filing requirements that companies are currently addressing.

We fundamentally contend that stock options represent a shareholder approved and shareholder funded incentive to company employee-owners. Shareholders fund this incentive through dilution of earnings, which is currently recognized in an entities' income statement. The simple fact that the actual cost of stock options is funded through shareholder dilution and does not result in a reduction of the net value in a company's balance sheet should eliminate any consideration of income statement recognition as compensation expense. Furthermore, the risk and benefit from changes in the share price is transferred to the employee, as an owner, at the date of grant and does not accrue against company assets. Therefore, equity accounting continues to be appropriate for stock options.

Additionally, we note that convergence with IASB standards appears to be a driving factor in the Board's conclusions on this issue. Although we continue to be supportive of convergence efforts we contend that convergence should not drive standards that are in conflict with the existing FASB conceptual framework. We believe that the Board should address these conceptual issues and other technical accounting concerns prior to issuing a final standard.

Further, we recognize that certain companies have adopted the expensing provisions of Statement 123 as a corporate governance measure. This may have occurred as a voluntary management action, or through shareholder initiatives and/or outside pressures. Our experience indicates that companies who have voluntarily adopted are predominantly without broad-based plans and/or have plans with a nominal income statement impact. The merits of the corporate governance argument are outside of the mission of the Board and we believe that the Board should ensure that accounting standards are developed on their accounting merits without regard to corporate governance concerns.

Finally, we note that there are multiple references in the Exposure Draft to concerns of users of financial statements about the usefulness and transparency of financial reporting of stock options under Opinion 25. Our experience with users of financial statements indicates that they are focused on cash flows - which this standard has nothing to do with, and the predictability and understandability of earnings - with which this standard does nothing, if not impair due to the highly complex nature and lack of reliability of the valuation methodology. The exposure draft does not adequately explain how the standard will improve the usefulness and transparency of financial reporting and we would suggest removing such references from the literature as it appears self-serving and weakens the document. Furthermore, there are references to issuing this document to simplify U.S. GAAP. The fact that we, a multi-national company with revenues exceeding \$3.7 billion will need to hire a valuation firm to develop a valuation model does not support that this Exposure Draft is simplifying GAAP. Again we recommend that such references be removed from the final standard.

**Company Information**

Guidant Corporation is a world leader in the treatment of cardiac and vascular disease. The company pioneers lifesaving technology, giving an opportunity for better life today to millions of cardiac and vascular patients worldwide. Driven by a strong entrepreneurial culture of 12,000 employees, Guidant develops, manufactures and markets a broad array of products and services that enable less invasive care for some of life's most threatening medical conditions. Guidant Corporation shares are traded on the New York Stock Exchange under the symbol GDT.

If you have any questions regarding this letter or would like to discuss any of our views further, please feel free to contact me at (317) 971-2004.

Sincerely,



Peter J. Mariani  
Vice President, Corporate Controller, and Chief Accounting Officer  
Guidant Corporation

## Section 2 – Technical References and Supporting Arguments

### Recognition of Compensation Costs – Issues 1 and 2

We believe that the Board’s overall conclusion around the expensing of share-based payments contains conflicts with the existing conceptual framework. These concerns include the following:

- We take exception with the Board’s position on why share-based payments should be treated as anything other than an equity transaction with owners under Concept Statement 6.
- The Exposure Draft has not adequately addressed how the existing valuation methodologies for share-based payments meet the reliability criteria of Concept Statements 2 and 5.

We fundamentally contend that stock options represent a shareholder approved and shareholder funded incentive to company employee-owners. To this point, expensing of stock options is inconsistent with the definition of *expense* provided in Concept Statement 6 - “...a using up of company assets...”. In other words, a real expense results in a reduction of the net value of a company’s balance sheet– this simply does not occur when stock options are granted to employee-owners, as the net assets of an entity are unchanged upon issuance of an option. *Equity*, on the other hand, is defined in the same statement, as “investments by owners.” Although the Board briefly addresses this topic in C14 of the Exposure Draft the discussion is not sufficiently persuasive as it fails to acknowledge the important difference between the company’s long-term and captive relationship with employee-owners, and the transient negotiations with independent, unrelated third parties providing goods and services – the value of which, by definition can be readily determined. As such we cannot agree with the Board’s conclusion. We contend that equity accounting continues to be appropriate for share-based payments because they represent transactions with owners. The risk and benefit from changes in the share price is transferred to the employee, as an owner, at the date of grant and does not accrue against company assets. Further GAAP requires that the number of shares granted be added to the number of shares outstanding in the companies EPS calculation. This properly acknowledges the dilution “cost” incurred by the existing shareholders.

