

**STANDARD
& POOR'S**

Timothy A. Luehrman, Managing Director
Corporate Value Consulting

617-530-8005 Tel
617-507-5652 Fax
timothy_luehrman@sandp.com

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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

Reference No. 1102-100

Dear Ms. Bielstein:

We are pleased to have the opportunity to comment on the FASB's recently issued Exposure Draft on Share-Based Payments. Our comments on selected issues and answers to selected questions enumerated by the Board in the Exposure Draft are attached. Please note that we have not commented on every issue.

We commend the Board and the FASB Staff on their diligence and dedication in addressing a difficult issue.

Should you have questions about our views as expressed in the attached comments, please contact Timothy Luehrman ((617)-530-8005) or Paul Barnes ((215) 430-6025).

Sincerely,

Timothy A. Luehrman

For Standard & Poor's Corporate Value Consulting

**Comments on the Financial
Accounting Standards Board's Exposure Draft:
*Proposed Statement of Financial Accounting Standards,
Share-Based Payment – an Amendment of FASB Statements No. 123 and 95,*
Released March 31, 2004**

June 28, 2004

Our responses to the issues and questions raised by the FASB in its Exposure Draft on Share-Based Payments appear below. Our comments are based on S&P Corporate Value Consulting's expertise in technical valuation methods; on our familiarity with the particular valuation issues presented by share-based payments generally and employee stock options particularly; and on our experience to date assisting companies in their preparation for the valuation requirements of the proposed Standard. Accordingly, our comments focus on those issues involving valuation and do not respond to all the issues raised by the FASB in the Exposure Draft.

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure fair value. Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model. Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

We agree that observable market prices are the best evidence of fair value and we note that share-based compensation itself and/or other elements of the design, underwriting and distribution of corporate securities may evolve in the future in ways that enable more companies to obtain indications of fair value for employee options from traded securities.

We agree that such market prices are presently unavailable for a large number of companies' employee stock options and that this fact necessitates the use of an option-pricing model.

We believe that the guidance in the Statement is generally helpful and promotes consistency in the selection and application of an option-pricing model. However, we believe the cause of consistency might be promoted further if the Board offered additional guidance on when the

generally preferred model (i.e., a lattice-based model) is actually required. We believe the Board is wise not to require it in all circumstances. The Standard as written does not preclude the adoption of better methods should they become available, and this is appropriate. The Standard as written is somewhat less clear about circumstances in which less-favored models (e.g., simple closed-form models) are permissible (see paragraphs B11-B12).

We observe that even within a lattice-based model, judgments still must be made about, for example, how to treat certain features of a contract, and that this scope for judgment may be viewed by some as detrimental to consistency. For example, a vested option owned by an employee who leaves the company is generally subject to forfeiture after some period of time if not exercised. Some contracts stipulate a short period, say 30-90 days, which is not difficult to model. However, others provide that an employee who meets certain age and/or service criteria has a longer post-termination period, say one year or even five years, to exercise before forfeiture. In-the-money options subject to forfeiture will surely be exercised, but when? The valuer must exercise judgment about how to model this.

We assume the Board is aware that even if it chose to stipulate a model and specific approaches to formulating assumptions, that this need for judgment would remain. We recognize that it admits the possibility of inconsistency. However, we do not believe the degree of likely inconsistency is great enough to be objectionable.

Issue 4(b): Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options? If not, why not?

We agree that fair value can be measured with sufficient reliability using existing models and methods as embodied in current best practice of knowledgeable market participants. Such methods are based, ultimately, on (1) the proposition of "no arbitrage," which is perhaps the most powerful and reliable principle in financial economics; (2) the mapping between the terms of the contract and the features of the model; and (3) objective data that support assumptions and parameter estimates.

We agree that, generally speaking, a lattice model permits greater fidelity between the features of the model and the terms of the typical contract. We further agree that this greater fidelity is important and will result in a material improvement in the estimated fair value as compared to simple closed-form methods. On this basis, and from a valuation perspective, we agree that lattice approaches are to be favored. However, we also agree with the Board's observation that these preferred approaches require more data than simple closed-form models.

Because lattice-based methods are more complex and require both more data and more expertise than does the simple Black-Scholes-Merton formula, the cost to comply with the proposed Standard is higher than the cost to comply with SFAS 123. The proposed Standard also may be costlier to audit than SFAS 123. We assume the Board is aware of these considerations, and has concluded that the additional compliance and auditing costs are not excessive and that the additional reliability of lattice-based methods justifies them.

We believe that whatever the initial compliance and auditing costs turn out to be, they will decline dramatically afterwards. That is, companies and their service providers are already seeking a “scalable” solution to the programming and data requirements of a lattice-based model. Such a solution will offer companies that issue standard options a low cost method of complying, once initial data collection chores have been completed.

We note further that it will always be possible for a company to invent an option contract containing conditions that standard lattice methods do not address well. For this reason we support the Board’s decision to state the principle of fair-value-at-grant-date, and accordingly we expect such options, if they exist, will require augmented valuation methods that may or may not be based on lattices. In our view, such methods should be chosen to comply with the principle of fair value, not because of a rule mandating lattices.

Issue 4(c): If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

We believe the Board should not require a specific method for estimating expected volatility. We regard the Standard’s stipulation that an estimate be “reasonable and supportable” as sufficient and preferable to a recipe. The substantial variety of commonly encountered circumstances, including both business and statistical factors, can lead to one method being preferred over another in a given situation. Therefore, any single recipe the Board might stipulate would undoubtedly lead to demonstrably poor estimates in some fairly ordinary conditions.

