Letter of Comment No: 3277
File Reference: 1102-100

June 9, 2004

director@fasb.org
File Reference No. 1102-100

This letter is in three parts. The first is a general overview of our comments; the second is a point-response to those of the 18 issues raised by FASB; and the third is comprised of additional comments on other issues raised in the Exposure Draft which we believe FASB should re-examine prior to the release of a final set of rules.

PART I – General Comments on the Proposed Regime

The overriding objective for FASB, and its Statements is, and should be, the development of accurate, usable financial statements for the consumers of those statements, whether it be by investors, management or the general public. In achieving this objective, we believe that several factors need to be taken into consideration, specifically:

- ***Actual numbers are better than estimates*** – Since the goal of financial statements is to provide an accurate assessment of a company's performance, actual costs and benefits are to be preferred to estimated ones.

- ***Timeliness*** – Costs should be recognized over a time period that corresponds to the actual life of the vehicle.

- ***Reliability*** – Can the numbers reported be accurately reproduced by others? Is there a common set of assumptions that a reasonably intelligent user can use to derive the same number that has been reported?

- ***Processes should be consistent across organizations*** – In order to facilitate the transparency of financial statements, processes should be applied consistently to similarly-placed companies whenever possible.

- ***Materiality*** – Numbers should be meaningful in terms of their impact on Users of Financial Statements (henceforth "UFSs"). If the number does not ave a meaningful impact on behavior, is the expense of preparing and justifying the number appropriate?

- ***Implementation should not be cumbersome*** – The implementation of accounting principles should not create undue expense for companies, relative to the benefit to the users of financial statements.

- ***Similar results should have similar accounting consequences*** – Form should not be elevated over substance.

We believe that the ED raises significant concerns in many of these areas, which, at a minimum, require clarification of many parts of the ED, and at a maximum may require considerable reworking of parts of the draft.

First, the ED elevates estimates over actual costs. The ED fundamentally pins the value to be assigned to stock options to either closed-end or lattice option pricing models which, although they have proven effective for establishing values for relatively short-term, exchange traded options still do not effectively determine a value for long-term employee options. As shown in last year's case of Microsoft's stock option repurchase, over half of the employees accepted a value *considerably less than the Black-Scholes value* in exchange for their options.

If the Board holds to the determination that *the date of grant* is to be the point of determination, then *prima facie*, the "cost" assigned to the company will not, except through serendipity, generate an actual cost equal to the estimated cost. This remains true even with the "truing up" allowed under the ED. If, for example, options go "underwater" and never return to the money, companies incur a cost that is never either recovered or transferred to the employees. Conversely, it could deliver many multiples of the cost incurred if the stock price soars. In both instances, the value delivered bears no relationship to the cost incurred. The alternative, however, which would be to require all grants to be treated as variable would be even more unpalatable. This would, in effect, play havoc with company's income statements as the market price of the stock shifted.

This same concern applies to elements within the ED – income tax benefits, for example which are *actual* determinable values are artificially capped, creating phantom values, or accelerating recognition of expenses in the modification process, again creating expenses that are never realized.

Second, a question exists as to the appropriate time period for measurement of expense. While the Board has established (as noted) that the date of grant is the appropriate date on which to determine the cost, the amortization of that cost occurs over a vesting period. This is justified based on the assumption that the "period of service" is the appropriate time frame. We would suggest that, similar to the process used for determining depreciation, the more appropriate period would be the estimated life of the instrument

Third, the proposed regime of side-by-side existence of closed-end, binomial and (for non-public entities) fair-value or intrinsic pricing violates the principle of consistent application, and undermines the transparency that the Board seeks to achieve. The result will be obfuscation, not clarification. In a worst case situation, users of financial statements may see two substantially similar companies report dramatically different results for items which are similar in substance. This would happen if Company A chooses to spend the time, money and effort to develop a highly customized lattice model, detailed data-mining to minimize volatility, holding periods (and other values which drive the option pricing model) and convince their auditor of the logic of these determinations, while Company B applies a simple

Black-Scholes model, which result in Company A reporting a 30% lower per-option cost, while in a consistent universe the two companies have the same per-option cost.

