

Letter of Comment No: 59
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November 4, 2002

Director of Major Projects and Technical Activities
File Reference No. 1101-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Re: Proposed Statement on Accounting for Stock-Based Compensation – Transition and Disclosure

We are pleased to respond to the Financial Accounting Standards Board's (FASB's) Exposure Draft of the proposed Statement, *Accounting for Stock-Based Compensation – Transition and Disclosure* (October 4, 2002).

We agree with the Board's decision to permit alternative transition methods for companies that elect to adopt the fair value method for purposes of recognizing stock-based compensation expense. We also agree with the requirement to provide quarterly disclosures of the amount of expense that would have been recognized had the fair value method been adopted as that disclosure would provide investor's with important information on a timelier basis. We do not believe the argument that comparability will be impaired as a result of permitting multiple transition methods has merit since the FASB is not mandating *adoption* of the fair value method in this proposed Statement. Therefore, since companies will continue to report results from operations using the intrinsic value method, comparability will not be any more impaired by virtue of giving companies that want to adopt the fair value method more choices in how to adopt. Permitting the multiple transition alternatives allows companies to adopt the fair value method in such a way as to avoid the ramp up effect that would result from adopting under the prospective method but does not penalize those companies who elected to adopt the fair value method prior to the Board's decision to take on this project using the prospective method.

We do not believe the requirement to provide pro forma disclosures in the summary of significant accounting policies footnote is necessary, nor do we understand why the FASB believes this pro forma disclosure, above all others, should appear in that footnote. We do not believe presenting the pro forma information in the summary of significant accounting policies footnote is consistent with the purpose of that note, which is to provide the user of the financial statements with an understanding of the accounting policies followed by the reporting entity. Paragraph 12 of APB Opinion No. 22, *Disclosure of Accounting Policies*, provides that companies "should identify and describe the accounting principles followed ... and the methods of applying those principles" While we acknowledge the importance of stock-based compensation to users of financial statements, the information to be presented in the summary footnote is already available in the footnotes, albeit in a slightly different form. Further, the importance of that information has not increased. In fact, the FASB acknowledged the importance of stock-based compensation to users of financial statements at the time FASB Statement No. 123,

Accounting for Stock-Based Compensation, was issued, but chose not to mandate where the pro forma information should be presented. We see no compelling reason for requiring that information to be presented in the summary of significant accounting policies footnote at this time. We are aware that certain constituents have argued that the pro forma information required by Statement 123 is not readily accessible, primarily because it is buried deep in the footnotes. However, since the information is available, we do not believe that is a sufficient reason to mandate its presentation in the summary of significant accounting policies footnote.

The remainder of this letter addresses items that we believe should be considered prior to issuance of the final Statement.

Amendments to Transition Provisions

The discussion in proposed paragraph 52b indicates that the “modified prospective” method applies to all awards granted, modified, or settled subsequent to the effective date of Statement 123, whether or not those awards are vested as of the beginning of the year in which the fair value method is adopted. This conclusion is different from our understanding of the Board’s decision when deliberating this project and is inconsistent with the discussion in paragraphs A10 and A12 of Background Information and Basis for Conclusions, which indicate that the fair value method would be applied to the unvested portion of previously-issued awards, as well as new awards granted after the beginning of the year in which the fair value method is adopted. We have the same question on the transition method discussed in proposed paragraph 52c. The FASB should clarify whether the method specified in proposed paragraph 52b should only apply to awards where any portion is unvested as of the beginning of the year of adoption and, if that is not the case, should clarify the discussion in the basis for conclusions related to that proposed transition method.

If the Board believes the “modified prospective” method should require a company adopting the fair value method using that transition method to determine the fair value of all awards granted, modified, or settled subsequent to the effective date of Statement 123, it should discuss the reasons for the difference in the excess tax credit determined under that method from the excess tax credit determined under the “modified retrospective” method in proposed paragraph 52c. Since proposed paragraphs 52b and 52c both require a company to determine the compensation cost to be recognized for all awards granted, modified, or settled in fiscal years after December 15, 1994, it would seem that the excess tax credits would be the same under the two approaches.