We agree that consideration of the factors listed in paragraph B25, in addition to indications from historical volatility, improves the estimate of expected volatility. We believe this improvement will be significant in some cases, but will owe its significance to different factors in different degrees, depending on the case. Hence, the best “recipe” for a reasonable and supportable estimate of expected volatility cannot be stipulated in a vacuum, without consideration of case-specific facts.

Issue 4(d): Do you agree that use of the expected term and the modified grant date method give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option’s fair value? Please provide the basis for your position.

The modified grant date method permits the effects of certain vesting requirements to be incorporated into the calculation of compensation expense outside of the option-pricing model. We agree this is a useful practical expedient and support the Board’s decision to require it.

We find the explication of expected term to be potentially confusing or misleading. In a lattice-based model of the type described in the Standard, “expected term” is not a model input. Paragraphs 19 and B21 acknowledge this, but in our view still leave room for confusion. A lattice-based model includes supported assumptions about employee exercise behavior and the likelihood of post-vesting forfeiture. It does not require an explicit assumption about expected

term. We read the Statement as requiring disclosure of an estimate of expected term, even if it is obtained as an implied output from the model (e.g., per footnote 16, paragraph B20). We agree that such a disclosure is useful. However, in the absence of more clarity, we think it is possible that some companies may seek to support assumptions about exercise behavior by observing that they are consistent with some estimate of expected term. This, of course, is backwards.

We also have found it possible and useful to take a more nuanced approach to characterizing employee exercise behavior than the method suggested in paragraph B20. That paragraph suggests employees might exercise options when the share price reaches, say, 200 percent of the exercise price. Even if this parameter (200%) is supportable as the observed mean of S/X at exercise or settlement ($S/X = \text{share price} / \text{exercise price}$), the description of its application in paragraph B20 implies everyone exercises all at once. Our treatment of this problem rests not on some critical value of S/X, but rather on the observed relationship between the probability of exercise and S/X; that is, the likelihood of exercise rises monotonically with intrinsic value.

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments. Paragraphs C96–C115 explains the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

We regard the principles regarding modifications as appropriate. However the guidance for implementation strikes us as needing further development. The illustrative examples provided in the Appendix tend to be simpler than situations that may be commonly encountered in practice, and proper application of the principles does not seem as clear as simple examples suggest. If we are mistaken, then a more robust set of sample circumstances would show this and be very helpful.

Transition

Issue 13: Do you agree with the transition provisions (i.e., modified prospective method of transition for public companies and would not permit retrospective application) of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

We have no comment on the accounting methods incorporated in the transition provisions referenced above.

However, we have some concern about the nearness of the proposed effective date as it will apply to some companies. We have been assisting our clients as they prepare to comply with the new Standard, in anticipation of its adoption in substantially its proposed form. Based on our experience, we believe that some companies, and possibly their auditors, will need all the

available time between now and the effective date to prepare and accomplish implementation. We believe, therefore, that should the Board decide to make further significant modifications or encounter delays in releasing a final Standard, it should consider whether such modifications or delays require a change in the effective date. There is not much cushion presently.

Nonpublic Entities

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

We observe that the valuation problem facing a small non-public issuer differs from that facing a large public company. First, some data are missing or less readily available: non-public issuers cannot observe a stock price so a share value must be estimated. For the same reason, they cannot estimate expected volatility from their own historical stock prices. Second, some researchers have argued that a portion of the volatility in publicly traded shares is due to the fact that they are publicly traded – i.e., trading itself creates volatility - “noise” - that cannot be explained by news about fundamentals. This makes it more difficult to measure a non-public company's volatility from supposedly comparable public companies' stock prices. Certainly it may not be measured with as much confidence and arguably the estimate is not only noisy but also biased. Third, a (partially) fixed compliance cost is relatively more burdensome to a small company (public or not) than to a large company.

Due to these issues, it is reasonable to expect that imposing the same accounting standard with respect to share-based payments on non-public companies as on public companies will impose a somewhat greater burden and yield a somewhat less reliable estimate of fair value. At the same time, we believe that making exceptions to a clearly stated principle is undesirable in the absence of compelling reasons. We cannot tell whether the Board has assessed this trade-off correctly; we believe the Board is in a better position to do so than we are. However, we agree that the issues facing small non-public companies are real and worthy of consideration. Moreover, we are not troubled by the Board's conclusion, as it appears to proceed from concerns we regard as generally valid.

Issue 14(b): The Board decided to permit nonpublic companies to elect to use either the fair-value-based method or the intrinsic value method of accounting for the share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition. Moreover, the Board decided to extend the effective date of this proposed standard for nonpublic companies. Do you believe the decisions made relating to nonpublic entities are appropriate? If not, why not? Should other modifications of this proposed Statement’s provisions be made for those entities?

Please see our response to Issue 14(a) above. We believe the Board is justified in seeking to mitigate transition costs for non-public companies. We are not able to judge whether it has done so optimally.

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

Our response to Issue 14(a) above described circumstances affecting small non-public companies that may justify exceptional treatment. The scale (relative burden) issue we mentioned applies in theory to all small companies. However, the greater-burden-less-reliability observation we made above is largely mitigated for small companies if they are publicly traded – the cost is less and the benefit larger. Hence, we believe extending the reach of the exception to small public companies is not justified.

Understandability of This Proposed Statement

Issue 18: The Board’s objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

We believe the Standard, taken as a whole, achieves that objective, at least to the extent of other recently issued standards. This is not to say that the Standard could not be improved.

This Standard, more than many, touches issues pertinent to both the accounting and finance disciplines and must speak to practitioners in both fields. Unfortunately, the two disciplines do not always speak the same language. What is worse, they sometimes employ similar terms, but define or deploy them differently. The Board’s drafting job is harder as a result. We believe the understandability of the Standard might improve if the Board freed itself of the need to revise existing Standards and instead simply wrote a new one from “scratch.”