By not establishing a consistent set of assumptions, or even a consistent model, the Board is creating a situation whereby financial statements will become more opaque, and will, in fact make it more difficult for investors and others to draw cross-company comparisons than it is today.

Three alternative solutions to this issue exist, each with its own set of follow-on problems:

- Mandate a common technique for setting assumptions on which awards are valued – either closed-end *or* lattice, realizing that selecting a single approach will either entail unnecessary expense (requiring detailed lattice models from all issuers) or less-than-perfect *estimated* costs (using a closed end model).

- Either in conjunction with setting a common technique or in lieu, establish a set of decision rules to determine assumptions. While this goes contrary to the Board's desire to move towards a more principles-based scheme, it would forestall the impending chaotic response of the auditing firms. In preliminary discussions with several of the major accounting firms, we have found not only dissimilar, but diametrically opposed views on the acceptability of certain approaches to setting the *prospective* assumptions called for in the ED. The negative consequence of this rule-setting by the Board however is the fact that the Board has already noted – One size does *not* fit all, and the imperfect past is not an accurate predictor of future performance.

- Do nothing, and accept the fact that the consequences of the ED will be that the expense will be less transparent and create more confusion among shareholders and others than the current system.

The fourth area of concern is one of "means versus ends" or the cost/benefit ratio of the ED. The existing Black-Scholes approach, whether footnote-focused or reported in the income statement (as at least 483 companies have done to date) is already understood, both by companies and the users of financial statements. Although it has been categorized as "simplistic" by some commentators and members of the FASB group which examined valuation issues, it is ultimately no more, or less, representative of the actual costs incurred and value transferred by options than the lattice model. Given the additional time and expense involved with the "preferred" lattice model, in terms of determining assumptions (whether it is the number of nodes or the exercise assumptions that pertain to each node) and then defending these same assumptions to auditors who have been given little, if any, guidance as to the standards to be applied in auditing these programs, the preferred methodology appears to be an exercise in delusive exactitude.

The final area of concern is the question of form over substance. One of the theories advanced in support of the ED is that the objective is to place equity compensation

on a level playing field with other forms of pay, primarily cash (although the ED does also reference other elements, such as pensions). Unfortunately, the ED does not achieve this, and in some instances, the pendulum swings too far in the other direction, making equity a *disadvantaged* form of compensation. Specifically, the key issues in this regard are:

- With all other forms of compensation, if the compensation is not paid, the cost to the company is reversible. This is not the case with vested options, which, though they expire underwater, continue to be a cost to the company.

- With all other forms of compensation, the cost incurred by the company is fixed at the time of payment, not grant.

- With other forms of compensation, there is not a "double hit" to earnings per share – there is a reduction in the numerator (earnings) but no impact on the denominator (number of shares). As a result, in this ratio focused on by many investors, equity fares substantially worse than other forms of compensation.

- Even within the ED, there is a distinction between *near-identical* instruments, the only distinction being that one pays out solely in stock and the other in either cash or stock. This highlights the notion that all forms of compensation *are not* being addressed in a similar manner.

Ultimately, the issue turns on whether the ED qualitatively advances financial reporting over the previous FAS123. Putting aside the question whether options should be reflected in the footnote or the income statement (or pursuant to the old APB 25, at all), the underlying issue we raise with the ED is whether the benefits outweigh the costs. On balance, they do not, because:

1. The multiple valuation methodologies make comparisons more, rather than less difficult;

2. The introduction of the lattice model encourages divergence of statements, rather than convergence due to the multiplicity of models and potential assumptions; and

3. The amortization rules make allocation of costs more opaque;

4. All of the above occur without a demonstrable improvement in the functionality of reports to UFSs such that compliance costs will be significantly elevated without a corresponding benefit.

In conclusion (to this Part I), we believe that the ED, as it is presently structured, requires significant additional work to make it of practical use in the marketplace. It does not create parity among compensation vehicles. It elevates estimated costs over actual costs. It is more opaque than the pre-existing FAS123, and at the cost of more time and effort.

