



3M Center  
St. Paul, MN 55144-1000  
612-736-1097

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File Reference: 1102-100

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Suzanne Q. Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1102-100

3M Company would like to thank you for this opportunity to comment on the FASB's Proposed Statement Of Financial Accounting Standards ("SFAS"), Share -Based Payment, an amendment of FASB Statements No., 123 and 95 (the "ED").

We believe that equity instruments granted to employees are a form of compensation and should be recognized in a company's results of operations. Companies utilize equity based compensation (EBC) instrument in an attempt to compensate employees for future services. We believe that EBC may be estimated and therefore should be recognized as compensation. Please see our primary concerns that follow that relate to the ED's proposed treatment of graded vesting patterns (issue # 9), remeasurement as a new grant of reload events (issue # 10), and the treatment of the income tax effects (issue # 11). In addition we are concerned with the anticipated timing of the final statement and the extremely short turn around to adopting January 1, 2005. There are several implementation issues discussed below, the most onerous being the tracking of individual tax grants and exercise, that will take significant time, expense and planning that can not be completed in that short of a period of time. These changes are not practical to perform before the final standard is released due to the time and expense that would go for naught if the rule were modified. In addition, the binomial model is requiring most companies to utilize outside consultants at potentially a high price. Again the decision to incur an expense that may not be necessary would have to be made before the final standard is issued. In addition the model requires the company to make significant assumptions about future equity market and stock performance that greatly impact the valuation generated by the binomial model. In general, we believe that all standards should have a minimum implementation period of at least six months, the exception being standards that eliminate a practice that may change market behavior, i.e. SFAS No. 141's elimination of pooling-of-interest method of accounting for business combinations. We believe that a hasty implementation may result in unforeseen issues that could impair quality financial reporting and cause users to not fully understand the impact of this significant change in accounting, thus providing less financial comparability across companies. We believe that an interim period adoption of this standard would not be unreasonable, but would recommend a one year deferral from the proposed adoption date.

Again thank you for allowing us this opportunity to comment on the ED, please contact Jon Kugel (651) 736-1097 with any questions.

Sincerely,

/s/ Jonathan E. Kugel

Jonathan E. Kugel  
Financial Manager 3M Finance

Responses to Specifically Identified Issues set forth in the ED

**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.**

We concur.

**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?**

We agree that pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements, but as previously mentioned in our introduction paragraph a reasonable implementation period should be provided to transition to the new valuation models.

**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?**

We agree with the Board's conclusion that compensation cost related to employee services received in exchange for equity instruments issued should be based on the grant-date fair value. We believe the grant date should be either the ED date definition "date at which the employer and employee reach a mutual understanding of the key terms and conditions of a share-based payment arrangement" or the date the relevant terms are approved by the board of directors or other appropriate authority, provided there is not an unreasonable period of time between that date and the date the awards are communicated to individual employees. The approval date is indicative of the date the employer and employee reach a mutual understanding as after the board of directors approval the communication to the employee does not change the grant and essentially the employee has agreed to the grant.

**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?

We concur

**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?

We concur, however we are concerned that consistency and comparability may be lost due to the complexity of the lattice models and encourage the final statement be written in a manner to permit the Black Scholes model to be used and the potential for the development of more accurate and transparent models.

**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 do not believe the Board should prescribe a specific method of estimating expected volatility.

**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.**

We agree with the Board's decision that compensation cost should only be recognized for those equity instruments that vest to account for the risk of forfeiture due to vesting conditions. The fundamentals of accrual accounting dictate and support that the amount that is estimated to be the ultimate liability is the amount that should be initially recognized, therefore forfeitures should be estimated at the grant date and adjusted as necessary till vested.

**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?**

No comment

**Employee Stock Purchase Plans**

**Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?**

We agree that if an employee can purchase shares on terms that are more favorable than those available to all holders of the same class of the shares; those favorable terms should result in compensation costs. However, we believe that a sufficiently small discount is comparable to stock issuance costs avoided by issuing securities to employees rather than to the public, and therefore should not represent compensation cost. The primary purpose of our employee stock purchase plan is not to compensate employees for services rendered, but rather to increase employees' holdings of our common stock in an effort to align employee and shareholder interests.

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

**Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?**

We concur

**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?**

We believe the guidance in estimating the requisite service period is sufficient.