Further, we noted in the Exposure Draft that equity instruments are most often referred to as “valuable equity instruments.” Many share-based payments result in value to their holder. Value, however, in and of itself, does not trigger an expense requirement. Concept Statement 6 indicates that “expenses are outflows or other using up of assets...from delivering or producing goods, ...or carrying out other activities that constitute the entity’s ongoing major or central operations.” There are several items of value “used in the issuing entity’s operations” that are not expensed in the income statement. As examples, goodwill and the value of patents internally developed contribute significantly to the revenues we generate; however, we do not estimate the fair value of internally developed intangibles and ratably expense them, and no expense is recorded for goodwill values. The name of our Company also has value – but GAAP does not require us to quantify and expense that value. And, as discussed in more detail below, the value of a sales force acquired in a business combination, though significant, is not recognized in a company’s income statement.

Pro forma disclosure of a value is not a substitute for recognition of compensation costs in the underlying financial statements. However, we believe that there are instances wherein the quality or relevance of the underlying transactions/activity may be of a nature that disclosure may be the appropriate alternative. As it relates specifically to share-based payments, we fundamentally disagree that such payments represent compensation expense. However, if users of the financial statements believe that a review of a pro forma value and other disclosures would enhance the footnotes then such disclosures can be provided and already are available in large part. However the quality and relevance of the disclosures come into question as a result of widespread valuation concerns and should prevent consideration of the amounts for income statement recognition.

#### **Fair Value Considerations - Issues 3 and 4**

Although we believe that the binomial lattice approach to valuing employee share-based payments is an improvement over models like Black-Scholes, the model continues to have notable relevance and reliability issues.

Our concerns include the following:

- The Exposure Draft does not explain how fair value can be relevant for stock options in practice given that the captive environment in which stock options are *issued* does not allow for a bargained fair value "... between willing parties..." under Concept Statement 7.
- We do not believe the binomial lattice-based model, or any other models currently available, adequately recognizes the unique characteristics of nontransferable employee share-based payments, nor do we believe the use of an expected term compensates for this restriction.
- The markets will continue to develop better models, and share-based plans will continue to evolve that do not lend themselves to current valuation models. Companies should have flexibility in determining the type of option pricing model to use to value options and the use of a particular model should not be dictated.

Paragraph C16 indicates that the amount of compensation cost must be based on the fair value of the instruments issued "...that is consistent with the measurement basis for other forms of employee compensation, including cash, other assets, pension benefits...the Board sees no reason to measure compensation paid in share options or other equity instruments on a different basis." The Board has defined fair value in Concept Statement 7 as "the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Paragraph C20 notes that the basis for using pricing models for these options is that they are a proxy for fair value because on the grant-date "the employer and the employee come to a mutual understanding of the terms of a share-based payment arrangement." These statements fail to acknowledge that there is a captive environment between an employer and the employee that does not allow for a negotiation of terms. As an employee, I can represent that the number of options I receive or the terms under which they are granted is not negotiable. I am not a "willing" buyer, in the spirit of this definition. I simply receive an option grant determined according to my position and rating, consistent with the terms approved

by the shareholders. Negotiating more options, options with different terms, or a different mix of options, base and bonus compensation, or benefits is not possible without risking my continued employment with the company. Therefore a stock option grant does not allow for a calculation of “fair value” under concept statement 7.

Further, the value of acquired sales forces in business combinations can be significant and was the primary driver for a business combination we completed five years ago; however that item is not valued and expensed in our income statement. In Statement 141, paragraph 169 the Board concluded that assembled workforces acquired in business combinations would not be separately identified and amortized because “the Board believes that replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired... techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available.” However, the Board has been made aware of the multitude of valuation issues with share-based payments: they cannot be traded, systematic risk is difficult to measure on an option, difficulties in predicting volatility over long periods of time because that tells us what happened in the past, not what is to come, volatility on an option is not constant, etc. Yet, though the Board is aware of these issues, the project is still proceeding.