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

Consequently, we would advocate that:

- The current ED be significantly reworked to improve clarity, consistency and elevate substance over form;
- The Board focus on developing *one* acceptable methodology; and
- This methodology consider placing all compensation on a more equal footing.

PART II – FASB-Raised Issues

Note that in this section, the paragraph numbers and letters correspond to the issues that the Board raises in the "notes for recipients" that prefaces the ED.

1. We believe that providing equity to employees in exchange for services is compensation. However, we also believe that the regime presented by FASB potentially misstates the cost of this compensation and double-counts it, from several perspectives:

    a. The first question is where the cost of the equity compensation is borne. A strong argument can be made that the cost is one that is borne not by the company as an entity itself, but rather by the shareholders of the company. In the most simple analogy, if three people among them "own" a pie, and I wish to give the baker a slice of the pie, the pie itself is not diminished, but rather each of the three owners of the pie receive a proportionately smaller share. So too with a corporation – if shares are issued to an employee, there has been no *diminution* in the assets of the company (although there has been a diminution in the assets held by other shareholders and in their potential future appreciation), rather there has been a *reallocation* of those assets, and the potential future return thereon. The shareholder's relative stakes have been diminished, but not the company itself. This is fundamentally different from cash compensation, where there is an immediate reduction in the assets of the company itself when the compensation is paid.

    b. If the expense is recognized based on either a lattice or closed-form model, the dilutive effect of the additional shares which are either outstanding (in the case of restricted stock) or issuable (in the case of stock options) results in counting two "costs" for equity – an earnings charge and a dilution-of-earnings effect. As a result, in some instances (e.g., the grant of restricted stock), the "cost" of using equity is greater than using cash.

    c. The "cost" represented by equity compensation as presented in the ED is an *opportunity cost,* not an actual expense to the company. If

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

the company issues an option to an employee, and the employee later exercises the option, the opportunity cost of that option to the company is the difference between the grant price of the option, and the market price at the time of exercise – the company still receives both the underlying exercise price and (assuming a non-qualified stock option or NQSO) the tax benefit on the spread. If a restricted share is issued, then the opportunity cost is the full value of the share, less the tax benefit. If we are going to require companies to book opportunity costs, we potentially open an endless can of worms – could we have sold our goods at a higher price if we brought them to market sooner, or later? If our suppliers drop their prices after we have locked in a long-term contract, are we obliged to use the lower price they are charging other customers, even though we were locked into the higher price?

2. We do not agree that there is benefit to be gained from moving the "cost" of options or other equity from the footnote to the income statement itself, because the cost is an estimated cost, undeterminable at the time of the grant. The Board notes in the comment in C29 that the treatment should be similar for equity expenses as it is for "warranties, pensions and other post-retirement benefits." The distinction we would draw is that these items, as well as reserves for items such as law suits, represent an estimation of a future cash settlement cost for the company. This settlement cost *does not exist* for equity compensation. Contrawise, the exercise of a stock option generates positive cash flow for the company, as well as a tax deduction (assuming a non-qualified stock option, NQSO). The cost to the company, as noted previously, is an opportunity cost. Given that for most companies, options are, as much as source of financing as they are a cost, we believe that the current footnoting of the artificial "fair value" cost, coupled with the actual dilution, cash flow and income statement impact of the taxes is more effective and accurate.

3. The grant date fair value approach is flawed. To the extent there is an income statement cost to equity, it should be equivalent to the cash cost. Cash costs are accrued, and adjusted until they are paid. This applies to the contingent costs noted in C29, and even in the ED, FASB notes that instruments which, while denominated in equity are paid in cash, are required to be "marked-to-market." Why is there a distinction because an instrument is settled in shares rather than in cash? If the goal is to treat all compensation equally – to create that so-called "level playing field", it must be one where there is complete equivalence between cash and equity – where all costs are variable and accrued to the date of payout. This will guarantee that costs are both correct (there is no need to engage in unproductive estimation under either a closed-end or binomial model) and level between cash and equity. The alternative is to move all cash compensation to a "best estimate" model and eliminate variable accounting for long-term cash incentive programs.