**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?**

We believe that a share-based award with a graded vesting schedule is a single award. The award has one exercise price, one approval process, is issued as one award, and the number of shares granted is typically determined by one previous review/evaluation period. In addition, straight-line amortization over the vesting period tracks more consistently with the value of the services provided by the employees. The application of the straight-line amortization of the single grant theory, provides a more accurate amount recognized if the employee were to terminate service before the end of the full vesting period. As an example an employee is granted 400 options over a four-year period (100 options vesting per year),

the options have a \$10 fair market value (same FMV for each year), and the employee terminates employment two years and three months after the grant date. Under the ED graded vesting amortization method the company would have recognized \$3,313 of expense as compared to \$2,250 utilizing a straight line method, when only \$2,000 should have been recognized. The resulting adjustment would be \$1,313 versus \$250, for the ED method compared to the straight-line method. The amount over expensed is more significant in the early years as compared to the latter years, but the adjustment is always greater under the ED method. The single grant approach would also have one valuation, which would be more reflective of the value the company is attempting to impart on the employee versus remeasuring the value in future periods allowing changes in other drivers (i.e. volatility, share price, exercise history) could affect the valuation resulting in a different compensation expense impact than initially intended. Administratively the single grant approach is significantly less complex than having to separately value and track/account for each tranche, including the tax tracking burden, binomial valuations for each tranche, and system modifications to track each tranche. After the initial ramp up years the difference between the two methods would essentially be lost on a total basis. This is especially true in the case of most companies, wherein grant levels and valuations remain relatively constant over time. In such cases, after the initial ramp-up of expenses that would occur under the ED's proposed methodology, the amount of costs recognized under the ED's approach and the single grant straight line approach would be fairly consistent.

### **Modifications and Settlements**

**Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.**

We do not agree with the ED's proposed accounting for "reload" option. We believe that a reload provision increases the value of the option, and that the reload provision should be included in the initial fair value estimate. We believe this feature can be built into a lattice model. We believe that the granting of an option with a reload feature is a single option grant as evidenced by the number of options, the vesting schedule, and exercise period remaining the same as the initial grant. In addition, no additional company approvals are required, services provided by the employee or dilution results at each reload event. Also, the reloading event is entirely at the discretion of the employee, much like the final exercise decision, which does not result in additional compensation expense to the company, thus providing inconsistent treatment of subsequent exercise actions by employees. Therefore, we believe the subsequent reloading event should not be recognized as a new grant, but added to the initial valuation.

In addition, administratively significant complexity and cost would result from the recognition of each reload event as a separate grant. Systems would need to be developed to track each reload event and interim valuations would need to be performed more frequently adding cost.

## 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?**

We believe the tax benefit recognized for EBC should be reflective of the amount of compensation expense recognized, with any differences between the amounts expensed and the amount ultimately realized by the individual adjusted to equity. Per the ED, the granting of the option represents a compensation transaction, whereas the exercise of the stock option, which is not adjusted for book expense, represents an equity transaction by the option holder. Therefore, we believe the amount of income tax benefit recognized for the option grant should be consistent with compensation expense recognized in the income statement. The difference in the realized tax benefit, both higher and lower, should be recognized in additional paid-in capital similar to the impacts of underlying option exercise.

We also are concerned with the unnecessary administrative burden that would result for the ED method of tracking grant exercise by individual employee. For large multinational employers with broad plans that include tens of thousands of employees throughout the World who frequently relocate to other countries and tax jurisdiction, the process of tracking and matching up grants basis to actual exercise is an undue administrative burden that would require an extensive system that is not presently in place and would be difficult to implement in the ED’s proposed timing. It is true issuances and exercises of EBC are presently tracked, but the detail and interaction with overseas systems typically does not provide all of the information that would be necessary to comply with the ED. We believe the Board should adopt a portfolio approach to tracking and accounting for the benefits realized upon exercise or settlement of EBC payments.

## 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.**

We believe the disclosures required by the ED are complete and sufficient to meet the Board’s disclosure objectives. Due to the significant impact certain assumption can have on the EBC valuation, we believe that disclosures that assist the financial statement user in

evaluating the consistency and comparability of EBC compensation expense is essential, especially in the initial adoption periods.

### **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?**

We concur.

### **Nonpublic Entities**

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

We do not agree with the Board's conclusion to allow different accounting for nonpublic and small business issuers. We believe consistency and comparability require all companies complying with U.S. GAAP.

**Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?**

We do not agree with the Board's conclusion to allow different accounting for nonpublic and small business issuers. We believe consistency and comparability require all companies complying with U.S. GAAP.

### **Small Business Issuers**

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

We do not agree with the Board's conclusion to allow different accounting for nonpublic and small business issuers. We believe consistency and comparability require all companies complying with U.S. GAAP.

### **Cash Flows**

**Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?**

As discussed in issue 11, we do not support the treatment of the excess tax benefits and therefore do not agree with modifying SFAS No. 95 to reflect this treatment.

### **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?**

We believe the board should use the ED and subsequent comment period and public hearings to arrive at the highest quality standard.

### **Understandability of This Proposed Statement**

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

We believe that the accounting standard can be read and understood by such an individual as described, although the length may discourage the attempt. However, due to the significant complexity of valuing EBC instruments, we are concerned that less guidance would damage the consistency of financial statements, due to the inability of the investor to analyze EBC valuations across different companies.