

June 29, 2004

Director of Major Projects  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1102-100; Proposed Exposure Draft – Share Based Payments

Dear Sir or Madam:

This letter is in response to the Financial Accounting Standards Board's ("FASB" or "Board") invitation to comment on the Board's proposed Statement of Financial Accounting Standards ("SFAS") for share-based payments (the "Statement"). We appreciate the opportunity to comment on the exposure draft.

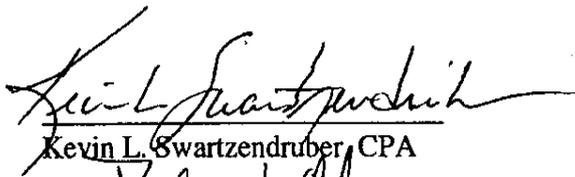
We understand and appreciate the Board's desire and effort to reform corporate accounting in the wake of the scandals over the last few years and we support the Board's efforts to make financial statements more useful for investors and creditors concurrent with improving the quality of accounting standards. We wholly support any approach which enhances the transparency of financial statements and ensures the integrity of earnings. Nevertheless, we want to emphasize that we are opposed to the mandatory expensing of options for the following reasons:

- Although we acknowledge there are compelling arguments that there is a compensatory element to an employee stock option, it is not reasonably estimable upon grant.
- There is no systematic and rational means for valuing options issued to employees because there is no open market for options with the associated intricacies.
- The use of the prescribed valuation models, specifically the lattice model, gives rise to numerous subjective assumptions that can only obscure the comparability of financial statements across registrants.
- The proposed Statement would significantly increase the subjectivity, complexity and cost of financial reporting for which there is no clear additional benefit derived for users of the financial information. Ultimately, the proposed statement will not promote an enhanced understanding of an entity's financial performance and will likely create less comparability between, and greater complexity among, financial statements.
- The granting of an employee stock option does not impact the ongoing operating cash flows of an entity and does not hinder the entity's ability to fund its working capital obligations, make capital expenditures and service its debt. Accordingly, we believe the economic impact, if any, may only be to the detriment of the shareholder and already reflected in diluted earnings per share.

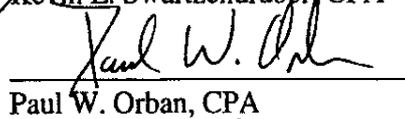
Each of these points is discussed at length in the attached responses to the specific issues raised by the Board for comment.

In closing, we believe that rather than providing investors with meaningful information, expensing will have the opposite result and the enactment of the proposed Statement may result in a significant step backwards with respect to fair and objective financial reporting. An alternative to the Statement may be to enhance the disclosure only provisions under the current accounting standards to align with the disclosure provisions for the proposed Statement which would provide the users of financial statements with sufficient information to derive their own assumptions about whether the grant of an employee option gives rise to an expense, and if so, the amount of that expense. We are therefore respectfully asking that the Board reconsider its position, continue the intrinsic model of accounting under APB 25, and retain or expand the disclosure only provisions under SFAS 123.

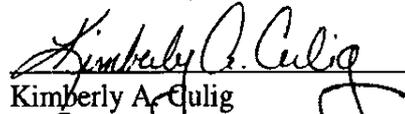
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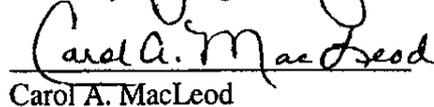
Kevin L. Swartzendruber, CPA



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## **Response to the Issues Identified under the Board's Invitation to Comment**

### **Recognition of Compensation Cost**

*Issue 1:* The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

**Response:** We acknowledge there are compelling arguments that there is a compensatory element to an employee stock option and would agree with the Board's conclusion that if such cost is reasonably estimable, the amount would logically be recognized in the financial statements. However, we do not agree with Board's conclusion that the fair value of an option granted to an employee is measurable. This is due to the features of employee stock options that distinguish these instruments from options that are freely tradable on the open market, and the inherent limitations in using market-based models to value the instruments.

The characteristics of employee options vary significantly from market-traded options. Specifically, employee options;

- cannot be transferred or freely traded on an open market thereby making the employee the only market for the equity instruments,
- are subject to varying degrees of vesting,
- generally have terms that are significantly longer than options traded on an open market,
- are subject to tax categorizations (e.g., incentive or non-qualified), and
- upon exercise, are subject to various levels of other restrictions, including but not limited to, blackout periods.