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

4. Turning to the issue of Fair Value Measurement (FVM):

   a. The ED creates more problems than it solves with regard to guidance in applying the various FVMs to equity expensing. If the objective is to provide clear and consistent information to investors and other UFSs the ED is less effective than the pre-existing FAS123. Under the existing FAS123, the vast majority of companies have used the Black-Scholes closed-end model, in relatively standardized formats. The handful of variables, while "simplistic" in the words of one Task Force member, are both known and have understood implications which can be evaluated by UFSs. The ED, through the recommendation of, but not mandating, a lattice model, has created a situation where UFSs, who seek to compare companies "see through a glass darkly" if at all.

      Unless financial statements become extremely more complex (thereby reducing their usability to the average user) to state all the assumptions, choice of models and weightings assigned to each node of a lattice model, it becomes more difficult to make "apples to apples" comparisons across companies, and actually decreases the utility of all pricing models. Given that *no* model will accurately project the *actual* expense a company will incur, the FASB should err on the side of ease of use and transparency rather than seek delusive exactitude.

      Ultimately, the impact of this approach will be the creation of a new class of actuarial/investment advisors who will be required to evolve the same set of standards and procedures that have evolved for pension calculations. Given the existing data that is available under the predecessor FAS123, it would seem that the ED represents a significant increase in compliance expense in exchange for a marginal increase in the accuracy of what is already an estimated number.

   b. While we believe the closed-end models are flawed in terms of projecting the actual value derived from an employee stock option, we believe that the simplicity, ease of use and relative transparency of the closed-end model outweigh the supposed additional accuracy of the lattice approach. In the Board's comments at C22, the valuation of closed-end and lattice models is likened to loan loss reserves, pension costs, etc. Again, the fundamental difference is that while estimates are made for loans and pensions, these are ultimately reconciled at an actual cost. With options, it is serendipitous at best if the binomial or Black-Scholes value assigned to an option equals the compensation that an employee ultimately receives from the option's exercise. That reservation noted, however, we would still suggest that one, simple

standardized approach would serve the financial markets better than a plethora of customized models where it is impossible to compare the costs assigned by two companies without a tutorial on the separate variations on the binomial model. Further, the allowance, even the encouragement of a variety of models with multitudes of assumptions will further complicate the reporting and audit process, increasing the financial burden on all companies.

c. We agree with the Board's decision not to impose uniform volatilities and historic volatilities on companies. While one might question the importance of volatility in measuring an option with a 10-year life (surely over this time, company performance should assume a greater role in the value of options and the underlying stock than the short-term amplification of the "random walk"), it is part of the unique valuation of a granting company. To require uniform volatilities would further remove the valuation of an option from the realm of hard and accurate numbers and create more, not less, opacity in the financial statements.

d. With regard to the unique aspects of employee options, we generally support the Board's view. Employees typically suboptimize their equity plans because they have different investment issues than the pure investor/option speculator. As a result, they are more likely to exercise early (either for cash flow or to achieve investment diversification) rather than hold their options to the full term. In our studies, we have found that in the majority of companies with broad-based equity plans, the average expected life of an employee option with a 10-year term is typically less than half that. Our primary concern is with options that are never exercised. With cash compensation, if the compensation is never paid (e.g., a forfeited bonus, or pension benefits that are not paid because of mortality) those expenses are reversed. An option which vests, and expires unexercised is still charged against earnings. This is yet another instance where equity compensation is treated *more* harshly than cash compensation. A simple fix for this would be to allow a reversal of expense, or a credit in the year of expiration, for equity which had previously been expensed, but is never realized.

5. As noted earlier, if an income statement expense is to be recognized for equity programs, in order to create true equality between cash and equity compensation, all equity should be accounted for in this fair value manner.

