



ICU Medical, Inc.

Letter of Comment No: 5282
File Reference: 1102-100

June 24, 2004

Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

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

ICU Medical, Inc. is pleased to present its comments on the proposed Statement of Financial Accounting Standards. We are a developer and manufacturer of disposable medical devices. We have been public since 1992, and broad based employee stock options have been an important part of our compensation program.

We strongly oppose the proposed statement. Valuation techniques for equity instruments commonly used to compensate employees are not sufficiently developed for use in measuring compensation cost for the purpose of recording it in financial statements, and financial statements in which employee compensation is recorded based on measurements using such techniques will be inaccurate, and such inaccuracies may be material.

The outcry for transparency in financial statements, in the face of large corporate fraud, is causing a surge of popular and political pressure to record compensation expense for employee share options. But, there is no direct evidence that unethical or illegal behavior undertaken to increase stock prices is in any way tied to broad based employee stock plans. The Board should not be swayed by this unfounded pressure, but should have the courage to defer any requirement to record compensation expense for employee share options until adequate valuation techniques are developed. Any new standard must have a sound valuation methodology. The debate over accounting for employee share options has been going on for over 50 years; the Board has made much progress, but additional time to get the right answer is needed; in the context of a 50-year effort, the additional time needed to get the right answer may be relatively small.

As an interim measure, we would find the use of minimum value method to value employee share options to be acceptable.

Issue 1: We might agree with the Board's conclusion that employee services received in exchange for equity instruments give rise to recognizable compensation cost in those instances where the compensation cost can be reliably measured. However, we believe that the measurement techniques proposed by the Board are not reliable for the employee share options commonly used to compensate employees and that therefore the Board

should defer any requirement to record such cost in the financial statements until reliable measurement techniques are developed.

Issue 2: We do not agree that pro forma disclosures are not an appropriate substitute for recognition of compensation cost in financial statements. However, measurement techniques for employee share options are not sufficiently reliable to measure compensation cost for the purpose of recording it in financial statements, so pro forma information may have some use for a “what if” presentation on a supplemental basis. At the same time, the Board should permit and encourage experimentation in the use of varying measurement techniques in the hope that experimentation will lead to development of reliable measurement techniques for employee share options.

Issue 3: We agree with the grant-date fair value approach.

Issue 4(a): The guidance provided in the proposed statement might be useful in achieving consistency of application, but the underlying pricing models do not yield reliable results for employee share options, and guidance, no matter how good, will not solve that.

Issue 4(b): We do not agree that employee share options can be measured with sufficient reliability. Use of option pricing models developed for use in valuing traded options is inappropriate for valuing non-tradable employee share options. There are essential differences between the two that cause this.

Traded options can be bought and sold any time prior to expiration, and are typically not exercised until at or near expiration. Volatility in the underlying shares causes price changes in the options and the holder can benefit from those price changes by selling the option. In contrast, a holder of an employee share option can realize the benefit of price changes only by exercising the option and selling the underlying shares, and this is often done well before the expiration of the option. In addition, the income tax consequences of realizing that benefit are usually different and more adverse to the holder (and favorable to the company) than would occur on the sale of a traded option. Further, there are usually periods of time when an employee may not exercise the option or may not sell shares received on exercise of the option, either because of vesting restrictions or entity imposed “blackout” periods; those restrictions seriously reduce the ability to take advantage of volatility in the value of the underlying shares.

There is no objective evidence that the valuation techniques proposed by the Board yield correct valuations. There is no observable market, no trading of any type in employee share options, and none of the “data points” that one would look to for the purpose of validating a valuation technique.

While lattice models may be preferable because of their greater flexibility, they still do not adequately reflect the unique aspects of employee share options. Further, the lattice models are complex and we believe will be difficult and costly for many to use, which is

likely to cause most companies, particularly smaller companies, not to attempt to use them.

Issue 4(c): The Board should not prescribe a specific method for estimating volatility.

The factors to consider in B24 B26 seem to be presented as all-inclusive. They should not be. Other factors may be identified, or techniques identified to quantify some known factors such as the effect of “blackout” periods, that could impact calculation of expected volatility.

