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Ms. Suzanne Bielstein
Director—Major Projects and Technical Activities
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
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Letter of Comment No: 3072
File Reference: 1102-100

Dear Ms. Bielstein:

BDO Seidman, LLP is pleased to submit this summary of our views on the Exposure Draft (ED), *Share-Based Payment*, in preparation for the Roundtable at the end of June. We intend to submit a supplemental letter on the ED responding to the Issues for Respondents by the June 30 comment letter deadline.

We agree with many of the FASB's principal conclusions in the ED that:

- There should be just one method of accounting for share-based payments to employees,
- APB Opinion No. 25, *Accounting for Stock Issued to Employees*, has become an obsolete model, both in its use of intrinsic value to measure the compensation from option grants and in its arbitrary distinction between fixed and variable plans,
- Grants to employees should be classified as liabilities or as equity instruments based on the guidance in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, rather than some unique framework for employee awards,
- The compensation cost of equity grants to employees should be measured at grant date and recorded over the service period,
- The modified grant date approach is the most appropriate way to deal with service and performance conditions, and
- The compensation cost from option grants should be derived from an option-pricing model.

However, there are number of areas in which we believe the ED could be improved. We have divided our suggestions into those pertaining to option valuation, other accounting matters, and disclosure.

Option Valuation Issues

Expected volatility. We continue to be troubled, as we were in our comments on the Invitation to Comment, about the ability of employers to estimate the expected volatility of their stock price. The ED puts employers in an untenable position by stating that unadjusted historical volatility is inappropriate, but that adjustments to historical volatility should be "reasonable and supportable." In most cases, we suspect that the adjustments to historical volatility will be subjective and judgmental and difficult to substantiate/audit. For example, if an employer concludes that the stock market bubble of 1997-2000 and the subsequent bear market, including the terrorist attack of September 11, 2001 and the war in Iraq, are abnormal periods, and that pre-1997 historical volatility is the mean to which volatility will revert, would that be "reasonable and supportable?" What about an otherwise similar employer who concludes that bull and bear markets are normal phenomena? Forcing employers to estimate expected volatility, when objective techniques for doing so don't exist, will sustain an illusion that options are being measured at fair value. We believe it would be better to forthrightly acknowledge that expected volatility (and, as a result, fair value) can't be objectively estimated, and permit employers to use zero volatility (minimum value). If the Board finds that unpalatable, then permit employers to use a standardized volatility measure, like the average volatility of the Standard & Poor's 500 index.

If the Board retains the requirement to estimate volatility, we suggest adding to the factors in paragraph B25 the implied volatility of the share price estimated from the market prices of the employer's convertible securities, if any. The calls embedded in convertible securities typically have long terms, which would make them indicators of market expectations about volatility over extended periods.

Binomial model. We have several comments regarding the binomial model.

- The binomial model should not be required. We find the ED ambiguous about whether the binomial model is preferable, or required, for employers who have the necessary data. Some paragraphs seem to say that the binomial method is preferable; others seem to say that it is required. Because the binomial model is more costly to apply than Black-Scholes, we believe employers always should have the choice, even if they have the necessary data. In addition, while the binomial model offers the possibility of better estimates of fair value than Black-Scholes, it also offers the possibility of deliberately minimizing the estimated values. The FASB expresses a jaded view of the motives of some employers in paragraph C67 (dealing with inability to estimate fair value), and then throws the barn doors wide open to abuse with the binomial model.
- The relevance of group data to estimating the fair value of individual options. For the most part, the ED calls for employers to value each individual option grant. In applying the binomial model, however, the Board permits employers to use the past behavior of groups of employees to estimate the behavior of each individual

employee. We wonder whether that approach truly results in the fair value of each individual option. If an employer were to pay an outside party to assume its obligation under an individual employee option, would the outside party set its fee (premium) based on group data, or would it make more conservative assumptions about the behavior of that individual employee? We agree that group experience should be considered, because we believe it will result in a better estimate of the aggregate compensation cost for the entire employee population. However, we question whether that approach provides a good estimate of the fair value of each individual option grant. We recommend that the Board explain better the relevance of using group data to estimate individual option values.

- Guidance on statistical significance of employee exercise data. Assuming that past group behavior is relevant to valuing individual options, we believe that the group behavior should be considered only if the group is large enough to have statistical significance. The ED as drafted does not make this point clearly. Paragraph B11 refers to enterprises that "lack the historical data" or do not have "a significant history of share option exercise." Paragraph B22 refers to "sufficient information." Paragraph B23 refers to "aggregating individual awards into relatively homogenous groups." Nowhere does the ED explicitly link sufficiency of information to statistical concepts. We recommend that a discussion of statistical significance be added to the final Statement.