6. Although we believe there are public policy arguments for providing separate and favorable treatment for employee stock purchase plans (ESPPs), we agree that ESPPs are compensatory in that they are a consequence of the employee relationship. Given the Board's belief that

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

the sole consideration of FASB policy is the transparency and applicability of accounting principles, the public policy argument must fail before the application of the accounting principle, if one accepts that there should be an opportunity cost assessed for equity compensation. If one believes that only the actual compensation should be a charge, then there should be a slightly different outcome from the Board's approach in only charging the discount at the time of the purchase as a compensation expense, as opposed to the opportunity cost represented by the "option" element.

7. We would prefer to see the cost amortized over the expected life of the instrument, rather than the vesting period. Given that, until a full-value share (restricted stock or performance share) is vested or an option is exercised, it represents only the *potential* of compensation delivery, the expected life is a more accurate period. As a matter of practice, typically options are held for 1-3 years following their vesting, resulting in the expense being accrued in a significantly accelerated manner (especially when combined with the FIN28-like amortization schedule for graded vesting). For most full-value vehicles, the service period and the life instrument are identical, so there would be no difference between the ED and our preferred position. With regard to options, using the expected life of the option rather than the service period would allow more accurate allocation of the expense. If an option were fully vested, but expire unexercised (either for being underwater or an individual being terminated for cause, for example), the employee in fact recognizes no compensation, and therefore, there should be no expense allocated to the company. Again, by comparison with cash, the ED creates situations where the company can recognize a compensation *expense* and the employee realizes no compensation *benefit*. This is a consistent concern with the ED, which unlike the Internal Revenue Code does not require any balancing of income and outflow, cost and benefit.

   Conversely, if the Board is wedded to the service period equaling the vesting period, then we would argue that, since the expected life over which the vehicle is expensed is limited (typically a 4-year vest) that the life of the option likewise be capped at the vesting period, for purposes of accounting consistency.

8. The creation of implicit, explicit, derived and requisite holding periods is evidence of the problem with the decision to amortize over service period rather than the actual life-of-the-instrument. Requiring five pages of regulations to determine what should be a simple observation suggests that there is an underlying problem. The problem is that the ED seeks to accelerate the recognition of expenses (e.g., the requirement to move to a FIN28 recognition model for plans with graded vesting) rather than have the expense occur ratably over the life of the instrument. When allocating depreciation expenses, the cost is amortized over the life of the asset.

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

When accruing pension costs, the cost is allocated based both on the expected life of the beneficiary and the period over which funding can occur. Consistent with these, the cost of an equity instrument should be allocated over the expected life of the instrument *qua* instrument – the vesting period for full value shares and the expected life for options. If the instrument vests (or is exercised) prior to the end of the expected life, any unrecognized expense can be accelerated into the last period, as is the case now, for example, with performance-accelerated equity vehicles. This contrasts with the ED, whereby expenses can be accelerated to times prior to the award being converted into outright owned equity, and, due to vagaries of the market (e.g., underwater options) never be realized as compensation by the employee.

9. We believe that the requirement of treating graded vesting awards as separate awards requires further study, from several perspectives. It is highly likely that this is the appropriate approach given employee behavior, but we are not sure there is normative data to support this. Given the desire of the Board to reflect costs as accurately as possible, we believe that some additional research on actual option exercise patterns is appropriate. There is a sense that employee exercise patterns are more reflective of the "time from vesting" rather than the "time from grant" or "time until expiration." If this is in fact the case, then the adoption of the FIN28 standard is the most accurate and should be adopted (albeit over the appropriate lifespan). If, however, research shows that employees tend to hold for a period certain from grant or expiration, then we would suggest that this approach creates a layer of needless complexity, especially for those companies in the technology sector where many companies have granted options with monthly vesting over a four-year period. This effectively creates 48 separate grants where one existed before, and despite the wonders of modern software, the administrative burden is increased significantly for what might, in practice, be an inaccurate reflection of actual employee behavior. In addition, each of these 48 separate tranches may need separate assumptions for the lattice or closed-form valuations, thereby adding yet another layer of complexity to the calculation, and further obfuscating the results.

