

TENTATIVE COMMENT LETTER

Letter of Comment No: 3085
File Reference: 1102-100

June 7, 2004

Mr. Lawrence Smith, CPA
Director, Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: March 31, 2004 Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards (SFAS), Share-Based Payment [File Reference 1102-100]

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the above-referenced ED and is providing the following comments for your consideration. Our comments focus on the key aspects of the ED that affect our constituency.

GENERAL COMMENTS

TIC's previous letter to the FASB on its Invitation to Comment, dated July 18, 2003 (TIC's 2003 comment letter), expressed support for expensing stock options and measuring the options at fair value. In that letter, TIC requested that the FASB grant certain concessions to nonpublic entities. The most important of these was the retention of the minimum value method, unless new methods of measuring fair value could be adopted that would be more meaningful, reliable and cost effective for nonpublic entities than the existing option pricing models.

TIC continues to believe that the board should retain the minimum value method (MVM) described in SFAS No. 123, *Accounting for Stock-Based Compensation*, as the alternative valuation method for nonpublic entities. In TIC's view, the MVM better achieves the FASB's dual goals of effecting a charge to expense at the grant date and separating the compensatory transaction from the equity transaction compared to the intrinsic value method (IVM).

TIC would also like to acknowledge certain concessions that the Board has made in this ED for the benefit of nonpublic entities.

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SPECIFIC COMMENTS

Alternative Valuation Method for Nonpublic Companies

TIC understands that the Board was reluctant to permit alternative accounting methods for share-based payments.

After considering the Board's Basis for Conclusions on this issue, TIC strongly disagrees with the FASB's decision to select the modified IVM as the appropriate alternative valuation model for nonpublic entities that offer stock-based payments to their employees. The MVM is at least as conceptually sound as the IVM and has the added advantages of being consistent with past practice, easy to apply and considerably more cost beneficial. The IVM is conceptually inconsistent with certain of the FASB's objectives and, although it is quite understandable, penalizes nonpublic entities in its simplicity. [FASB Issues 14(a) and 14(b)]

TIC believes that the Board's preference for the modified IVM is not sufficiently justified and is based on inaccurate assumptions, stated primarily in paragraphs C70 – C72 of the ED. Paragraph C70 states that the modified intrinsic value method is superior to the minimum value alternative in SFAS No. 123. Although unclear as written, the Board seems to be justifying its claim on both conceptual and cost/benefit considerations. TIC does not find these arguments convincing.

The Board admits that both methods are flawed since neither method incorporates expected volatility into the measurement of fair value. In an attempt to correct a second flaw in the original IVM (the failure to recognize an option's time-value component), the Board is asking nonpublic companies to obtain the fair value of their shares every year so as to recalculate the intrinsic value at each reporting date. However, the MVM currently used by nonpublic companies already incorporates the time value component as acknowledged in IFRS 2, Basis for Conclusions, paragraph BC 82:

The minimum value measurement basis captures part of the time value of options, being the value of the right to defer payment of the exercise price until the end of the option's term.

TIC compared the conceptual attributes of the two methods and concluded that the modified IVM still has a significant flaw.

The IVM as described in the ED overstates compensation expense over the life of the option thereby penalizing the income statements of those nonpublic companies that need to look to an alternative valuation method. Under the MVM in SFAS No. 123, subsequent changes in the price of the stock did not affect compensation cost. In the modified IVM, changes in the fair value of the award from year-to-year until settlement are charged or credited directly to compensation cost. This would seem inconsistent with the Board's objectives.

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TIC understands that the allocation between equity and compensation cost is an important objective of the Board. The potential for overstatement of compensation cost under the IVM method would seem to be at least as flawed as the understatement of compensation cost that may occur under the MVM.

Contrary to the assumptions stated in the ED, TIC maintains that the cost effectiveness of the MVM is far superior to the modified IVM. The FASB ED, paragraph C47, states that the modified IVM was adopted, in part, "...to mitigate the incremental costs of complying with this Statement." TIC does not foresee that the IVM will achieve this objective. The share-based payment award would need to be revalued every year, which would be an expensive, additional cost for most nonpublic companies. Under the MVM, the award would be valued only at the grant date and allocated to future years based on the vesting period.

Furthermore, paragraph C70 erroneously implies that most nonpublic companies that issue share-based awards to employees do so regularly and therefore would be accustomed to calculating intrinsic value for their shares. Given these assumptions, these companies would easily adjust to the IVM option both in terms of cost and ease of use. As TIC indicated in its letter to the Board on the ITC, the majority of nonpublic companies do not issue these awards on a regular basis, do not have a future plan to go public, rarely have recent transactions in their stock, and have previously used nothing more than management's best estimate of the market value of the stock at the grant date. In these cases, management's best estimate was highly subjective and not based on an objective assessment of what the company was worth.