On a related point, we believe the definition of grant date should be clarified. The Exposure Draft defines the grant date as the “date at which the employer and employee reach a mutual understanding of the key terms and conditions of a share-based payment arrangement.” In practice, this date will generally differ from the measurement date (the date at which the share price of the instrument is fixed, which is often the date all the requisite approvals have been obtained) due to the logistical and administrative efforts required to execute broad-scale communication plans in larger companies. For most stock option plans, where the exercise price is equal to the market price of the underlying stock on the measurement date, we do not believe the fair value calculation should be impacted for changes in the market value of the underlying stock during the administrative/communication period. Thus, we believe the definition should be clarified to acknowledge that the grant date may be the date the relevant terms are approved by the board of directors or other relevant authority, provided there is not an unreasonable period of time between that date and the date the awards are communicated to employees. This logistical issue at large companies further illustrates that there is no “mutual understanding” reached. If there were a “mutual understanding” we would all be negotiating the strike price and number of shares and receive the shares that same day – or the employer would negotiate with each of us the number of options and strike price we are willing to work for. As noted above, in broad-based plans such as ours, options are granted according to position and rating and at a common exercise price. It is difficult to understand how these circumstances could support the notion of a “bargained for” transaction.

Concept Statement 2 explains that both relevance and reliability are qualitative characteristics of accounting information. It also explains that there are trade-offs to be made between the two. Additionally, we note that it is well understood that disclosure is not an adequate substitute for recognition, if something meets the relevant criteria for recognition. However, what has not been made clear to us in this Exposure Draft is what information financial statement users are missing – what relevance expensing of share-based payments bring

to the financial statements when weighed against the reliability, comparability and measurability questions. The issues with reliability have been demonstrated to the Board on multiple occasions. We note that the decision was made in Statement 141 that information was not sufficiently reliable on sales forces to separately value them in a business combination, for example, and we challenge if that same level of rigor is being applied to this decision to expense share-based payments.

On a more specific point, we do not believe the Board should prescribe a specific method of estimating expected volatility. We believe the factors for consideration set forth in the Implementation Guidance (paragraph B25) provide sufficient guidance in supporting the overarching principle that expected volatility should be both reasonable and supportable. The guidance provides a framework for management to apply its judgments and estimates to its specific facts and circumstances. Additionally, such an approach is consistent with the Board's movement towards principles-based standards. Consistent with this view, we do not believe the final standard should prohibit defaulting to the historical volatility, as there may be cases in which, absent any other determining factors, historical volatility levels may be the best indicator of future levels.

We do not believe the use of an expected term will adequately compensate for the lack of transferability in the captive environment in which employee share-based transactions occur. We continue to believe that an adjustment must be made for the lack of transferability inherent in most employee stock option plans in order to properly reflect its value. Given the transfer restrictions and the captive environment in which options are granted (i.e., employer/employee relationship vs. an open market with a willing third party buyer and seller), employees (the buyer of the equity instrument) would require a much larger risk premium than would a true third party investor buying a freely traded option. Again, if the Board continues down the path of expensing, we believe that companies should be allowed the ability to exercise judgment in its approach to reflecting the effects of non-transferability, although, due to the complexity, diversity in practice is bound to evolve.

We also observe that the complexities involved in using the binomial lattice model result in significant cost to comply with the Exposure Draft, due to both the internal efforts devoted to populate and understand the model and fees charged by external valuation experts. We estimate initial costs will exceed \$150,000 with annual costs of around \$50,000. Even in cases where such complexities are not warranted (for companies with basic plans and insignificant costs), the Board's designation of this model as the preferred approach will likely cause companies to incur the cost and effort to utilize it.

We do agree with the Board's decision that compensation cost should only be recognized for those equity instruments that vest to account for the risk of forfeiture due to vesting conditions.

### **Income Tax Effects Issue 11**

We do not support the Board's conclusions related to accounting for the income tax effects of share-based payments. We believe 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. 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, assuming the Board continues down the expense path, and 2) any subsequent differences in realized tax benefits, both higher and lower, should be recognized in additional paid-in capital along with the impacts of underlying option exercise. We believe this treatment is conceptually consistent with the intra-period tax allocation principles of Statement 109. We note that the Board concluded in paragraphs C128 and C129 of this Exposure Draft that the grant and exercise are separate transactions (the former being consideration for services and the latter being an equity transaction). However, we find it difficult to understand the Board's conclusion that the tax effect of the portion of the transaction up to the initial grant value treated as compensation is recognized in the income statement and only that portion of the exercise resulting in a tax benefit in excess of the originally recognized benefit is treated as an equity transaction.

We further believe that the Exposure Draft's proposed requirement to calculate and account for the tax impacts of share-based payments at the individual employee level, vs. the portfolio approach in Statement 123, is inconsistent with how such payments are valued in practice. In practice, share-based payments are valued using a portfolio approach. Inherent in this valuation approach is the fact that even if the option holders as a group realize the same ultimate amount of intrinsic value as was recognized as compensation cost by the company, some options will be exercised before this value is attained (resulting in a tax deficiency or excess deferred tax assets being charged to earnings under the Exposure Draft), while others will be held and exercised at amounts above the estimated value (resulting in the realization of an excess tax benefit, credited to equity under the Exposure Draft). Over time the inconsistent treatment of a tax deficiency as compared to an excess tax benefit will result in a higher effective tax rate, but the Exposure Draft has not explained why this is the conceptually preferable answer in a manner we can understand.

