

Letter of Comment No: 3076 File Reference: 1102-100

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June 7, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: Exposure Draft of a Proposed Statement of Financial Accounting Standards, Share-Based Payment (File Reference No. 1102-100)

Dear Ms. Bielstein:

We appreciate the opportunity to provide the Financial Accounting Standards Board ("FASB" or "Board") with a summary of our initial views on its Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (the "ED"). This summary is provided to facilitate our proposed participation in the roundtable discussion scheduled for June 29, 2004. We will submit our detailed response letter by the June 30, 2004 due date indicated in the ED.

### **Recognition of Compensation Cost**

We support the Board's efforts to require the recognition of compensation cost for the fair value of equity instruments granted to employees in exchange for the services provided by such employees. We believe that equity instruments granted to employees are a form of compensation and should be recognized in a company's results of operations. We also believe that the alternative permitted in FASB Statement No. 123, Accounting for Stock-Based Compensation ("FAS 123"), to disclose rather than recognize compensation cost should not be retained in the new standard because it is not conceptually sound as disclosure is not a substitute for recognition

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#### Measurement Attribute and Measurement Date

We accept the Board's proposed conclusion on the use of the modified grant date method. While we were originally supportive of a "pure" grant date model, we recognize and accept the Board's retention of the modified grant date model due to the unresolved valuation issues inherent in a "pure" grant date model (such as valuing performance awards). We also believe that the modified grant date method provides an acceptable solution to address the recognition of compensation cost for awards that do not vest.

#### Fair Value Measurement

We agree with the Board that the relevance of financial statements will be improved by recording an expense for the fair value of employee stock options. However, we continue to have concerns regarding the reliability of fair values determined by the use of an option-pricing models, such as binomial or Black-Scholes models. We agree with the Board that binomial models address certain issues that exist in closed form models, such as Black-Scholes. However, we note that binomial models also have potential issues to be addressed including the complexity of those models and the costs to implement. Despite our concerns, we support the Board's conclusion to recognize compensation cost of the fair value of employee stock options.

We believe that the Board should not indicate that one model (the binomial) is preferable (or arguably required) relative to another model. We observe that our view is consistent with the approach in International Financial Reporting Standards 2, Share-based Payment. The Board's current deliberations on the proposed standard Fair Value Measurements summarize its conclusions on the hierarchy of valuation techniques used to measure fair value, but the Board has not indicated a preference for a specific valuation technique within a given level of the hierarchy. The proposed standard on Fair Value Measurements would provide preparers discretion in the selection of a valuation technique within a given level of the hierarchy. We believe that such flexibility regarding the selection of optionpricing models is consistent with the Board's tentative conclusion in the proposed standard Fair Value Measurements and should be included in the final standard on Share-Based Payment. Such flexibility will allow preparers to assess the costs and benefits of all available models given their unique circumstances. We recommend that the Board continue its research efforts regarding valuation techniques to determine if there are other models that could be adapted to address the characteristics of employee stock options. We also recommend that the proposed Standard permit preparers to consider the use of models that may be developed in the future. Additionally, we generally believe that the Board has provided sufficient guidance regarding the assumptions to be used in an option-pricing model.

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We also agree with the Board that disclosure of the assumptions and model selected is critical for users of financial statements to understand management's decisions in estimating the fair value of awards granted.

#### **Income Taxes and Cash Flows**

The Board's underlying logic related to the accounting for income taxes for employee stock options has persuaded us to change our view regarding this subject. While we agree with the Board that the income tax accounting method established by FAS 123 should not be carried forward, we believe that the accounting model for income taxes proposed in the ED is inconsistent with certain principles of FASB Statements No. 95, Statement of Cash Flows ("FAS 95") and No. 109, Accounting for Income Taxes ("FAS 109") and may be impractical because of the complexities of the proposed model.

We support the ED's approach whereby a deferred tax asset is recognized based upon the compensation expense recorded for financial reporting purposes and is then not adjusted until the award is settled (absent certain potential impairment considerations). However, contrary to the approach in the ED, we would propose an accounting model under which all adjustments necessary to account for differences between the tax effect of the compensation cost recognized for financial reporting purposes and the tax benefit of the actual deduction realized upon settlement of an award (i.e., both "windfalls" and "shortfalls") are recorded as part of income tax expense in the statement of operations.

We believe that our proposed model is consistent with the broad principles of FAS 109 and is analogous to the treatment of other "permanent" differences. For example, the tax law measures statutory depletion in a different manner than is done for financial reporting purposes and the tax benefit for statutory depletion is recorded in the period in which the additional depletion is deductible on the tax return. The accounting issues for statutory depletion are very similar to the accounting issues regarding income tax accounting for employee stock options. We believe that these transactions should be accounted for consistently. Additionally, we believe that our proposed accounting model better reflects the different measurement basis between book and income tax accounting for a share based award and, accordingly, would be more intuitive to users of financial statements.

We also believe our proposed accounting model is simpler to apply. For example, we believe that the model proposed in the ED would lead to a significant number of implementation issues regarding "backwards tracing" of the settlement of option awards and is an exception to the general principle regarding intraperiod tax allocation under FAS 109. Our approach would eliminate the need for an additional exception to FAS 109 in situations where "windfall" benefits are lodged within net operating loss carryforwards.

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Our model is also more consistent with FAS 95 because it retains the principle that all tax activity be recorded through the operating section of the statement of cash flows.

### **Transition**

We agree with the Board's transition proposals to use the modified prospective method for public companies and the prospective method for nonpublic companies. We also believe that both public and nonpublic companies should be allowed to restate previously issued financial statements, if they so choose, by recording the amounts that they previously disclosed in accordance with the requirements of FAS 123 as is currently permitted by FAS 148. This would also entail allowing nonpublic companies the ability to restate using the minimum value method under the provisions of FAS 123 and FAS 148. Additionally should a nonpublic company elect to restate, we believe that it should be required to use the modified prospective method to recognize the unvested portion of any awards outstanding at the effective date of the proposed standard.

### **Nonpublic Companies**

We believe that nonpublic companies, similar to public companies, should be required to adopt a fair value approach in order to provide greater consistency across all entities and because exceptions to a principles-based approach should be kept to a minimum.

### **Effective Date**

We are concerned with the proposed timing for the release of the final standard and the proposed effective date for calendar year end public companies. We believe that the Board should select an effective date that reflects not only the need to issue standards in a timely manner, but also allows preparers and their auditors sufficient time to ensure that new standards are implemented with high quality. Under the proposed timing for the release of the final Standard, preparers will have only a limited time to address the valuation issues arising from using a binomial model, as well as to develop the systems to record compensation cost and to individually track the tax effects of their option awards. We believe that a high quality implementation of the proposed standard will provide the capital markets with better and more useful information than if the Board issues the final Standard providing limited time for preparers to address implementation issues.

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#### **Additional Comments**

We expect to issue a detailed response letter by June 30, 2004. Our response letter will include comments on other areas of the ED where we believe the Board could provide additional clarity on how to implement the proposed standard. Among other things, our comments will principally focus on the definition of requisite service period, differentiating between liability and equity awards, accounting for modifications, and expected volatility.

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We commend the Board for its efforts in preparing this ED and support the Board's intention to require the recognition of compensation cost for employee stock options.

We appreciate the opportunity to express our views and to participate in the roundtable discussion on June 29, 2004. In the interim, if you have any questions regarding our comments, please contact Dave Kaplan at (973-236-7219) or Ray Beier at (973-236-7440).

Very truly yours,

PricewaterhouseCoopers LLP