In paragraph C70, the Board further assumes that nonpublic companies would incur little additional cost because "the variable accounting method required by Opinion 25 for certain share options was the same as the intrinsic value method required by this Statement." In TIC's collective experience, use of the variable plan accounting method under APB 25 among nonpublic companies was not prevalent. Generally, it is used to account for plan changes only, which would generally occur infrequently for most companies.

Paragraph C70 also contains an argument in favor of the cost benefit of the IVM based on its similarity to calculations that are necessary for tax purposes. TIC believes that the Board places too much weight on the fact that:

...the final measurement of compensation cost under the intrinsic value method in this Statement is the same as the measure of the related income tax deduction for nonqualified options under current U.S. tax law.

The tax law requires that the employer measure the tax deduction in the year that the employee exercises the option. The above statement implies that employees will be exercising options in most years, and the employer would therefore be measuring the intrinsic value of the shares in each of those years for tax purposes. Employees do not

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exercise options routinely in many nonpublic companies. At best, employees may exercise options one to three times in 10-15 years. Since the tax deduction would be calculated infrequently, it is not a valid example of how the modified IVM would be a cost effective alternative to the MVM.

For the reasons outlined above, TIC believes that the modified IVM will not provide more reliable data to users and will not be more cost-effective for preparers to implement. While we applaud the Board's efforts to provide an alternative valuation method, TIC does not understand how changing from one flawed method to another at added cost will be in the best interests of constituents or accomplish the Board's objectives. TIC requests that the Board reconsider the rationale underlying its preference for the modified IVM apart from the international convergence objective.

The Issue of Volatility in Measuring Fair Value of Share Options for Nonpublic Entities [FASB Issue 4(b)]

Paragraph C72 of the ED encourages nonpublic entities to use the fair value methods outlined in the ED over either the IVM or the MVM. The Board supports the concept that a reasonable estimate of fair value could be obtained for a nonpublic company because estimates of expected volatility were attainable. To support this argument, the Board cites the opinion of its Option Valuation Group, which stated:

[M]any nonpublic entities could consider internal and industry factors likely to affect volatility, and the average volatility of comparable entities, to develop an estimate of expected volatility.

This view directly contradicts SFAS No. 123, paragraphs 174 and 178, respectively, which state:

However, the Board recognizes that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. [Paragraph 174]

The use of minimum value by nonpublic entities is a practical solution to the difficulties of estimating expected volatility for a nonpublic entity. [Paragraph 178]

When the above comments were written, they were considered sufficient justification to exempt all nonpublic entities from the fair value requirement. In TIC's view, more reliable or easier ways of determining expected volatility for private companies have not been developed in recent years. The estimation techniques cited in the ED existed when SFAS No. 123 was issued and were considered unreliable. For example, paragraph B16 of the ED states that expected volatility could be estimated for many nonpublic companies by referring to "the average volatilities of otherwise similar public entities."

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TIC believes that the use of public company volatility data is seldom a reliable proxy for non-public company volatility data. This opinion is supported by Shannon Pratt, Robert Reilly and Robert Schweihs in their widely used text *Valuing a Business* (McGraw Hill, 4th Edition, 2000):

When valuing the options of a privately held company, reliable historical prices are not available. Using the price series of a comparable public company to estimate the volatility factor may not be an acceptable proxy.

In addition, TIC disagrees with the conclusions in paragraph C22, which compare the estimation of volatility with estimating depreciation and health care cost increases. Estimates of the latter are similar across all businesses both public and private. Volatility, on the other hand, can vary greatly across and within industries and even within the same company over time.

The difficulties in estimating expected volatility lead to more difficulties for auditors in auditing these calculations. For example, if a company is looking for a buyer, it could decide to artificially inflate volatility assumptions to inflate the fair value of the share-based payments. The subjectivity of valuation engagements is such that several significantly different, yet supportable, valuation assumptions can be made for a particular company. The auditor would then be in a difficult position if it were necessary to challenge a client on a valuation. TIC believes that special audit guidance may be needed to help auditors avoid these conflicts. Of course, as the complexity of the audit effort increases so will the audit costs.

If certain nonpublic companies have the ability to measure expected volatility, then we support the use of the fair value methods outlined in the ED. However, given the continued problems in estimating expected volatility, TIC believes that most nonpublic companies will continue to look to an alternative measurement method. This is why retention of the MVM over the inferior IVM is critical. IVM does not incorporate expected volatility, will not be cost-effective to apply and distorts compensation cost over time.

