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Letter of Comment No: 2152
File Reference: 1102-100

From: Barlow_James [Barlow_James@Allergan.com]
Sent: Monday, May 03, 2004 5:12 PM
To: Director - FASB
Subject: File Reference No. 1102-100

VIA E-MAIL

May 3, 2004

Director of Major Projects--File Reference No. 1102-100

Financial Accounting Standards Board

of the Financial Accounting Foundation

401 Merritt 7

P.O. Box 5116

Norwalk, Connecticut 06856-5116

Re: Exposure Draft—Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (File Reference No. 1102-100).

Dear Director:

I appreciate the opportunity to respond to the Financial Accounting Standards Board (the "Board") regarding the Exposure Draft, Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (the "Proposed Statement"). I am the Corporate Controller of a publicly traded, specialty pharmaceutical company listed on the New York Stock Exchange. The comments below represent only my personal views related to the above noted Exposure Draft.

I support the Board's efforts to make financial statements more useful for investors and creditors concurrent with improving the quality of accounting standards. Nevertheless, I am concerned that certain aspects of the Proposed Statement will be counterproductive to investors' and creditors' interests and will likely create, in many instances, less comparability and greater complexity among financial statements.

I would like to specifically respond to portions of the following issues:

- Issue 4(a);
- Issue 4(d);
- Issue 7; and
- Issue 11.

Before discussing my responses to the above issues, I would like to establish a background for my comments. Accounting for the exchange of services between an employee and a company requires that services be rendered in exchange for consideration received. I agree with the Board's position in Issue 1 that a company receives employee services in exchange for equity instruments given to the employee and that the fair value of such an exchange

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represents compensation cost.

Paragraph C20 states the following, “For equity instruments awarded to employees, this Statement requires that the estimate of fair value be based on the share price (and other pertinent factors) at the grant date. That estimate is not subsequently adjusted for either increases or decreases in the share price. After an employee share option (or other equity instrument) vests, the employer has benefited from the services received. Both the benefit and the risk of subsequent price changes are the employees. No additional compensation cost is recognized subsequent to vesting because the exchange transaction has been consummated; the requisite service has been rendered by the employee and equity instruments have been issued by the entity—the exchange transaction is complete. The effect is similar to a warrant issued by a company for cash that expires worthless; the company retains the premium received (in this case, services) and an increase in paid-in capital, even though no shares ultimately were issued.”

From the quote above, I would like to focus on the following economic factors:

- 1) After an employee share option vests, the employer has benefited from the services received. In other words, the employee share option only provides value to the employer during the vesting period. In its discussion of Issue 4(d), the Board clearly has agreed that share options that do not ultimately vest should not be recorded as compensation cost.
- 2) Any increase or decrease in the value of the share option after it vests to the employee is simply a market play by the employee and has nothing to do with the value of the share option to the employer. After the vesting date, the employee chooses to play the market with respect to the timing of any potential exercise of the share option.
- 3) If a warrant expires worthless, a company gets to keep the cash and record an increase to paid-in capital. No other transaction is recorded. The corollary to this Proposed Statement with respect to the value of a share option that vests but has no economic value to the employee at the time of vesting is that the employer should record the value of the paid-in capital provided by the employee for services rendered in exchange for a share option without recording any compensation cost because the employer is not required to issue any shares to the employee at the time the share option vested. Any value created after the share option vests is simply a market play by the employee and has no future service benefit to the employer.

Based on the above background information, I will now provide my response to the issues previously noted.

Issues 4(a) and 4(d) – The fair value of equity share options awarded to employees should be estimated using an appropriate valuation technique that takes into consideration various factors, including the expected term of the option. The expected term is determined by adjusting the option’s contractual term for expected early exercise and post-vesting employment termination behaviors by the employees. I disagree with this position by the Board.

The expected term of the option for determining the value to the employer, on whose books the transaction is recorded, should not extend beyond the vesting date. As of the vesting date, the exchange transaction is complete (see discussion above regarding paragraph C20). If the employee were recording the value of the option on his personal financial statement, he or she would incorporate an estimate of the expected term that extends beyond the vesting date by adjusting the option’s contractual term for expected early exercise and post-vesting employment termination behaviors as prescribed in this Proposed Statement.

Issue 7 – I agree with the Board’s position that compensation cost be recognized in the employer’s financial statements over the employee’s requisite service period, which is generally defined in paragraph B37 as the vesting period, when only a service condition is presumed. I believe that the great majority of share options at public companies only have a service condition prescribed. Again, this is consistent with the Board’s reasoning in paragraph C20 that the exchange transaction is complete at the vesting date.

Issue 11 - In paragraphs C128 through C131, the Board concluded that any tax effect previously recognized in a company’s financial statements related to the estimated value of a share option on the date of grant that does not ultimately become realized should be reversed through the income statement. I agree with that concept. However,

consistent with the discussion surrounding paragraph C20 above, the value of employee services rendered to a company ends on the date a share option vests. At the time of vesting, a company should then review the associated tax effect, and make a determination of whether or not an adjustment should be made to the original estimated value of the tax effect previously recognized through the income statement based on the "in-the-money" value of the share option to the employee at the vesting date. Any subsequent change in the tax effect ultimately realized after the vesting date (as well as any excess tax benefit at the vesting date) should then represent a capital transaction because any subsequent movements in share price simply represent a market play by the employee and should have no effect on the value of the underlying service transaction recorded by the employer through the vesting date.

Also, I find it very difficult to conceptually explain to accounting students that one must adjust a tax deficiency to potentially zero if no value is ultimately realized upon an employee exercising a share option without also adjusting the original fair value of the underlying share option upon which the deferred tax benefit was originally based. There appears to be a theoretical disconnect between the economics of the whole transaction. If a company is ultimately not required to issue any shares or shares with a realized value less than the original fair value estimated on the grant date, why would the company not record an adjustment to the original estimated compensation cost as well as the related estimated tax benefit? If the tax benefits are subject to "remeasurement," why are the share options, in the case of a realized value less than the amount originally estimated, not also remeasured? The economic relationship between a subsequent decrease in realized value as it relates to the estimated tax effect and the estimated original fair value of share options needs to be harmonized by the Board.

The problem with the comparison to a warrant in paragraph C20 is that the employer gets something (services) for ultimately nothing (no shares issued). In the case of the warrant, the company received cash (a benefit that can be used by the company) in the form of a capital contribution. No cash changes hands in the share option example, so where would the debit be posted? If one says compensation cost, how is a "cost" considered to be a "benefit" to the employer when nothing was ultimately given up or exchanged with the employee? The economic reality here is that if a share option expires worthless, the company received free services in exchange for nothing. I don't believe that current accounting principles require fair value recognition if employees choose to donate their services for nothing in return. An example of this would be CEO's who work for only a dollar a year and never realize any value from underwater option shares. Accounting needs to focus on reporting economic reality, so I believe there must be a consistent economic application of principles related to share payments, wherein original estimates are always true-up to actual values through the vesting date. Any changes in fair value after the vesting date are simply market plays by the employees with no benefit to the employer, except for the capital benefit of excess tax benefits realized.

Respectfully,

James F. Barlow