The above characteristics give rise to significant differences between employee exercise behaviors as compared to exercises of options that are freely tradable. The Board must have observed in its deliberations that most employees will exercise their options with several years remaining prior to expiration of the option primarily for personal financial needs and/or commencement of the holding period for the more favorable capital gains tax rate. Furthermore, employees often exercise options in excess of the aforementioned requirements to cover withholding taxes incurred from exercise. On the other hand, option theory would argue that, in the absence of dividends, a prudent investor would only exercise an option at the end of the option's life because at any time prior to expiration, the option has a value greater in total than could be obtained through exercise. As there is no open market for an employee to realize the full value of the option received (e.g., both the time and intrinsic value elements), the issuer should not be required to recognize an expense for the time value component that is not a fully realizable benefit. Accordingly, the intrinsic value model prescribed under APB 25 continues to be the appropriate accounting treatment.

The above limitations of employee stock options clearly demonstrate the very different valuation metrics inherent with employee stock options. Accordingly, any model mandated by the Board to measure a compensation cost that will be recognized in the financial statements must incorporate these assumptions. We would respectfully submit that to date there is no market-based model that incorporates the above limitations and allows for the pricing of employee options with any reasonable level of accuracy. There are numerous shortcomings associated with both closed form and lattice models, as these models are constrained to market-based assumptions that are based upon shorter term, unrestricted and freely tradable options, and accordingly are not designed to build in assumptions around transferability, vesting, lengthy terms, post exercise restrictions and ultimately, employee exercise behavior. Furthermore, the market assumptions employed in the model, most notably volatility, must be made over such a long period of time that these assumptions cannot be reasonably estimated with any degree of accuracy. Ultimately, forcing companies to adopt these approaches will result in a much higher level of subjectivity, a lower level of comparability in financial reporting, and increase the confusion to users of financial statements which would seem in stark contrast to what is being demanded of companies today.

The granting of an employee stock option does not impact the ongoing operating cash flows of an entity and does not hinder the entity's ability to fund its working capital obligations, make capital expenditures and service its debt. The only potential economic impact of any employee stock ownership plan, if any, may be to the detriment of the shareholder and is already appropriately accounted for under the current rules regarding shareholder dilution. Fully diluted earnings per share correctly assumes an economic sacrifice only when the employee option is in-the-money and correctly excludes any implied cost for those options that are out-of-the-money. Further, shareholders may vote to approve stock option plans, and accordingly, can decide whether to retain and inspire employees to increase productivity via share ownership to improve share values. This conscious decision on behalf of the shareholder comes with an economic cost to the shareholder only that is already inherent in dilution. The cost/value relationship in this scenario is not incorporated into the proposed rules, and accordingly, to record a charge to earnings in addition to dilution can be construed as double counting the economic impact for those employee options granted.

*Issue 2:* Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro-forma net income and related pro-forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro-forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

**Response:** In paragraph C29, the Board "noted that if disclosure and recognition were equal alternatives, the arguments for only disclosing the amount of

compensation cost from share-based compensation arrangements with employees would apply equally to other costs incurred during a period, such as warranties, pensions, and other postretirement benefits.” We believe that the Board’s consideration in the above comment is not analogous to the argument for pro-forma disclosures related to employee stock options as the referenced expenses do not incorporate the number of both ambiguous and subjective assumptions that are specific to the entity (i.e., not market-based or generally applicable to all entities) used to derive the fair value for employee stock options.

We believe that footnote disclosure is an adequate alternative to the recognition of an obtuse compensation cost in the financial statements that is ascribed by a fair value model not designed to value employee stock options, and is readily accessible to the user with a reasonable level of knowledge to understand financial statements. Further, footnote disclosures that describe how fully diluted weighted shares outstanding are calculated and the remaining number of options outstanding is sufficient to inform investors of future potential dilution. Considerable debate still exists as to whether employee stock options represent an expense and there remains a plethora of issues surrounding valuation. Accordingly, the current widely used practice for disclosure of pro-forma expense continues to be the logical alternative. As discussed more fully in *Issue 12* below, we agree with the Board’s proposal to enhance footnote disclosure and include additional information about the employee stock option plan(s), and entity’s estimates used to derive a pro-forma fair value. Those who believe that the purported expense is a meaningful number would have this information to evaluate the impact on the entity’s financial performance. Likewise, those investors who believe that the grant of employee options is meaningless from the standpoint of a charge to financial performance can continue to simply ignore it.