Transition Issues

If the modified IVM is retained, TIC believes that nonpublic companies should be allowed to switch from the IVM to the fair value method on a retrospective basis, assuming that the company can develop the appropriate data over time. TIC understands that Illustration 21 (paragraph B183) of the ED would prohibit retrospective application of the fair-value-based method to unvested awards at the date that a company voluntarily or involuntarily changes to the “preferable method” because estimating the grant-date fair value of unvested awards would involve “significant estimates by management.” (Paragraph C69 explicitly states that the fair value method is preferable for purposes of justifying a change in accounting principle.)

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In effect, TIC believes the ED arbitrarily delays the adoption of a more preferable accounting method in its presumption that appropriate estimates would be impossible to develop. TIC is concerned that an unintended consequence of the ED is that the entity would potentially have to report materially misstated amounts of compensation cost over the life of a share-based payment award.

Although this restriction would not affect most nonpublic entities that issue share-based payment awards and is not typical of most of our constituents, it may have a negative impact on certain entities that may want to go public in the future.

The following example may serve to illustrate the issue: New entities that issue stock options will have no “track record” and for this and possibly other reasons will generally opt to use the IVM. Assume a new entity adopts a ten-year option plan. Assume a portion of the share-based award is granted within the first three years and that, during that time, the company develops a track record for its share price. The track record would consist of the annual valuations of the company’s stock which could be used, in part, to estimate its volatility. The company believes it could now switch to the fair value method for the share options that are yet to be granted under the plan and retrospectively apply the fair value method to all options that have been granted previously and are outstanding. However, the ED requires the company to continue using the IVM for the options that have been granted in the first three years.

In TIC’s view, the entity should be allowed to re-measure the option using the fair value method if the appropriate data is available. Otherwise, compensation expense continues to increase throughout the life of the award in an inappropriate and artificial manner (and, TIC believes, contrary to the Board's objectives). The ED effectively penalizes companies with limited experience or no track record by forcing them to make a one-time accounting choice that can’t be changed for an award-in-progress even when better measurement methods are possible that allow for a reasonable estimate of the grant date fair value. Given the limited discussion on this point in the ED, TIC was unclear as to why the Board believes that these grant-date estimates would be any more unreliable than future estimates of compensation cost that are made at the grant date. TIC requests that the Board conduct further research and reconsider this provision

Understandability of the ED [FASB Issue 18]

TIC requests that clarifying guidance be provided on the example in Appendix B on the lattice binomial method. The example does not provide enough information to understand how the answer was derived. Given the complexity of the model, clarity in the example will be essential to understanding the principles of the model and how to apply it.

In addition, TIC believes that more guidance is needed to clarify the accounting for employee stock purchase plans. Illustration 20 (Paragraphs B180-B182) addresses the compensatory v. noncompensatory classification of employee share purchase plans, but based on the guidance in the ED, TIC was uncertain whether stock purchase plans of

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nonpublic companies could use the IVM outlined in the ED. TIC requests that this be clarified in the final standard.

A second issue in the accounting for employee stock purchase plans arises when a company has an employee stock purchase plan as well as a nonqualified stock option plan with fixed terms. TIC believes that the entity should be allowed to choose the appropriate valuation method for each share-based compensation arrangement. For example, a stock purchase plan may be difficult to value using the fair-value-based method, however a company may be able to determine the fair value of the nonqualified plan. TIC could not determine from the ED whether the accounting for each plan may be evaluated separately. TIC noted that the last sentence of Illustration 21 (paragraph B183), which discusses accounting changes to the fair-value-based method, implies that each award is evaluated separately in terms of the company's ability to reasonably estimate fair value. TIC recommends that the guidance for employee stock purchase plans be enhanced to explicitly address accounting options that are available to the company regarding the valuation of multiple share-purchase plans.

Additional guidance will be especially important given the new rules outlined in Paragraphs 9 and C77 of the ED that dramatically reduce the number of stock purchase plans that may be considered noncompensatory. Many companies will be adopting valuation methods for the first time and will need the new rules to be as clear as possible.

FASB Concessions to Nonpublic Entities

TIC applauds the FASB for including in the ED a number of concessions to the issues faced by small businesses that provide stock compensation to their employees. Many of these concessions are consistent with the recommendations made in TIC's 2003 comment letter and during subsequent face-to-face meetings with Board members. Specifically, the ED

- Acknowledges that no one particular option pricing model would have to be used for all share-based compensation;
- Permits an alternative valuation model for nonpublic companies. (Although TIC does not agree with the method chosen, TIC acknowledges the Board's willingness to consider alternatives);
- Retains the provisions in SFAS No. 123 regarding the accounting for forfeitures. That is, no compensation cost is recognized for the estimated number of options that will be forfeited;
- Allows for the prospective adoption of the standard for nonpublic entities that used the minimum value method for either recognition or pro forma disclosure purposes;
- Allows nonpublic entities a one-year delayed effective date;
- Provides many helpful examples.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

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Sincerely,

Stephen M. McEachern, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees