

Financial Accounting Standards Board
Director of Major Projects, File Reference No. 1102-100
sent via email to director@fasb.org

Zurich, 25 June 2004

Comment Financial Accounting Series 1101-100 (Share-Based Payment)

Dear Sirs:

We would like to take the opportunity to comment on Share-Based Payment as put forward in the Financial Accounting Series No. 1101-100 dated March 31, 2004.

Recognition of Compensation Cost

ad C13: we agree that a payment or benefit in any form (including share-based compensation) for employee services should result in an expense item in the income statement (with some caveats put forward under ad C14).

ad C14: indeed, share based compensation is under certain circumstances a transaction between employees and shareholders of a company. There are two different cases, however:

- a. if stock is purchased in the market (or taken from treasury stock) the company incurs a true cash cost through the purchase of shares and the company compensates existing shareholders for the transfer of the shares to employees. An expensing of equity based compensation fully mirrors the nature of the transaction. We believe, however, that the consequences for the **Statement of Cash Flows have not yet been properly addressed**. Any share repurchase in the market up to the numbers of shares for which a relating share-based compensation expense item exists in any given year should be treated as a cash expense relating to employee compensation. Such share repurchase would need to be charged to "Cash flow from operations" rather than "Cash flow from investing activities". (Naturally, any share repurchase exceeding the number of shares equivalent to the share-based compensation

charges would be treated the same way it is now, i.e. charged to than "Cash flow from investing activities").

- b. if, on the other hand, **stock is issued to cover share based compensation** then the cost of this issuance is borne by shareholders. This dilution can be calculated and is equivalent to the fair value of the options or shares involved at grant date. This transaction is equivalent to a gift from shareholders to employees of a company, and we believe it should be accounted for like a gift (or a subsidy), i.e. an income item reflecting the gift alongside the expense item:
- expense item like proposed (e.g. fair value of equity based compensation)
 - **income item** of same magnitude to reflect gift from shareholders or more precisely **"expropriation of shareholders in the form of equity-based employee compensation"**

On a gross basis, employee share based compensation will show up in the income statement and truly reflect total employee costs. The net effect to the income statement, however, is zero in case b. (This may be disturbing to many. We believe, however, that such issues are Corporate Governance issues and should be addressed there, i.e. through mandatory shareholder votes on share based compensation schemes). For as long as companies continue to be able to compensate their employees and have shareholders face the bill then this is similar to companies being able to get government subsidies, source their goods more cheaply in the market, etc. We believe our proposed accounting treatment accurately reflects the underlying nature of share-based compensation if shares are issued (rather than bought in the market or taken from treasury stock) and accurately reflects a company's financial performance. We would even argue, that if and when a company compensates employees by issuing shares (thereby having shareholders face the burden) and this compensation would be expensed as proposed this would give a misleading representation of the financial position of a company (i.e. an understatement of income). We also believe that the "the long-established practice" mentioned under C14 of recording shareholder payments to employees as an expense, alongside increasing shareholder paid-in capital, is fundamentally different from an *issuance of shares to employees* as discussed in this Proposed Statement.

The expensing of options programs (without the proposed accompanying "gift" revenue item) yields the same Net Income for cases a. and b. This may sound desirable (why should companies who dilute shareholders show higher Net Income?), but it is factually incorrect and may only act as a second best solution if Corporate Governance measures fail. We believe that accounting should not take on tasks which should be left to Corporate Governance. Indeed, Free Cash Flow is different under cases a. and b. (by the amount of options expenses) and we believe this should be reflected in Net Income.

What are "fully diluted shares"?

We would also like to point out that the share count used to calculate per share data is probably as important an issue as the question on expensing share-based compensation (somewhat in contradiction to C31 and C32). For most investors and analysts, key financial data is not "Net Income" (or related measures) but "per share" data, i.e. "Earnings per share (EPS)", "Cash flow per share", etc. The share count, i.e. number of shares that needs to be taken to accurately calculate EPS gets little attention in the

Proposed Statement (C31 and C32 partly deal with the issue: We only partly agree with those commentators who gave rise to C31, i.e. in case b. above EPS gets hit twice, and wrongly so, whereas in case a. the double-hit to EPS accurately reflects the underlying event. The comments in C32, again, are correct with respect to case a. above, but do not accurately reflect case b.).

Share-based compensation affects the number of shares outstanding, be this in the current (i.e. the period when share-based compensation is granted) or in future periods (i.e. when shares vest or options are exercised). Currently, fully diluted shares include outstanding shares plus convertible stock and in-the-money options granted to employees. We believe that "**fully diluted shares**" need to accurately reflect expected future share issuance stemming from share-based compensation and should therefore include:

- expected (at grant-date) share issuance from performance based or similar share compensation schemes (i.e. best estimates of the number of shares that will eventually vest)
- expected issuance of shares from employee stock options programs (these may be calculated using an option's "delta" which is available from the same models which are used to calculate options fair values). Switching to "delta-weighted" shares when counting employee stock options (rather than in-the-money options) would harmonize the methods used: when options are expensed, fair values based on options models are used rather than intrinsic values (which corresponds to the concept of "in-the-money options")

We would like to illustrate the different definitions of fully diluted shares with the following stylized example: Company XYZ generates Net Income of 100. Shares outstanding are 100. In Year 1, employees are granted options underlying 10 shares. The shares move in-the-money in Year 3. The options delta be 0.5 in Year 1, 0.6 in Year 2, 0.7 in Year 3, 0.8 in Year 4, and 1 (exercised) in Year 5.

Examples of different rules to count "fully diluted shares"

			Year 1	Year 2	Year 3	Year 4	Year 5
	Rule	Net Income	100	100	100	100	100
Case 1	only in-the-money	Shares	100	100	110	110	110
	options in share count	EPS	1.00	1.00	0.91	0.91	0.91
Case 2	"delta method"	Shares	105	106	107	108	110
	share count	EPS	0.95	0.94	0.93	0.93	0.91
Case 3	all options fully	Shares	110	110	110	110	110
	counted	EPS	0.91	0.91	0.91	0.91	0.91

Case 1 illustrates the current rule where only in-the-money options are counted in fully diluted shares. The obvious **disadvantage** is that EPS get a sudden hit whenever options move in-the-money while investors see no effect of the options in EPS (except for the expensing, of course) before options move in-the-money.

Case 2 (the proposed method) illustrates the "delta-method" (current shares outstanding plus "delta times options"). The **advantage** of this method is that options are in the share count already when they are granted (the delta is always above zero) and discretely move whenever the delta (mostly in relation to the stock price) moves higher (or lower).

Case 3 is an alternative where all options from grant date onwards are fully counted in the shares outstanding. This extreme case has the disadvantage that the share count needs to be reduced once options expire worthless in those cases when the share price remains below the strike price during the exercise period.

We propose that the count of "fully diluted shares" be redefined irrespective of the expensing decision on share-based compensation

Disclosures

We believe that disclosure is key for investors to judge potentially dilutive effects of share-based compensation.

We agree with Minimum Disclosure Requirements set forth under B191ff.

However, we would urge to add the following:

- wherever a number of shares in relation to share-based compensation is listed, this number should also be given as a percentage of total shares outstanding (currently in most annual reports, the number of shares in relation to share-based compensation and total shares outstanding are found in totally different sections or footnotes which unduly complicates the analysis of financial reports)
- wherever a number of shares in relation to share-based compensation is listed, this number should also be given as a "delta-value" (calculated using the same model used to determine fair value), i.e. the delta of the options times the number of share underlying the options, and this number as a percentage of total shares outstanding
- whenever Intrinsic Values of options are listed these should also be given as a percentage of the company's stock market capitalization at the end of the reporting period
- summary table of all shares outstanding, aggregate intrinsic values, etc. (as set forth under Minimum Disclosure Requirements) from share-based compensation:
 - total of shares outstanding
 - total of shares outstanding as a percentage of shares currently outstanding
 - total of delta-weighted shares outstanding
 - total of delta-weighted shares outstanding as a percentage of shares currently outstanding
 - intrinsic values of employee options
 - intrinsic values of employee options as a percentage of the total stock market capitalization

We also believe that such summary statement should be a financial statement in its own right (like the "Income statement" or the "Statement of cash flows") and be placed in a company's annual report as a financial statement and not only in a footnote.

Summary of suggestions

- we believe that share-based compensation should be expensed, but in the case of dilutive share issuance this should be accounted for by a corresponding income item
- more importantly, however, we believe that the count of fully diluted shares needs to be adapted to better reflect the dilutive effects of share-based compensation
- some enhancements to the proposed minimum disclosure rules would greatly facilitate the lecture and analysis of company statements

We hope this comments are useful and supportive to your project.

Sincerely yours

Otto Waser,
Partner