Private company intrinsic value alternative. The ED offers private companies the alternative of measuring compensation for option grants using intrinsic value measured at the exercise date. The stated rationale is to spare private companies the cost of running option-pricing models. We agree with offering private companies a lower cost alternative, but we believe this alternative is inappropriate. Instead, the alternative should be a grant date model for equity awards. For equity awards, the Board believes that fair value at grant date is the best way to measure the compensation cost of options. The proposed private company alternative, by comparison, uses an inferior method (intrinsic value) on an inferior date (exercise). We believe it would be more logical for the lower cost alternative to retain the preferred date (grant) and adjust the model to be less costly. Our first preference would be to retain the minimum value alternative of FASB Statement No. 123. That alternative comes closer to the preferred grant date fair value method, giving private companies specific relief on the most difficult assumption—expected volatility. If the Board finds zero volatility unpalatable, then another approach would be to specify a standardized volatility for private companies, such as the average volatility of the Wilshire 5000 index.

We would further observe that for a private company that makes relatively infrequent option grants, the Board's alternative might not even offer lower cost. The exercise date method requires annual valuations of the company's shares; some companies may have no other reason to perform annual valuations. Such annual valuations may be more costly than running an option-pricing model once, at grant date.

Other Accounting Issues

Requisite service period begins before grant date. The ED identifies two situations in which the requisite service period begins before the grant date: (1) some term of the option, such as exercise price, is not fixed initially, but the employee begins providing services, or (2) the employee begins providing services before the option is approved by the relevant authority. The ED specifies the same accounting for both situations—begin accruing compensation cost at the beginning of the requisite service period. We believe the two situations are fundamentally different, and that the proposed accounting is totally inappropriate in situation 2. Instead, in situation 2, no compensation cost should be accrued until the relevant authority approves the award. If an employee begins providing services knowing that his option grant is subject to nontrivial approval, he is knowingly rendering service in exchange for the authorized compensation only. Once the option grant is approved, the terms of the exchange shift, and services are now being exchanged for all of the authorized compensation. We believe the Board would establish an undesirable precedent by requiring accounting recognition for unapproved transactions. Furthermore, requiring accounting recognition for unapproved transactions is inconsistent with the approach in other recent FASB Statements, such as Nos. 144 and 146.

Under the accounting in the ED, a company would debit compensation cost and credit shareholders' equity before the approval of the grant. We do not know how to explain or justify either side of that journal entry. At a recent meeting, a member of the FASB staff suggested that the accounting is based on promissory estoppel, although that rationale appears nowhere in the ED. In the situations described in the ED, promissory estoppel seems irrelevant. If an employee begins working knowing that his option grants are subject to shareholder approval of an option plan, and the shareholders reject the plan, whom would the employee sue and what claim would he have?

Noncompensatory plans. The ED proposes that employee equity plans would be compensatory unless they meet two conditions: (1) substantially all employees participate on an equitable basis and (2) its terms are no more favorable than those available to shareholders generally. We agree with the first condition, but believe the second condition should be changed to focus on the employer (the issuer of the financial statements) rather than its shareholders. We recommend that the second condition should be that the proceeds the employer receives are not less than the proceeds it would receive in an offering of shares to independent investors. As applied to common fact situations, and assuming that the first condition is satisfied:

- If a public company offers shares to employees (no option features), the plan would be compensatory if the proceeds received were less than the proceeds from an underwritten public offering of shares.
- If a private company offers shares to employees (no option features), the plan would be compensatory if the proceeds received were less than the proceeds from a private offering of shares.

- If a company offers options to employees, the plan would be compensatory if the proceeds received were less than the proceeds from an offering of similar options to investors.

Accounting for income taxes. We agree with two aspects of the proposed accounting for income taxes—that an employer should record a deferred tax asset as it accrues compensation expense and that the test of realizability of deferred tax assets should ignore the current stock price. After basing compensation cost on a grant date measurement, it would be inappropriate to introduce earnings volatility from quarterly movements in the stock price via the income tax provision. However, in other respects we disagree with the proposed approach.

As we stated in our comments on the Invitation to Comment, we believe the Board errs in characterizing the income tax deduction as being partially a compensation deduction and partially a deduction for a capital transaction. U.S. tax law generally does not give deductions for capital transactions. The tax deduction for options and nonvested stock is entirely a compensation deduction. This is more obvious for nonvested stock, where no sale of shares occurs. Depending on an employee's election regarding nonvested stock, compensation is deductible either at grant or when the restrictions lapse. For options, the deduction is triggered by exercise, but the deduction is for compensation, not for the issuance of shares. Thus, we believe the entire tax benefit should be recorded in earnings, and no part should be recorded as a credit to capital.