We acknowledge the SEC generally disfavors pro-forma financial disclosures; however, we believe that Board sanctioned pro-forma financial information would continue to acknowledge the considerable valuation problems that exist in this area.

### **Measurement Attribute and Measurement Date**

*Issue 3:* This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

**Response:** We agree that fair value is the relevant measurement attribute when fair value is estimable however, and as discussed in our responses to *Issue 1* and *Issue 4(b)*, we do not believe that there currently exists a systematic and rational methodology for fair valuing employee stock options. Accordingly, in the absence of a reliable estimate, the most precise and obvious alternative measurement attribute

and measurement date is the intrinsic value measured as of the exercise date (which, not by accident, represents the opportunity cost to the entity).

To the extent that the Board ultimately concludes that the fair value of employee share options can be reliably measured, we would submit the vesting date as an alternative measurement date for your consideration. There is authoritative literature, specifically EITF 00-8, which supports the measurement of equity instruments issued for services as of the earlier of the date the parties come to a mutual understanding of the terms and a performance commitment is reached, or the date at which the grantee's performance necessary to earn the equity instruments is complete. The guidance further states that performance by the grantee must be probable in order to meet the criteria of a performance commitment, and that forfeiture of the equity instruments as the sole remedy is not considered a sufficiently large disincentive for which measurement is warranted. Accordingly, the measurement date is the date on which the employee services have been rendered in sufficient fashion to earn the equity award (e.g., the vesting date).

### **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 the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). 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. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). 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?

**Response:** As we discuss in more detail under our responses to *Issue 1* and *Issue 4(b)*, market-based valuation models in use today are severely flawed with respect to valuing employee stock options, and accordingly, the Board cannot offer any level of guidance that would ensure the fair value measurement objective is applied with any level of reasonable consistency. The underlying principal for recognition of a liability under SFAS 5, and we acknowledge that it is an analogy for the instant case, is that it must be both probable that a liability has been incurred and reliably estimable. The volatility assumption alone implies that a future stock price may

either increase or decrease with an almost equal probability based upon a lognormal curve. When coupled with the possibility that an employee stock option may be either forfeited or expire worthless, it is questionable whether the probability criteria has been met. The current closed form and lattice models are highly subjective with respect to the assumptions employed, ambiguous, prone to manipulation and error and extremely complicated to implement. It is therefore not at all conclusive that a reliable estimate can be made. Accordingly, the basic tenant for recognition of a liability under the guidance of SFAS 5 has not been achieved.

Ultimately, forcing companies to adopt these approaches will result in a much higher level of subjectivity, a lower level of comparability in financial reporting and increased confusion to users of financial statements which would seem in stark contrast to what is being demanded of public companies today. Furthermore, the costs associated with developing and maintaining the requisite assumptions will far outweigh the benefits derived from the proposal.

*Issue 4(b):* Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. 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?

**Response:** We believe that consistency within the accounting framework requires the mandate of an appropriate measurement for all costs and expenses. There is no reasonable debate that counters the fact that market-based models currently available today are inaccurate in valuing employee stock options. Market-based models such as the Black Scholes and lattice models assume the options are freely tradable and transferable on open markets, with relatively short terms and no restrictions. Accordingly, option theory would argue that, in the absence of dividends, a prudent investor would only exercise an option at the end of the option’s life. At any time prior to expiration, the option has a value greater in total than could be obtained through exercise, and the market-based option models contemplated above reach this same conclusion for freely traded options. The Board must have observed in its deliberations that most employees will exercise their options with several years remaining in the option term, thereby clearly demonstrating there are very different

valuation metrics inherent with employee stock options. We are not aware of any analysis that can reasonably estimate this impact and consistently model how employees value a contract with the requisite restrictions.