Amendments to Disclosure Provisions

We believe the tabular presentation of the pro forma information required in proposed paragraph 45c would be less confusing if only the net difference between compensation expense determined in accordance with the provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and the expense that would have been determined under Statement 123 was presented. Under that presentation method, the net difference of zero would be reflected in the table under the column for 2003 as opposed to having the same number added in and then subtracted out. As pro forma information is intended to show what results would have been had a particular accounting principle been applied, it does not make sense to present the gross reconciling items as being pro forma information for a period in which the fair value method has been applied to all awards (for example, the year of adoption for a company that elects to transition to the fair value method using the modified prospective method). We are not sure what incremental benefit is achieved by a presentation in which the number added back to net income as reported is the same as the number deducted to arrive at pro forma net income and believe that

providing a reconciliation for a period in which the fair value method has been fully applied will be confusing and potentially misleading.

Illustrative Guidance

While the illustrations provided are helpful, we believe you should also provide an illustration of the transition adjustment for a company that elects to adopt using either the modified prospective or modified retroactive methods. We have provided examples based on our understanding of the transition adjustments that would be required under those methods as Attachment I to this letter.

Other Matters

We do not believe disclosures about the classification of stock-based employee compensation in the income statement would be particularly useful information to investors because stock-based compensation is only one component of total compensation cost reflected in the financial statements. In addition, since most companies following Opinion 25 structure their stock-based awards so as to result in no compensation expense, if the disclosure is required, it will likely only impact those companies that have adopted the fair value method. Therefore, it is unlikely that the disclosure will make companies financial statements more comparable. In addition, companies currently have the ability to provide information about stock-based compensation expense on the face of the income statement, but tend to do so only when they want to highlight for investors the significance of non-cash compensation charges.

We believe the concern over stock-based compensation is directed at the value being transferred to executive officers of a company. As such, information about the percentage of total awards of stock-based compensation to executive officers of the company may be more useful information for investors than the classification of stock-based compensation expense.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to John Archambault at (312) 602-8701.

Very truly yours,

Grant Thornton LLP

Attachment I

Example 1 - Stock Appreciation Rights

XYZ Company grants stock appreciation rights (SARs) to certain employees on January 1, 20X1 based on 100,000 shares. The stated price of \$10 per share is equal to the fair market value of the stock on that date.

The SARs provide the employees with the right to receive, at the date the rights are exercised, shares having a market value equal to the market appreciation since the grant date of the rights. The employees do not have the ability to receive a cash payment. All of the rights vest (e.g., become exercisable) at the end of three years and must be exercised no later than the end of the fifth year.

XYZ Company elects to adopt the fair value method for recognizing expense associated with its stock-based compensation arrangements on January 1, 20X3. XYZ Company elects the modified prospective method for transitioning to the fair value method.

As of December 31, 20X2, XYZ Company has recognized the following amounts related to the January 1, 20X1 grants:

	<u>20X1</u>	<u>20X2</u>
Compensation expense ¹	66,667	66,667
Deferred tax benefit @ 50%	33,333	33,334

As of December 31, 20X2, XYZ Company has recognized a deferred tax asset of \$66,667, deferred compensation of \$66,666, and has increased additional paid in capital by \$200,000.

The fair value of the SARs on the grant date was \$2.10 per share, or \$210,000. Had XYZ Company applied the fair value model from the grant date, it would have recognized the following amounts related to the January 1, 20X1 grants:

	<u>20X1</u>	<u>20X2</u>
Compensation expense	70,000	70,000
Deferred tax benefit @ 50%	35,000	35,000

Under the fair value method, XYZ Company would have recognized a deferred tax asset at December 31, 20X2 of \$70,000 and an increase in additional paid in capital of \$140,000.²

¹ Compensation expense for 20X1 and 20X2 is based on a market price of \$12 per share at December 31, 20X1 and 20X2. As of December 31, 20X1 and 20X2, one-third and two-thirds, respectively, of the vesting schedule had lapsed.