10. While we understand the Board's public policy desires to minimize the modification of pre-existing equity vehicles (witness prior FASB statements on the treatment of cancellation and reissuance of stock options), we believe this section represents an inconsistency in the Board's position, and would suggest, that just as public policy considerations do not determine the treatment of ESPPs, they should likewise not intrude here. Underlying the Board's approach to assessing a cost for equity compensation is the theory that the cost is determined at the time the award occurs. Looking at modification events, one can make one of two things happens:

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

a. The modification has increased the cost of the instrument over *the initial value* of the instrument. In this case, the incremental value should be expensed, over the appropriate period.

b. The modification has not increased the cost of the instrument over the initial value of the instrument. If the determinate date is the date at which the instrument was granted, then as long as that value is not exceeded, any modification should not be deemed material.

This approach provides a simple, principle-based result, reflecting the initial cost of the vehicle, which the Board has established as the measurement date.

Alternatively, if the Board takes the position that the modification is, in fact, the cancellation of the old instrument and the creation of a new instrument, then the principle-based handling of the transaction would be:

a. Cease all accruals of the old vehicle.

b. To the extent that it has not vested (pursuant to the Board's period of service approach) or accrued (pursuant to a preferable life-of-the-instrument approach) any excess should be reversed. Again – no compensation is being realized by a recipient, why should a cost be assessed to the company, a result that would not obtain with cash compensation.

c. Any new instrument is just that, a new instrument. Therefore, its cost would be accrued *de novo,* based on the "fair value" (regardless of methodology) of the new instrument.

Ultimately, under this approach, the company is required to recognize the expense the associated with the ultimate vehicle delivered.

Under either of these approaches, the cost to the company will reflect the "at grant" values. Under the current proposed approach, the actual cost realized by the company will exceed the cost of a similarly-structured cash-based compensation plan.

The existing ED methodology is a nod in the direction of public policy rather than principle-based consistency. If the Board is going to base its statements on public policy considerations, then strong arguments would exist for providing exceptions for ESPPs or treating the equity of the senior executives differently from that of the rank & file. The Board has resisted this in these instances, it should likewise resist it in this instance as well.

11. We do not raise any issues with regard to the proposed tax effects.

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

12. We would raise one concern with regard to the requested disclosures noted in B191-193. The proposed cash flow effects may in fact be difficult, if not impossible, to quantify. A company could, with sufficient record-keeping, monitor those instances where options or other shares are settled for cash as opposed to shares being delivered. However, there are numerous instances where there is either a question of the directness of linkage between the stock-based compensation and cash flow (e.g., if restricted shares are retained by the company rather than the employee being required to write a check to the company, does this constitute a "cash flow" event for the company? If a company, without a formal plan, occasionally repurchases shares in the market, loosely based on the number of option exercises occurring, does this constitute a "cash flow" effect?). Given the level of scrutiny of financial statements and the Sarbanes-Oxley requirements for signing off on financials, this could constitute an undue burden on companies and their officers.

13. We support the Board's decision to require one method of adopting the new rules. To the extent that the new rules are intended to provide a level playing field, the use of multiple transition strategies would only serve to cloud comparison of financial statements for up to four years following adoption (given that some equity-based plans have as much as a five year vesting period).

14. We do not raise any issues on the private company methodology

15. We have no position on the applicability to small business issuers.

16. As noted in our answer to Question 12, we believe that, to the extent the tax benefit is actually realized, it is a reduction in taxes paid, regardless of the recognition of the estimated expense of the option. Tax reductions are actual, realized numbers. Characterizing these as "financing" as opposed to "tax reduction" is a misstatement of the actual impact.

17. Our preferences are for the treatment outlined in this materials. In those instances where there are other variations between the Board and IFRS2, we prefer the Board's position to those expressed in IFRS2.