We believe that the proposed valuation methods will produce inaccurate, inconsistent, and unreliable results that will distort, and not improve the transparency and comparability of financial information. We want to remind the Board that according to paragraph B5, the Board requires that fair value is estimated using a technique that “reflects any and all substantive characteristics of the instrument.” As discussed above, neither lattice models nor Black-Scholes models can reflect “any and all substantive characteristics” of an employee option. At the end of the day, valuations derived from such models with respect to employee stock options are hypothetical at best, and should not be imposed on the financial statements.

To the extent that the Board ultimately concludes that the fair value of employee share options can be reliably measured, we agree that the lattice model is preferable as it offers greater flexibility than the Black-Scholes model. We are requesting however, that the Board keep an open mind with respect to additional flexibility in the Statement by permitting the use of new and more refined models, if and when developed, when more accurate estimates of fair value can be achieved.

*Issue 4(c):* Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

**Response:** We do not believe that the Board should require a specific method of estimating expected volatility, and any assumptions used should directly correlate to the entity’s specific facts and circumstances. We are however, highly concerned that assumptions of volatility are extrapolated over the life of the option, and by default, the proposed literature implies that companies make predictions of up to 10 years into the future. The Board cannot realistically expect for any entity to predict stock price variability over such a lengthy period of time with any degree of accuracy considering the systematic and non-systematic variables outside of an entity’s control. We respectfully ask that the Board further bear in mind when considering

the total argument for or against the mandatory expensing of employee stock options, that volatility is often the single most important assumption impacting valuation.

*Issue 4(d):* This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the non-transferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods 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.

**Response:** We acknowledge that adjusting the life of the option from the contractual term to the expected term may account, in part, for the fact that employee stock options are required to vest, but we remain unconvinced that it is an appropriate substitute when using a market-based model to value non-marketable options. We wish to further point out that any valuation for employee options should never contain an assumption whereby the expected term of the option would extend beyond the vesting date. As of the vesting date, the exchange transaction is complete (as acknowledged by the Board in your discussion under paragraph C20) as the employee has met all performance obligations. Any benefit or risk assumed subsequent to that time is entirely the employee's and accordingly, to the extent that the Board ultimately concludes that the fair value of employee stock options can be reliably estimated, the entity should not bear the "cost" for the time component in the fair value calculation subsequent to the vesting date.

The proposed adjustments do not address the other restrictions that exist for employee stock options, such as the fact that an option cannot be transferred, hedged, pledged or sold, in the assumptions used in ascribing a fair value. At the time of grant, these options have a significantly reduced value, if at all, because they are not transferable, are not exercisable for a significant period of time, and they are subject to numerous contingencies. Accordingly, their future value is speculative at best. Clearly, by not discounting for these restrictions in valuing the employee option, the fair value ascribed is overstated which would appear to violate the Board's overriding fair value directive.

Further, and with respect to options that expire out-of-the-money, the employee has never received a benefit and likewise, the entity has not incurred any expense however, unless accurately estimated in the fair valuation on the grant date (which can be up to 10 years in advance of exercise and/or expiration), the financial statements will not reflect the true economics. The proposal's failure to permit the reversal of the charge for an option that expires unexercised significantly misrepresents attributed cost. The assignment of value before any of the economic

realities is known, (i.e., before the option is exercised) will cause further distortion and confusion to an already complex accounting standard.

*Issue 5:* In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

**Response:** We do not agree that variable accounting under APB 25 is an appropriate alternative as the methodology essentially integrates the stock price with the income statement. There will inevitably be instances where the revaluation will result in significant credits to the income statement to true-up for previously overstated expenses, and this will be extraordinarily difficult to explain to shareholders and the users of the financial statements. Again, in accordance with sound accounting theory, when the liability and related expense cannot be reasonably estimated at the date of grant, the expense, if any, should be recorded when known (i.e., the exercise date).

#### **Attribution of Compensation Cost**

*Issue 8:* Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

**Response:** We believe that the guidance related to Share-based Payment Arrangement with Market Conditions is not clear. Specifically, according to paragraph B38, "Derived service periods are implied by, or can be derived from, certain valuation techniques used to estimate fair value... That derived service period represents the duration of the most frequent path of a path-dependent option-pricing model on which the market condition is satisfied." Further, per paragraph B48, "A market condition may be satisfied on some paths of the lattice and not be satisfied on other paths of the lattice. On the paths of the lattice on which the market condition is satisfied, that satisfaction will occur at different times during the contractual term of the award. For purposes of this Statement, the derived service period is equal to the mode of the distribution of outcomes in which the market condition is satisfied..." The example in the proposed Statement makes an assumption for the service period, but does not provide any guidance on how the assumption was derived. We cannot interpret the appropriate application of this paragraph's requirement. Furthermore, it would appear that highly subjective and potentially manipulation prone assumptions would be required in applying the provisions of this section.