From a practical perspective, if the Board were to conclude that the individual employee level is the preferred method, the requirement to account for the deferred tax consequences at an individual employee level is not operational without a substantial amount of effort and resources to build and maintain systems capable of tracking the tax impacts at the individual employee level, a project made even more complex in the case of large, multinational enterprises that must factor in multiple taxing jurisdictions and movements of its employees between the various jurisdictions. The tracking of deferred taxes at the individual employee level will also require the tracking of tax legislative and regulatory changes with respect to the deductibility of share-based payments. We do not believe the benefits of such treatment will outweigh the costs and ask the Board to field test how such treatment could be relevant to shareholders or improve transparency of results.

### **Transition – Income Tax Accounting - Issue 11**

Additional guidance is needed relative to the transition rules and the impact on deferred taxes. For example, it is unclear how tax benefits realized from the exercise of options, for which no compensation expense was recognized under existing rules, should be accounted for. We would assume such benefits would be credited to equity since no compensation expense was recognized, but it is not clear from reading the standard, and divergence in practice might result. Also, it is unclear as to whether the individual or portfolio approach would be utilized for purposes of determining the appropriate tax treatment upon exercise for options outstanding but not fully vested as of the date of adoption, as well as for options fully vested as of the adoption date for those companies that used the fair value approach under FASB Statement 123. We believe it would be impractical to force companies to go back and calculate the information needed to apply the individual approach for these previously issued options. Thus, assuming the individual approach survives the final standard, we believe the portfolio approach should be grandfathered for all options outstanding – both vested and unvested - as of the date of adoption.

### **Transition Method - Issue 13**

We disagree with the Board's conclusion that the final standard should be adopted using the modified prospective method. We believe a more appropriate approach would be to follow Statement 148, where the Board permits three separate adoption models for stock-based compensation. More specifically, we believe the Board should allow prospective, modified prospective and "modified" retroactive adoption methods in the final statement. Any method but retroactive will result in mixed valuation models and impair comparability. Prospective was allowed under Statement 123, now the Board indicates in this Exposure Draft that lattice models are better, but does not allow the transition methods committed to under Statement 148. We have to assume this is because of a rush to publish a final standard, as there is no clear justification in the basis for conclusion. Paragraph C159 acknowledges that this statement elaborates on Statement 123's guidance, and "as a result, an entity might conclude that some aspects of its estimation method used in prior years should be changed..." but goes on in paragraph C160 to conclude that companies already have the fair-value based method expense for any option granted after December 15, 1994 -- those two statements are contradictory. Statement 148 is barely over a year old, the conclusion in that Statement that three methods for adoption are acceptable should not have this drastically changed in such a short time period.

We question the decision usefulness and transparency of having some information presented using Black-Scholes valuation under Statement 123 mixed in the same year with the new valuation guidelines identified as preferable in this Exposure Draft.

We also believe the prospective method of adoption should be an available alternative. A number of companies have recently chosen, in good faith, to adopt the fair value of accounting for options under the Board's recently issued Statement 148. To prohibit such an alternative in the Exposure Draft would be a disadvantage to such companies, since they would need to "re-adopt" the fair value method using a new transition method.

However, if the Board requires the modified prospective transition approach, an example of a transitional disclosure would be beneficial and encourage consistency. We believe the modified

prospective approach creates a number of transitional issues, which are not specifically addressed in the Exposure Draft. We request additional transition guidance on the following:

- How to account for the true up of deferred tax assets for pre-adoption awards (i.e. should the tax benefit received be compared to the actual deferred tax asset recorded post-adoption or to the “theoretical” deferred tax asset that would have been recorded had the company been applying the provisions of the Exposure Draft since the award’s grant date).
- How to account for forfeitures of pre-adoption awards that occur post-adoption (i.e. apply a required forfeiture estimate rate similar to new awards or continue to record actual forfeitures under the SFAS 123 alternative methodology).
- How to account for modifications of pre-adoption awards that occur post-adoption (i.e. should the computation of incremental compensation cost be computed as the fair value of the award at the modification date less (1) the fair value recorded post-adoption, pre modification or (2) the “theoretical” fair value that would have been recorded since the grant date under the SFAS 123 pro forma approach).

