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**Ms. Suzanne Bielstein**  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
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**Letter of Comment No: 5743**  
**File Reference: 1102-100**

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

Dear Ms. Bielstein:

We appreciate the opportunity to comment on the Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95* (the "ED"). In general, we support the issuance of this ED as we agree with the fundamental principle that employee services received in exchange for equity instruments give rise to compensation cost; that such cost should be recognized in the financial statements in the period in which the employer benefits from an employee's service; and that pro forma disclosures, as permitted by SFAS 123, are not an appropriate substitute for recognition of compensation cost in the financial statements.

Further, we agree that grant-date fair value is the measure that most appropriately captures the substance of the arrangement between the employer and employee. We recognize that there is no method or model that will accurately determine the fair value of certain share-based payment arrangements. However, we believe that the proposed methods are sufficiently reliable and that estimated fair value is a more representationally faithful measurement than the current practice of non-recognition for certain awards.

We support the Board's preference for a lattice model because it addresses certain issues that exist in a closed-form model, such as Black-Scholes. However, we believe it is critical to allow companies flexibility in measuring share-based awards. Therefore, we believe that the Board should not indicate that one model is preferable (or required) over another model, which is consistent with the approach in IFRS 2. Such flexibility will

allow companies to assess the costs and benefits of all available models given their unique circumstances. We recommend that the Board add language to the ED to permit companies to consider the use of models that may be developed in the future to the extent that such a model provides a more accurate estimate of fair value.

The following paragraphs express our comments and recommendations for those provisions in the ED that are relevant to Merrill Lynch.

**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?**

We agree with the Board's rationale in paragraph C129, which states that the total tax deduction pertains to two separate transactions or events:

1. A transaction in which employees render services as consideration for an award of shares, share options, or other forms of share-based payment. Use of those services in the entity's operations results in compensation cost, which is an income statement item.
2. An equity transaction, i.e., the exercise of share options. That equity transaction will be affected by share price changes between the date an award of options is granted and the date the award is exercised.

The Board concluded in paragraph 44 of Appendix A that if changes in the fair value of an entity's shares after the grant date result in deductible compensation cost reported on the employer's tax return that exceeds the compensation cost recognized for financial reporting, any resulting realized tax benefit that *exceeds* the previously recognized deferred tax asset ("excess tax benefit") shall be recognized as additional paid-in capital. We agree with this conclusion as it results from an equity transaction and not from a stock compensation transaction.

The Board also concluded that if the amount deductible on the employer's tax return is *less than* the compensation cost recognized for financial reporting, the write-off of the portion of the deferred tax asset related to the deficiency ("tax deficiency"), net of any valuation allowance, shall be recognized in the income statement. The Board's rationale was that the "portfolio" approach of netting tax deficiencies on some instruments against excess tax benefits on other instruments is not appropriate. We disagree with this conclusion as we believe that a tax deficiency should be recognized in a similar manner to excess tax benefits. From a theoretical perspective, we believe that the treatment of a tax deficiency as an income statement item is inconsistent with the Board's "two transaction approach" above. From a practical perspective, we disagree with the

"individual" approach in the ED because in practice, the valuation and grant date tax accounting is performed on a portfolio or grant-by-grant basis. Thus, the proposed requirement that tax "true-ups" be performed on an individual basis would be extremely burdensome to large companies with broad-based plans (for example, Merrill Lynch has over 19,000 option holders, most of whom hold multiple grants).

Therefore, from both a theoretical as well as a cost-benefit perspective, we recommend that the Board reconsider their conclusion on the treatment of tax deficiencies. We believe that all tax deficiencies should be recognized in additional paid-in capital regardless of previously realized excess tax benefits.

The ED also retains the guidance in paragraph 43 of SFAS 123 regarding valuation allowances for deferred tax assets resulting from share-based payments. Paragraph 43 states that SFAS 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some or all of the deferred tax asset will not be realized. It also states that differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity's stock shall not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under this statement. However, we believe there may be instances where the recoverability of the deferred tax asset is highly unlikely because the current price of the stock will most likely not reach the sum of the grant price plus fair value. We would argue that in this instance the deferred tax asset should be adjusted prior to exercise or expiration.

**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.

We support the Board's conclusion that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. However, we do not believe the Board should prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. We believe that companies should be able to use all available information in determining their best estimate of expected volatility.