We acknowledge that the following commentary is not necessarily in response to the Board's specific request for comment on this subject however, we believe it is important to point out that overall the Statement does not provide sufficient guidance in providing a "bright line" that distinguishes between a performance condition and a market condition. Furthermore, when the performance criteria is not reasonably estimable, or cannot be estimated altogether, the Statement does not provide any guidance or examples to assist the reader in determining the appropriate accounting treatment, which we would assume is that fair value is not measurable until that time the achievement of the performance criteria is met or is reasonably estimable.

According to *Issue 18*, the Board's objective is to issue financial accounting standards that can be read and understood by those possessing, among other things, a reasonable level of accounting knowledge, and understanding of the business and economic activities covered by the accounting standard. We would respectfully submit that the above guidance does not achieve that objective.

*Issue 9:* For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

**Response:** We agree that the grant date fair value, when reasonably estimable, for an equity based arrangement with cliff vesting will differ from an arrangement with graded vesting. However, we believe that the pattern of requisite service for either vesting arrangement is the same from the perspective of both the company and employee. To clarify, the proposed accounting requires that a considerable share of the total compensation cost (greater than 50% in certain scenarios) would be recognized during the first year of the arrangement, and diminishing amounts thereafter. We would argue that neither the company nor the employee believes that the intent of the equity-based arrangement was for the employee to provide this level of the requisite service over the first year. Accordingly, we believe the attribution period should be the same under either arrangement.

Furthermore, when considering costs and effort against benefits, requiring the issuer to make the inordinate number of assumptions required to separately value and account for numerous tranches results in extraordinary costs and time to the entity with what would seem to be very little incremental benefit to the user of the financial statements. For example, a single employee option grant with a 5 year vesting period that vests 20% over the first year and monthly thereafter results in making 49 separate assumptions and the tracking of what amounts to be 49 separate grants. Further, it dramatically increases the number of highly subjective, ambiguous and manipulation prone assumptions input into the valuation model.

Conceptually, for an entity that issues a relatively level number of at-the-money employee options each year, the proposed methodology should not result in incremental aggregate share-based expense year over year of which justifies the incremental underlying costs involved to implement this proposal. Accordingly, and to the extent the Board ultimately concludes that the fair value of employee stock options can be reliably measured, we believe that the fair value cost of the option should be spread evenly over the employee's requisite vesting period.

## **Income Taxes**

*Issue 11:* This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

**Response:** The Board acknowledges in paragraph A41 that "tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements". In fact, since binomial lattice models assign probabilities to multiple future stock prices, it is unlikely that the U.S. tax deduction (based on the intrinsic value at the date of exercise) will ever equal the book compensation expense. It could even be argued that the book compensation amount may not be a reasonable estimate for the future tax deductions related to the options. While we understand the proposed tax accounting model that would take tax effects of tax deductions in excess of book compensation expense to equity and tax effects of book compensation expense in excess of tax deductions to the income statement, we believe that this tax accounting promotes an inherent volatility in the income statement. To tax effect the book compensation amount, which is certain of not equaling the future tax deduction, arguably will produce tax amounts which are misleading.

We believe that the intrinsic value tax accounting methodology reflected in IFRS 2 generates far less volatility in the income statement. In the United States, the future tax deduction will generally be based on the intrinsic value of options at exercise so recording tax benefits as the intrinsic value of the option develops is believed to produce more reliably accurate tax accounting results. The downside of the IFRS 2 intrinsic value approach to the tax accounting for share-based payments is that the tax benefits related to the book compensation are recognized more slowly than if the book compensation were used as an estimate of the future tax deduction. However, given that the book compensation is a poor predictor of the future tax deduction, the slower recognition of tax benefits is an acceptable trade off to the higher volatility produced by the Board's proposed tax accounting. In addition, IFRS 2 requires the tax effect of tax deductions in excess of book compensation to be recorded in equity similar to the Board's proposal. What IFRS 2 does insure is that tax benefits

recorded up front related to book compensation will not have to be reversed in a subsequent period when it is determined that the book compensation exceeded the tax deduction. An additional advantage of utilizing tax accounting comparable to that in IFRS 2 is that the convergence would be achieved between the U.S. and international standards.