If the Board wishes to retain the notion that the deduction has two parts, then we believe a more appropriate approach would be to measure the compensation part of the deduction equal to the compensation cost for financial reporting purposes, and attribute the differential, either positive or negative, to a capital transaction. The Board's approach, that the compensation portion of the tax deduction is the lesser of the actual tax benefit or the compensation cost for financial reporting, seems illogical. The compensation portion of the tax deduction should be based either on tax law or on the compensation cost for financial reporting; it makes no sense to say it is the lesser of the two.

The ED requires the shortfall for each individual option grant to be charged to income tax expense, and prohibits the long-standing practice of charging capital to the extent of prior credits. The ED explains that each option grant is accounted for individually, and that netting a shortfall against excess credits from other grants is inappropriate. As we observed previously in this letter, the ED does not truly account for each grant individually, because it permits the use of group experience to value individual option grants. It seems inconsistent to estimate the fair value of grants based on group experience, but then require strict segregation of tax benefits by individual grant.

Modifications. The ED provides extensive guidance on accounting for modifications. However, we are uncertain about the proper accounting for a common modification—

vesting a nonvested grant held by a terminating employee. We have identified three possibilities:

- Acceleration of vesting. Proponents of this view believe that the transaction is an acceleration of vesting. Accordingly, no new measurement of compensation is necessary, but catch-up amortization of the compensation measured at grant date is necessary.
- Forfeiture and new grant. Proponents of this view believe that the original grant is forfeited and that the act of vesting is, in substance, a new grant. They believe that the employer should reverse the compensation expense for the forfeited grant and estimate the fair value of the new grant. However, they believe that the compensation to be recorded for the new grant cannot be less than the grant date fair value of the original, forfeited award.
- Modification. Proponents of this view believe that the original grant is modified. They would accelerate the amortization of the compensation measured at the grant date of the original award. In addition, they would compare the fair value of the modified award before and after the modification and accrue the incremental fair value as additional compensation. If before the modification the award were out of the money, it would have zero fair value (because it is being forfeited). As a result, the full fair value after modification would be recorded as compensation in addition to the original grant date fair value.

We believe the second possibility is the correct treatment, but we are not sure. Therefore, we suggest that the discussion of modifications be clarified to explain the underlying concepts better. We also suggest adding this common transaction to the illustrations.

Disclosure Issues

Reduce intrinsic value disclosures. The proposed disclosures include extensive information about the intrinsic values of outstanding awards. We believe the intrinsic value disclosures should be eliminated, for several reasons:

- Unnecessary information. Under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, employers who continue to follow the less preferable intrinsic value method provide pro forma disclosure of earnings and earnings per share under the preferable fair value method. Under the ED, employers will apply the preferable fair value method. It is unnecessary to disclose information about the less preferable intrinsic value method.
- Clutters general-purpose financial statements. We understand that some professional users of financial statements believe that intrinsic value provides them with useful information. If that is the case, then companies can provide the information in statistical supplements for analysts, rather than cluttering their general-purpose financial statements with information that is useless, or confusing, to most readers.

- Perpetuates obsolete ideas about compensation. Many surveys of executive compensation treat the intrinsic value of options exercised and nonvested stock released from restrictions as compensation for that year. Effectively, those surveys report the accumulated share price appreciation on several years' grants as compensation in a single year. This is inappropriate and misleading. The ED appropriately focuses on the value of awards in the year they are granted. While the FASB cannot single-handedly correct a generation of misconceptions about executive compensation, the Board should not "fan the flames" by requiring prominent disclosure of information that is so frequently misused.

Disclosure of expected term. The ED requires disclosure of significant assumptions, including the expected term of share options. If an employer uses a lattice model, paragraph B20 states that: "Expected term then could be estimated based on the output of the resulting lattice." Footnote 16 to that paragraph suggests that for disclosure purposes, the estimated fair value from the lattice model could be used as an input to a closed-form model to solve for the expected term. If an employer were to follow that advice, what expected volatility would it use as an input to the closed-form model?

A Freestanding Statement

The ED is drafted as if it will be issued as FASB Statement No. 123 (Revised). We recommend that the final Statement should be a freestanding document (FASB Statement No. 15X) that supersedes Statement 123. While the format of the ED may have been helpful in highlighting changes from Statement 123, the document is disorganized and hard to use. To find an answer to a question, it often is necessary to look in three different places. In addition, if the final Statement is issued as 123 (Revised), the paragraph numbering will be confusing. FASB Statement No. 132 (Revised) and FASB Interpretation No. 46 (Revised) flow reasonably well because they track the original documents so closely. This document is ill suited to such an approach.

We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,

s/ BDO Seidman, LLP