18. We believe that the Board's objective, as narrowly defined, is being met. The ED, as presented is understandable by those with some financial sophistication, however, we believe that the broader objective, that of providing transparent, accurate statements which can be compared across companies and industries, is not being served. Ultimately, we believe that there are several salient issues which the exposure draft either fails to address or alternatively provides less satisfactory answers than the pre-existing FAS123. Specifically, we would divide these issues into the following categories:

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800

a. "Common yardstick" – The fact that there is no requisite model or set of rules for selecting assumptions ensures that the "value" assigned to stock options by one company will bear no relationship to the "value" assigned by another. Company "A" and Company "B" are in similar businesses, and their shares generally have a strong correlation in their trading. Company "A" chooses to apply a "simple" Black-Scholes model modifying its actual historic volatility to eliminate a two-month period of "excessive" volatility due to a business combination. Company "B" applies a binomial model with node assumptions linked to employee exercise histories, adjusted for a two-years period when all options were underwater. After this exercise, Company "A's" reported option value is 50% higher than Company "B's". Does this in fact mean that Company "A's" options are indeed worth 50% more, or does this simply mean that Company "B" invested more time and effort in reporting a lower charge to their earnings? We would suggest that the Board choose one methodology (the simpler the better) and apply it uniformly.

b. Actual versus Theoretical Costs – The nature of financial statements should prefer actual costs over contingent or theoretical costs. At several points in the ED, the Board errs in preferring to assess theoretical costs, rather than actual costs. Specifically:

   i. To the extent tax benefits exceed the cost accrued, these tax benefits are accurate, actual benefits. The ED would require bifurcated recognition of these actual benefits, subordinating them to the theoretical cost of the equity compensation.

   ii. The underlying choice of recognition expense – closed-end or lattice model – is, by its nature a theoretical value. Private companies, on the other hand, recognize a more accurate expense.

   iii. The treatment of modifications – by requiring the recognition of expenses which will never, in fact, occur, the ED requires the recognition of theoretical expenses (i.e., the cost of a grant if it were in fact allowed to continue to vesting) over the actual expense (i.e., zero, because the vehicle is cancelled prior to its vesting).

Part III – Additional Issues and Commentary

1. In Paragraph B4, the Board embraces the notion of *current exchange* as the cornerstone of the ED. The concern this raises from a compensation accounting perspective is that this is fundamentally different from the approach applied to other elements of compensation. Salaries, bonuses, pensions and other elements of pay are estimated *then adjusted* for

purposes of ultimately equating the cost to the company with the benefit received by the employee. The current exchange model is more akin to a capital transaction. If, in fact, this is a capital transaction rather than compensation, then it should be reflected in the capitalization of the company, not the income statement.

2. In Paragraph B5-6, there is the assumption that for public companies, there are observable market values which can translate to accurate values for employee equity plans. For some plans, such as ESPPs where the purchase periods are relatively short (typically six months) there are market analogies, such as publicly-traded options. However, when we turn to the most common vehicle – employee stock options – this analogy quickly breaks down.

3. In Paragraphs B13 – 29, there is insufficient guidance for the practitioner. First, as a practical matter, there is almost never an "observable market price" as called for in B13. Consequently, everything will default back to the choice of assumptions. We have found, for example, in dealing with auditors over "fair value" issues involved in option cancellation and regrants (6+1 programs pursuant to FIN44), that there is little, if any, common practice among the firms with regard to acceptable means of establishing valuation assumptions. As a result, without providing significantly greater guidance for selecting valuation models, the Board may, in fact, encourage "forum shopping" for the most favorable view of the assumptions to be set.

4. In Paragraphs B31 – B36, the biggest question is why does the Board allow reversals of charges for Performance and Service conditions, but not for Market conditions? This is a clear example of form over substance. If the objective is to provide statements that most accurately reflect the cost of the equity, why, in the case of market-based conditions, do we not allow a company to reverse charges which, based on market conditions, will not be incurred. This appears inconsistent with both the treatment of other performance-based conditions and the underlying philosophy of the ED.

Our other concerns have been expressed in Parts I and II of this letter.

Sincerely

Theodore R Buyniski
Principal
Mellon Human Resources & Investor Solutions

Two Willow Street
Suite 202
Southborough, MA 01745
(508) 460-3800