## **Disclosures**

*Issue 12:* Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

**Response:** We agree that an entity must disclose all information that enables users of the financial statements to understand the nature and general terms of employee share-based arrangements and the corresponding impact on shareholders, the effect of a *pro-forma* compensation cost arising from share-based employee arrangements had such *pro-forma* cost been recognized in the income statement, the method for estimating the *pro-forma* fair value and the cash flow effects resulting from such arrangements. The disclosure objectives sought by the Board can be effectively met by the disclosure of pro-forma values and expenses complete with the enhanced information proposed under paragraph B191. The disclosure is readily accessible to the user with a reasonable level of knowledge to understand the financial statements.

We believe that the disclosure requirements as outlined in paragraph B191(f) particularly provide the user of the financial information with the requisite data necessary to derive their own assumptions for fair value. Those who believe that the purported expense is a meaningful number would have this information to evaluate the impact on the entity's financial performance. Likewise, those investors who believe that the grant of employee options is meaningless from the standpoint of a charge to financial performance can continue to simply ignore it.

## **Transition**

*Issue 13:* This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions 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?

**Response:** To the extent that the Board ultimately concludes that the fair value of an employee share option is reliably measured, we agree with the Board's conclusion that retrospective application of the proposed Statement is impracticable. However, a modified prospective method will clearly result in comparability issues related to previously deferred compensation cost attributable to awards issued prior to the effective date for the proposed Statement. Whether the pro-forma value for these grants were calculated using a closed form or lattice model, we expect that there will be significant variability based upon changes in assumptions, most notably for employee's expected early exercise and post-vesting employment behavior, and for recognizing compensation costs with graded vesting schedules as in-substance separate awards. Accordingly, we believe that the full prospective methodology provides the most rational transition to the requirements of the proposed Statement.

We further believe that the transition period is too short. According to paragraph C157, the Board "concluded that a relatively early effective date would be feasible for public entities because those entities already have been either recognizing, or disclosing the pro-forma effects...[and] even though the fair-value-based method in this Statement differs...from the one in Statement 123, those differences are not sufficient to warrant an extended transition period." We disagree with the Board's assessment of the ease for public entities to transition into the requirements under the proposed Statement. We respectfully remind the Board that there will be significant time and costs involved in, among other things; evaluating whether a closed form or lattice model is appropriate for most reliably estimating the fair value for the entity's employee stock option grants; transitioning between models when required (we believe that most, if not all entities will transition from the Black Scholes model to a binomial model requiring changes in, or modifications to the mostly standard software programs used for fair valuing and tracking employee grants); fair valuing and accounting for employee grants with graded vesting as separate awards; and for deriving the additional assumptions that will be required under the proposed Statement, most notably an employee's expected early exercise and post-vesting employment behavior.

## **Differences between This Proposed Statement and IFRS 2**

*Issue 17:* Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

**Response:** As discussed more fully in our response to *Issue 11*, we believe that the intrinsic value tax accounting methodology reflected in IFRS 2 generates far less

volatility in the financial statements, and accordingly, is preferable to the Board's proposal.

### **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?

**Response:** We believe that until there is a systematic and rational means for valuing employee stock options, the Board should not issue the proposed standard. Although the Board has attempted to recognize the differences between employee stock options and freely tradable options, measurement of these equity instruments is generally flawed in rationale or methodology, and there is not sufficient guidance that can be read and understood by those possessing even an advanced level of accounting knowledge to explain how the Board believes the proposed Statement is applicable to real world applications. A prime example is the Board's guidance on estimating the requisite service period of awards with market, performance and service conditions as we discuss in our response to *Issue 8*. The proposed Statement would significantly increase the subjectivity, complexity and cost of both interpretation and financial reporting for which there is no clear additional benefit derived for users of the financial information, will not promote an enhanced understanding of the entity's financial performance, and will likely create less comparability between, and greater complexity among, financial statements.

The intrinsic value model prescribed under APB 25 coupled with the disclosure only provisions of SFAS 123 are the standards that achieve the Board's objective as stated above.