

# LEHMAN BROTHERS

Letter of Comment No: 3086  
File Reference: 1102-100

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

By email to: [director@fasb.org](mailto:director@fasb.org)

**Re: File Reference No. 1102-100**

Lehman Brothers is a leading financial services firm that serves the financial needs of corporations, governments and municipalities, institutional clients and high-net-worth individuals worldwide by providing equity and fixed income sales, trading and research, and investment banking, private equity, asset management and private client services. We appreciate the opportunity to comment on the Financial Accounting Standards Board's (the "Board") Exposure Draft, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95* (the "ED"). We are providing our comments by the Board's accelerated comment deadline and request the opportunity to participate in the June 29, 2004 public roundtable meeting in Norwalk, Connecticut.

Lehman Brothers agrees with the Board that share-based awards should be recognized as compensation expense in the income statement based on the grant-date fair value of the award. Therefore, we support the issuance of the ED to amend Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). While we have concerns with the reliability and comparability of the fair value measurements required by the ED, we believe estimated fair value is a more representationally faithful measurement of share-based awards than the current practice of non-recognition for certain awards (i.e., options). However, in this letter we offer comments on several proposals in the ED that are relevant to Lehman Brothers that we believe would improve the understandability and practicability of the final Statement.

## **Accounting for the income tax effects of share-based payments**

We disagree with the Board's conclusion that when the realized tax benefit of an award is less than the amount of the previously-recognized deferred tax asset ("tax deficiency"), the full amount of the tax deficiency should be recognized in income. This accounting differs from the accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and SFAS 123, both of which require tax deficiencies to be recognized in income only to the extent they exceed previously-realized excess tax benefits recognized as additional paid-in capital.

The Board concluded in the ED that tax deductions in excess of recognized compensation cost that result from increases in intrinsic value of an award after the grant date are due to

equity transactions and therefore the related excess tax benefits should be reflected as an adjustment of paid-in capital. We agree with this conclusion—changes in the value of stock-based awards after the grant date accrue to holders of the award in their capacity as equity participants and the associated tax effects also should be classified within equity. We question why the Board then concluded a tax deficiency is not also an equity transaction. We believe the payment for goods or services with an equity instrument encompasses two transactions: a compensatory transaction and an equity transaction. The recognized tax benefit of the compensatory transaction should be based on the accounting measurement of the compensatory transaction. Changes in the value of share-based awards subsequent to grant date are not compensatory transactions and therefore the related tax effects should not be recognized in income regardless of whether the change in value is an increase or a decrease to the tax benefit. Further, because the modified grant date approach measures compensation cost at the date of grant and does not adjust compensation cost for changes in the stock price between grant and exercise, we believe it is inconsistent to introduce changes in the stock price into earnings through the income tax provision.

We believe it is inconsistent to conclude the tax effect of an option exercise is an equity transaction when the realized tax deduction on the exercise date is *greater than* the recognized cost of the award, while the tax effect of exercise is not an equity transaction when the realized tax deduction on the exercise date is *less than* the recognized cost of the award. We believe the stock price on the exercise date (which drives the tax deduction) should not affect the character of the transaction and the accounting result should be *symmetrical* (i.e., tax deficiencies—to the extent of prior excess tax benefits—and excess tax benefits both should be recognized directly in additional paid-in capital).

We believe the long-established practice of recognizing excess tax benefits and tax deficiencies (to the extent of previously-realized excess tax benefits) in additional paid-in capital is sensible and well understood by financial statement users and should be retained.

#### **Attribution of compensation cost for awards with a graded vesting schedule**

The Board proposes to change existing guidance under SFAS 123 for awards with graded vesting. SFAS 123 allows companies to consider an award with graded vesting as a single award or as multiple awards. Therefore, under existing guidance a company that grants shares to an employee with 50% vesting in year one and 50% vesting in year two can choose to view the grant as a single award and recognize 50% of the cost of the award in year one and 50% in year two. Alternatively, the company can view the award as two awards and recognize 75% of the cost of the award in year one and 25% in year two. The ED proposes to change existing guidance by requiring companies to view awards with graded vesting as multiple awards, resulting in accelerated expense recognition.

We understand the mathematical logic of the Board's proposal. However, we believe financial statement users find the single-award method more understandable than the Board's proposed method and the single-award method is consistent with the intent of

granting awards to employees by the company. In particular, we believe financial statement users will find counterintuitive a method of expense attribution that accelerates expense recognition into the early years of an award while the benefit of employee services is received ratably over the service period. We believe this point is made starkly clear if instead of awarding share options or restricted stock with graded vesting, a company enters into a three-year employment contract with an individual that guarantees the individual a specified cash bonus at the end of each year. Would the Board suggest the cash bonus should be subject to the attribution method required by the ED? We do not believe this would be sensible. We believe the straight-line method better matches the expense with the benefit received.

The Board contends that the elimination of the alternative to account for awards with graded vesting as a single award would simplify U.S. GAAP. We point out, however, that it would increase exponentially the complexity of the *on-going application* of U.S. GAAP. The benefit of eliminating a one-time accounting policy decision would be far overshadowed by the ongoing administrative burden of researching, modeling, and tracking employees' early exercise and post-vesting employment termination behavior for a significant multiple (i.e., the number of individual award tranches) of the number of awards currently tracked by corporate America.

We suggest the Board retain the alternative attribution methods currently permitted by SFAS 123.

**Accounting for share-based awards when fair value cannot initially be reliably estimated**

The Board proposes to change the accounting for a share-based award when it initially is not possible to reasonably estimate the fair value of the award. In such instances the Board would require compensation cost to be measured based on the intrinsic value of the award for the life of the instrument. This proposal differs from SFAS 123, which requires compensation cost to be measured when fair value becomes reasonably determinable. In our view the Board's proposal would unduly penalize companies that issue such awards by requiring what is in substance variable accounting, even in periods subsequent to when the fair value of such awards became reliably estimable.

We believe the Board should retain the approach contained in SFAS 123. In those rare instances when it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, we believe the Board should rely on management and a company's auditors to determine when fair value first can be estimated and refrain from building into accounting standards self-policing provisions that lack a theoretical accounting basis.

**Valuation of share appreciation rights (SARs)**

The ED would require all share-based awards, including SARs, to be valued at fair value. Valuing SARs at fair value preserves the theoretical integrity of the ED. However, the final payment under a SAR always is based on the intrinsic value of the award at maturity and, therefore, amounts recognized for the time value of the award eventually will be

reversed. We support fair value accounting for all financial instruments; however, in this case we believe the complexity this approach would add to accounting for SARs will far outweigh the informational benefit to be achieved, particularly considering that the fair-value method would require the use of an option-pricing model to value the award at each reporting date, and not just at the initial award date as in the case of an equity-settled award. As a result, we believe SARs should be measured, and re-measured, at intrinsic value rather than at fair value.

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Thank you for the opportunity to provide you with our comments. If you have any questions, please do not hesitate to contact me at 212-526-0588 or Kristine Smith at 212-526-0664.

Sincerely,

/s/ Edward S. Grieb

Edward S. Grieb  
Managing Director  
Chief Accounting Officer

/s/ Kristine Smith

Kristine Smith  
Senior Vice President  
Director of Accounting Policy

cc: David Goldfarb  
Christopher M. O'Meara