#### **Effective Date**

The proposed Q1 2005 effective date is inappropriate given the overall complexity of the standard (specifically around the valuation methodologies and income tax treatment), together with the Sarbanes Oxley requirements and the accelerated SEC filing requirements also effective Q1 2005 that companies are currently addressing. The Board can argue that much of the required information for share-based payments is available as the disclosures have been required for some time. However, we believe that position is inconsistent with the Exposure Draft’s indication that the lattice models are preferable models. Why would the Board not want to encourage a complete and thoughtful recalculation of share-based payment values under the preferable model and allow adequate time to complete such analysis?

## **Section 3 - Responses to other issues identified for comment**

### **Employee Stock Purchase Plans - Issue 6:**

We disagree with this conclusion on the same basis of our other responses. However, if the Board continues down the path laid out in the Exposure Draft, for the reasons discussed in paragraphs 232-242 of FASB 123, we believe that a sufficiently small discount (i.e. 5%) is comparable to stock issuance costs avoided by issuing securities to employees rather than to the public, and does not represent compensation cost. In our view, the primary purpose of such a plan is not to compensate employees for services rendered; rather such a plan is designed to encourage employees to become stakeholders in an effort to link employee and shareholder interests. Accordingly, we support the Board's conclusions, if expensing of share-based payments proceeds, in SFAS 123 on Employee Stock Purchase Plans, and we recommend carrying forward its provisions to the new equity-based compensation Standard.

We also note that ESPPs are one example where no information on fair value accounting is available for Companies applying Opinion 25, and this is just one example where issuing a standard very late in 2004 that is effective January 1, 2005 is unnecessarily burdensome.

### **Attribution of Compensation Cost - Issue 7**

Assuming the Board concludes that expense must be recognized in the income statement, we would support recognizing compensation cost over the employee's service period, which we believe is generally the vesting period provided for in the award.

### **Requisite Service Period - Issue 8**

We believe the guidance in estimating the requisite service period is sufficient.

### **Modifications and Settlements – Issue 10**

We disagree with paragraph 35(b). If performance is not satisfactory, we believe it could be possible to change an award that results in a fair value less than the previous award. We do not understand the conceptual basis for requirement 35(b)(2) – understandably such situations would be rare, however, that does not justify a non-conceptual accounting result in our opinion.

### **Disclosures - Issue 12**

We question the appropriateness of the extent of the required disclosures. While the level may be appropriate under existing rules for a company that provides pro forma disclosure only, they appear excessive for companies recognizing compensation expense using a fair value model, and are disproportionate relative to the amount of compensation costs recognized and disproportionate to other compensation costs recognized in the financial statements or other

judgmental accruals we are required to recognize. We believe the Board should weigh the fact that they felt so many disclosures were required when considering if these disclosures are sufficiently reliable for recognition. We specifically question the value of the disclosure required in paragraph B191 (h.), as relates to the weighted average period over which unrecognized compensation will be recognized, (i.), related to the specific cash flow impacts, and (k.), related to management's policy and expectations on share repurchase activities. As relates to paragraph 191(k.), this forward-looking information is better positioned and effectively required in the management discussion of public companies' filings.

### **Cash Flows - Issue 16**

We understand the Board's rationale for requiring that excess tax benefits be included in financing cash flows, consistent with its view that options should be accounted for as two transactions, with the exercise of the stock option representing a shareholder transaction (itself is a financing transaction) and do not feel strongly about this issue. However, we question the value of this amendment to FASB Statement 95. We struggle with the value to financial statement users of separating the granting of a stock option with the exercise of the stock option for cash flow purposes. The two do not occur in silos, nor could one happen without the other, and as we have previously mentioned, we believe the entire stock option program is a transaction with a shareholder, so, it should stand to argue that all option activity should be a Financing activity.

### **Understandability of This Proposed Statement - Issue 18**

We believe the proposed Statement meets the Board's stated objective. However, we do not agree with that stated objective. The Board's objective is dependent on a reader's willingness to "study the standard with reasonable diligence" to understand the risks associated with the proposed accounting (most notably, the significant assumptions used to measure the fair value of share-based payments). Given the technical nature of such accounting and the length of the exposure draft, it is unlikely that any notable portion of financial statement users will study and understand the proposed accounting. Ultimately, the user's lack of understanding of this accounting could risk the credibility and comparability of financial statements, which may further erode investor confidence in our financial reporting model. In addition, due to the difficulty in estimating fair value of equity instruments and the complexity of the underlying models, it is unlikely that most users will be able to implement the proposed Statement without the use of use of outside experts, which will be costly, and significant internal resources as a result of the operational difficulties of implementing the Exposure Draft.