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Letter of Comment No: 3082  
File Reference: 1102-100

**Microsoft**

June 7, 2004

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

Re: File Reference No. 1102-100

Dear Sue:

Microsoft appreciates the opportunity to respond to the Exposure Draft (ED), "Share-Based Payment". We commend the FASB for their fortitude in trying to resolve this issue and agree with the comment that enough emotional, political, and economic capital has been spent on it. However, it is critical that the FASB perform an objective, in-depth analysis of the comments received on the ED.

Microsoft has two main concerns with the ED: the accounting for tax consequences of instruments awarded to employees, and the recognition of compensation costs for awards with graded vesting schedules.

#### Income Taxes

Microsoft strongly believes that employee share-based payment transactions consist of two components, a transaction in which employees render services as consideration for share-based awards and an equity transaction. Accordingly, the tax benefit recognized in the income statement should be based on the compensation cost recognized in the income statement and any excess tax deduction or shortfall resulting from the vesting of stock awards or the exercise of share options should be recognized as an adjustment to additional paid-in capital. This approach also provides the benefit of ensuring symmetry between the treatment of excess tax benefits and shortfalls and greatly reduces the administrative cost imposed in implementing the proposed standard, as preparers would not be required to separately track deferred tax assets at the individual employee level for each instrument granted.

Consistent with the view that employee share-based payments consist of a transaction in which employees render services as consideration for share-based awards and an equity

transaction, tax deductions from the vesting of stock awards or the exercise of share options should be reported entirely as financing cash inflows. The rendering of service for stock-based awards is a noncash transaction and we do not believe that any of the tax benefits from the vesting of stock awards or the exercise of share options should be reported as operating cash inflows.

#### Awards with Graded Vesting Schedules

We disagree with the conclusion that an award with a graded vesting schedule should be accounted for as separate awards. An award with graded vesting is in fact a single award, not a series of linked awards, and compensation costs for such awards should be recognized on a straight-line basis. We also strongly believe that is the way they are viewed by employees.

In the Basis for Conclusions in the ED, the Board concluded that it is not feasible to measure directly the fair value of employee services received in exchange for employee share options or other equity instruments, that is, the amount for which the services would be exchanged in the marketplace. Thus, the amount of the related compensation cost must be based on the fair value of the instruments issued as compensation for those services. We agree with this conclusion, but believe the underlying conceptual argument is that the fair value of the instrument issued is being used as a surrogate to value the services received, because the fair value of the instrument issued is more readily determinable than the fair value of the services received. Consistent with this underlying conceptual argument, we struggle with the notion that more compensation costs should be attributed to the early portion of the vesting period and less attributed to later portions of the vesting period.

For example, consider a grant of stock awards to an employee that vest over a five-year period, with 20% of the awards vesting each year. Under the ED, 46% of the compensation cost would be recognized in the first year, 26% in the second year, 15% in the third year, 9% in the fourth year, and 4% in the fifth year. We find it difficult to understand why the employee's service in the first year is almost twice as valuable as the service in the second year, three times more valuable than the third year, five times more valuable than the fourth year, and over ten times more valuable than the fifth year.

Our comments on the specific issued raised in the ED are attached. If you have any questions, please do not hesitate to contact me at (425) 703-6094.

Sincerely,

Bob Laux  
Director, Technical Accounting and Reporting

## 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.*

*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?*

Response: Microsoft believes that employee services received in exchange for equity instruments give rise to compensation costs and those costs can be measured with sufficient reliability such that they should be recognized in the financial statements.

## 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?*

Response: Yes, Microsoft believes that fair value is the relevant measurement attribute and grant date is the relevant measurement date, as that is the date both parties come to a mutual agreement on the terms of the arrangement.

## 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?*

Response: Yes, the Statement’s discussion of the appropriate valuation techniques, the assumptions to be used, and discussion of factors impacting those assumptions provide sufficient guidance for fair value to be measured with reasonable consistency.

*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?*

Response: Yes, as previously indicated, we believe the fair value of employee share options can be measured with sufficient reliability and that a lattice model is preferable as long as information is available to provide appropriate input into the model.

*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.*

Response: Microsoft agrees with the guidance on expected volatility in the Implementation Guidance and does not believe the Board should require a specific method of estimating expected volatility.

*Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options should be considered in estimating their grant-date fair value. For example, to take into account the nontransferability 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.*

Response: Yes, we believe the guidance in the proposed Statement gives appropriate recognition to the unique characteristics of employee share options.

*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, we believe the current requirements of FAS 123 should be retained such that if it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost should be the fair value based on the first date at which it is possible to reasonably estimate that value. Compensation costs for periods during which it is not possible to determine fair value should be based on the

current intrinsic value of the award. It appears from the Basis for Conclusions that the Board made this change due to abuse concerns, which we do not believe is the proper approach in establishing accounting standards. However, we do agree with the Board that there should be few instances where a public entity would not be able to reasonably estimate the fair value of an option or other equity instrument at the grant date.

### **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?*

Response: We agree with the Board's conclusion that transactions with employees in their roles as employees should result in the recognition of compensation cost.

### **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?*

Response: Microsoft agrees that compensation cost should be recognized over the period in which employee services are provided.

*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?*

Response: We believe the guidance provided 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?*

Response: Microsoft disagrees with the conclusion that an award with a graded vesting schedule should be accounted for as separate awards. An award with graded vesting is in fact a single award, not a series of linked awards, and compensation costs for such awards should be recognized on a straight-line basis. We also strongly believe that is the way they are viewed by employees.

In the Basis for Conclusions in the ED, the Board concluded that it is not feasible to measure directly the fair value of employee services received in exchange for employee share options or other equity instruments, that is, the amount for which the services would be exchanged in the marketplace. Thus, the amount of the related compensation cost must be based on the fair value of the instruments issued as compensation for those services. We agree with this conclusion, but believe the underlying conceptual argument is that the fair value of the instrument issued is being used as a surrogate to value the services received, because the fair value of the instrument issued is more readily determinable than the fair value of the services received. Consistent with this underlying conceptual argument, we struggle with the notion that more compensation costs should be attributed to the early portion of the vesting period and less attributed to later portions of the vesting period.

### **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.*

Response: Yes, the principles are appropriate.

### **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?*

Response: No, Microsoft strongly believes that employee share-based payment transactions consist of two components, a transaction in which employees render services as consideration for share-based awards and an equity transaction. Accordingly, the tax benefit recognized in the income statement should be based on the compensation cost recognized in the income statement and any excess tax deduction or shortfall resulting from the vesting of stock awards or the exercise of share options should be recognized as an adjustment to additional paid-in capital. This approach also provides the benefit of ensuring symmetry between the treatment of excess tax benefits and shortfalls and greatly reduces the administrative cost imposed in implementing the proposed standard, as preparers would not be required to separately track deferred tax assets at the individual employee level for each instrument granted.

## **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.*

Response: No, the disclosure objectives set forth are not appropriate. We are confused by the objective that the potential effects of stock-based compensation arrangements on shareholders (for example, the transfer of value from existing shareholders to option holders upon option exercise) be disclosed. In our opinion, the effect of stock-based compensation arrangements on shareholders is the compensation expense recognized in the income statement. Accordingly, for those entities recognizing the fair value of stock-based compensation as expense, we fail to see the need for the extensive disclosures of intrinsic value.

## **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?*

Response: We believe that entities should be permitted to elect retrospective application upon adoption since that application maximizes comparability between periods.

### **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?*

Response: Yes, as long as it is not practicable for nonpublic entities to estimate the fair value of stock-based compensation.

*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?*

Response: In general, we believe any exceptions to the provisions of this Statement should be based on a practicability exception which includes the notion of excessive costs.

### **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?*

Response: Only if those entities meet a practicability exception as discussed above.

## 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?*

Response: Consistent with the view that employee share-based payments consist of a transaction in which employees render services as consideration for share-based awards and an equity transaction, tax deductions from the vesting of stock awards or the exercise of share options should be reported entirely as financing cash inflows. The rendering of service for stock-based awards is a noncash transaction and we do not believe that any of the tax benefits from the vesting of stock awards or the exercise of share options should be reported as operating cash inflows.

## 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?*

Response: No, the Board should not consider adopting the accounting treatment prescribed in IFRS 2, as the purpose of convergence is to arrive at the highest quality standard, not to converge just for the sake of agreement.

## 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?*

Response: Yes.