Issue 4(d): The Board’s conclusions to adjust the contractual option term to the expected term until exercise and recognizing compensation cost only for options that vest in calculating grant-date fair value may be steps in the right direction, but there is no conclusive evidence that these adjustments adequately correlate with the difference in value between an employee share option and a freely tradable share option. And, neither takes in to account the fact that a holder of an employee share option cannot benefit from the volatility of the underlying shares in the same manner as the holder of a freely tradable share option.

The Board has not derived a method to give appropriate recognition to the unique characteristics of employee share options. As further explained in our response to Issue 4(b), until and unless it does, volatility, which is the principal problem, should be eliminated from the measurement of grant-date fair value. This, in effect, is the minimum value.

We would support the use of the minimum value method to value employee share options as an interim measure until such time, if ever, that a more reliable valuation technique is developed. This is the lowest amount in a range of possible values. Its use would be analogous to the use of the minimum amount in a range of expected losses when no amount within a range is a better estimate than any other amount in the range under FASB Interpretation No. 14, *Reasonable Estimate of the Amount of a Loss*.

Issue 5: It may be difficult to identify circumstances in which it is not possible to reasonably estimate the fair value of equity instruments using the Board’s valuation techniques, but the Board’s “solution” to require periodic remeasurement of the intrinsic value through the settlement date is unduly punitive. If the Board goes forward with its proposed Statement, it should either mandate the use of a best estimate, or permit the use of the minimum value method if there is no best estimate. It is appropriate to leave it to financial statement preparers and their auditors and financial advisors to implement the principle.

Issue 6: This is a case where theoretical purity has led the Board to a feckless conclusion. It would, indeed, be very rare for a company, especially a publicly held company, to sell shares to all its shareholders at a discount.

The United States Congress legislated favorable tax treatment for employee stock purchase plans; that is public policy. The Board's proposal will likely deter companies from using what historically is a popular and relatively inexpensive broadly based benefit. Rather than usurp public policy by imposing an onerous accounting treatment on employee stock purchase plans that will discourage their use, the Board should prescribe that such plans should be considered non-compensatory if they meet the requirements of the Internal Revenue Code Section 423. The Board has apparently taken a similar approach for ESOPs as well.

Issue 7: The requisite service period is the appropriate basis for attribution.

Issue 8: The guidance provided is sufficient, and we agree with it.

Issue 9: We agree with the accounting treatment for awards with a graded vesting schedule.

Issue 10: We have no objections to the Board's proposed principles for modifications and settlements of awards.

Issue 11: We do not agree with the Board's proposed method of accounting for the income tax effects of stock compensation cost.

The Board, in paragraph 42, limits recording deductible temporary differences to those instruments that ordinarily result in a tax deduction. However, for instruments awarded at fair value at grant date, such as most employee share options, there is no future tax deduction unless the issuers' shares increase in value; although they may have been valued for accounting purposes, there is no tax deduction at grant date. To record a deferred tax asset at award date for a future tax deduction that may never exist, and will only exist if the entity's stock increases in value, seems inappropriate. And to then require (paragraph 43) that the deferred tax asset not be adjusted for a difference in the temporary difference and the tax deduction inherent in the fair value of the entity's stock, effectively postponing the "day of reckoning" if the entity's shares have not increased in value, and leaving a non-existent asset on the balance sheet, is absurd; there is no asset.

We suggest a better accounting for employee share options granted at fair value at grant date. Record no deferred income taxes at date of grant. At each balance sheet date, record (or adjust) the deferred tax benefits available based on the entity's effective tax rate applied to the lower of (i) the cumulative compensation cost recognized, or (ii) the tax deduction inherent in the current fair value of the entity's stock. This would avoid carrying a worthless deferred tax asset as well as recording in income a non-existent deferred tax benefit which would be subject to reversal upon settlement of the instrument. This same basis accounting will also work if employee share options are granted at below fair value at grant date; in that case, deferred tax benefits based on the "discount" would be recorded at grant date.

If the Board maintains its current proposal in paragraphs 42, 42A and 43, then we do not agree with the proposed provisions of paragraph 44 which would require excess tax benefits to be recognized as additional paid-in capital, but require any shortfall to be charged to income. The excess benefit and the shortfall are both caused by the same circumstance: the entity's stock value did not increase by exactly the amount of the valuation at grant date. Conceptually, they should be accounted for in the same way. We believe that since accounting gains and losses attributable to an entity's own stock normally are credited or charged to equity accounts (usually paid-in capital, but retained earnings in some circumstances), that the excess benefit and the shortfall should both be recorded directly to the entity's equity accounts.

Issue 12: We have no objections to the proposed disclosures. We do note, however, that they may be unnecessarily lengthy because they contain much information that may have value only if share based compensation is not recorded in the financial statements.

Issue 13: We do not object to the proposed transition provisions. We would, however, allow retroactive application in the interest of better comparability among years in an entity's financial statements. We believe the lack of comparability between the calculations under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and those under the proposal would be relatively small and explainable in most cases, and would afford those entities which did not adopt Statement 123 an opportunity to present their financial statements on a basis comparable with those entities that did adopt Statement 123.

Issue 14(a): We believe nonpublic entities should continue to be permitted to use the minimum value method, as permitted under Statement 123. To require periodic remeasurement of the intrinsic value through the settlement date is unduly punitive. The Board should either mandate the use of a best estimate, or permit the use of the minimum value method. See response to Issue 5.

Issue 14(b): We applaud the Board's effort to be sensitive to the impact of the proposed statement on nonpublic entities. The transition provisions and extended effective date are helpful. However, the permitted use of the intrinsic method of valuation (with final measurement of compensation at settlement date) may not, in our view, be helpful, especially for nonpublic entities planning to become public. To avoid the potentially large charge to compensation expense on settlement after going public, they may be forced to adopt, as best they can, the fair-value-based method. If the use of the intrinsic value method is to have any real value to them, they should be permitted to make an accounting change for all unsettled share-based compensation arrangements at any time before becoming a public entity.

Issue 15: No. Small business issuers should follow the same accounting as other public entities.

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Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95*

Issue 16: We agree with the proposed requirement that excess tax benefits be reported as a financing cash flow. We have long believed that the requirements of FASB Statement No. 95, *Statement of Cash Flows*, are incorrect in this regard.

At the same time, we believe the Board should modify the conclusion of Emerging Issues Task Force Issue Matter D-83, *Accounting for Payroll Taxes Associated with Stock Option Exercises*. Payroll taxes that are directly attributable to the appreciation of stock options are not operating expenses, notwithstanding the view of the FASB staff. To the extent that they occur when the entity sells its stock on exercise of an option, they are a financing activity, as is the exercise of the option, and should be accounted for as such in the operating statement (i.e., charged against proceeds credited to equity accounts) as well as in the statement of cash flows.

Issue 17: Achieving convergence in U.S. and international accounting standards is a noble objective, but in the case of share-based payments, the majority of such payments have occurred in the U.S., so the FASB should not be unduly influenced by what is basically a minority position taken by the International Accounting Standards Board.

We believe that neither the IASB nor the FASB have adequately dealt with the issues surrounding measurement of fair value at grant date. Efforts to achieve "convergence" with a standard similar to IFRS 2 are misplaced until this very basic measurement issue is resolved; it rather makes the whole effort resemble the "convergence" that lemmings have on their way to drowning.

While neither the IASB nor the proposed FASB accounting for income tax effects is satisfactory, we believe the treatment in IFRS 2 is conceptually superior to that proposed by the FASB, for many of the reasons in our comments on Issue 11. We have no preference for the accounting treatments in IFRS 2 where they differ from the FASB proposal.

Issue 18: We would hope that in 200-plus pages, the Board has written a standard that can be understood. Of course, that presupposes that one is able to read and study all 200-plus pages. A truly principles-based, and shorter, standard would be preferable, but that may not be achievable for a topic as complex as share-based payments.

We would be pleased to discuss our comments with the Board or its staff.

Very truly yours,



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Chief Financial Officer

cc: Bob Greifeld, The Nasdaq Stock Market
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