Paragraph B25 provides a list of factors that might be considered in estimating expected volatility. One factor is that the implied volatility of the share price can be determined from the market prices of traded options. Additionally, the ED states that the term structure of the implied volatility of the share price over the most recent period should be generally commensurate with (1) the contractual term of the option if a lattice model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used. However, we note that even for large publicly traded companies where a liquid market exists for options on the company's stock, from which the implied volatility is derived, the term of those traded options (typically one to two years) will not be commensurate with the contractual term (typically, ten years) or even the expected term of the employee options. Notwithstanding this, we believe that applying the implied volatility for one or two year traded options produces a better estimate of option fair value than using historical volatility. This volatility is more representative of current market conditions and therefore best reflects the value transferred to employees at the time of grant. Furthermore, since empirical evidence does not support the notion of a term structure for option volatility, there is no reason to assume that long-dated volatility will be higher or lower than short-term volatility. Accordingly, we believe that the implied volatility derived from publicly traded options is the best available input to the fair value model, and would strongly recommend that the Board delete the requirement that the term of the instrument from which volatility is implied be commensurate with the contractual term or the expected term of the employee option.

**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?

Although we support international convergence of accounting standards, we do not agree with the Board's conclusion that an award with graded vesting should be accounted for as separate awards with different vesting periods. Further, we do not agree that elimination of the alternative to account for awards with graded vesting as a single award would simplify U.S. GAAP.

As stated in paragraph C91, the Board believes that accounting for an award with graded vesting as separate awards better reflects the exchange of employee services for the equity instruments. While a theoretical argument can be made for a method of recognizing compensation cost for each tranche over its vesting period, which would result in accelerated amortization (i.e., heavily weighted to earlier periods), we believe a stronger argument can be made that compensation cost should be recognized in a pattern that is representative of the service provided by the employee. We believe that employees' services are performed equally over the vesting period, regardless of whether

the award's terms are graded or cliff vesting. As a result, we believe that the straight-line method better matches the expense with the benefit received.

The Board noted in paragraph C91 that Statement 123 permitted the straight-line method for awards with graded vesting in part because it is simpler than the method required in the ED. We agree that the straight-line method is simpler, but we would also point out that the straight-line method is consistent with the accounting for cash based compensation arrangements. Further, we believe that the costs (i.e., overhaul or development of systems) of applying the model for both valuation and amortization of graded vesting awards will outweigh any potential benefits, especially for companies with broad-based option plans. Accordingly, we recommend that the Board continue to permit the straight-line amortization method for awards with graded vesting.

**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 nontransferability 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.**

We do not believe that the use of expected term rather than the contractual term is a sufficient adjustment for nontransferability of employee share options. This approach only reduces the value of an employee stock option for the remaining time value at the exercise date; however, no reduction in value is reflected for the inability to sell the option to a third party – a feature of a liquid option that enables the holder to realize both the intrinsic value and the remaining time value during the exercise period. We recommend that the Board continue its research efforts regarding valuation techniques to address the illiquid and unique characteristics of employee share options. Furthermore, we recommend that the Board add language to the ED to permit companies to consider the use of approaches that may be developed in the future that more accurately captures the nontransferability feature in estimating the fair value of employee stock options.

We agree with the Board's decision that compensation cost should be recognized only for those equity instruments that are not forfeited. We would also agree that estimating forfeitures (adjusted later as actual forfeitures differ from their estimate) is a reasonable method for attributing compensation expense. However, we disagree with the Board's conclusion to eliminate the alternative under SFAS 123 that allows an employer to attribute compensation expense assuming all awards will vest and reverse recognized compensation expense for forfeited awards when the awards are actually forfeited.

We believe that either method should be permitted, given that they are both intended to achieve the same result. Furthermore, we believe that in some sense, recording actual forfeitures as they occur produces a superior result, in that the use of estimates results in compensation cost not being recorded for employees who are actually providing service to the company (prior to forfeiture). Accordingly, we recommend that the Board continue to allow this alternative under the new guidance.

**Other Comments (not identified as Issues by the Board)**

Paragraph 37A in Appendix A states that a cancellation of an unvested award that is not accompanied by the concurrent grant of a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the date of the cancellation. While we understand that this may be intended as an anti-abuse provision (to prevent a cancellation and subsequent reissuance of a replacement award from not being accounted for as a modification of an award), there may be an instance where an unvested award is cancelled upon an employee's termination "for cause," and there is no subsequent reissuance of a replacement award. In this instance, we believe the cancellation is more akin to a forfeiture, and should be accounted for as such. At a minimum, we believe it would be inappropriate to recognize any previously unrecognized compensation cost at the date of the cancellation, as future services will never be provided by the employee and the employee will never receive the award.

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Once again, we appreciate the opportunity to provide our comments to you. We would be happy to participate in any potential discussions that may result from your continued deliberations on this issue. Please do not hesitate to contact me at 212-449-2048 should you have any questions regarding our comments.

Sincerely,

/s/ Esther Mills

Esther Mills  
First Vice President