² Under FASB Statement No. 123, paragraph 30, neither deferred compensation (contra equity) nor additional paid in capital is recognized on the grant date. Additional paid in capital is increased as compensation expense is recognized.

When XYZ Company adopts the fair value method, it will record the following adjustment to the beginning balances:

Deferred tax asset	3,333	
Additional paid in capital	63,333	
Deferred compensation		66,666

Example 2 - Stock Appreciation Rights

LMN Company grants stock appreciation rights (SARs) to certain employees on January 1, 20X1 based on 100,000 shares. The stated price of \$10 per share is equal to the fair market value of the stock on that date.

The SARs provide the employees with the right to receive, at the date the rights are exercised, shares having a market value equal to the market appreciation since the grant date of the rights. The employees do not have the ability to receive a cash payment. All of the rights vest (e.g., become exercisable) at the end of three years and must be exercised no later than the end of the fifth year.

LMN Company elects to adopt the fair value method for recognizing expense associated with its stock-based compensation arrangements on January 1, 20X3. LMN Company elects the modified prospective method for transitioning to the fair value method.

As of December 31, 20X2, LMN Company has recognized the following amounts related to the January 1, 20X1 grants:

	20X1	20X2
Compensation expense ³	66,667	333,333
Deferred tax benefit @ 50%	33,333	166,667

As of December 31, 20X2, LMN Company has recognized a deferred tax asset of \$200,000, deferred compensation of \$200,000, and has increased additional paid in capital by \$600,000.

The fair value of the SARs on the grant date was \$2.10 per share, or \$210,000. Had LMN Company applied the fair value model from the grant date, it would have recognized the following amounts related to the January 1, 20X1 grants:

	20X1	20X2
Compensation expense	70,000	70,000
Deferred tax benefit @ 50%	35,000	35,000

Under the fair value method, LMN Company would have recognized a deferred tax asset at December 31, 20X2 of \$70,000 and an increase in additional paid in capital of \$140,000.

³ Compensation expense for 20X1 is based on a market price of \$12 per share at December 31, 20X1. Compensation expense for 20X2 is based on a market price of \$16 per share at December 31, 20X2. As of December 31, 20X1 and 20X2, one-third and two-thirds, respectively, of the vesting schedule had lapsed.

When LMN Company adopts the fair value method, it will record the following adjustment to the beginning balances:

Additional paid in capital	330,000	
Deferred compensation		200,000
Deferred tax asset		130,000

Example 3 – Stock option grant

ABC Company grants its employees options on 100,000 shares on January 1, 20X0 at \$5.50 per share. The quoted market price on January 1, 20X0 is \$10 per share. The options become exercisable five years from the grant date. If an employee terminates before the end of 20X4, the option granted to that employee is cancelled.

ABC Company elects to adopt the fair value method for recognizing expense associated with its stock-based compensation arrangements on January 1, 20X3. ABC Company elects the modified retrospective method for transitioning to the fair value method. The earliest year for which an income statement will be presented in ABC Company's financial statements for the period of adoption is 20X1.

As of December 31, 20X2, ABC Company has recognized the following amounts related to the January 1, 20X0 grants:

	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
Compensation expense ⁴	90,000	90,000	90,000
Deferred tax benefit @ 50%	45,000	45,000	45,000

As of December 31, 20X2, ABC Company has recognized a deferred tax asset of \$135,000, deferred compensation of \$180,000, and has increased additional paid in capital by \$450,000.

The fair value of the options on the grant date was \$6.00 per share, or \$600,000. Had ABC Company applied the fair value model from the grant date, it would have recognized the following amounts related to the January 1, 20X1 grants:

	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
Compensation expense	120,000	120,000	120,000
Deferred tax benefit @ 50%	60,000	60,000	60,000

Under the fair value method, ABC Company would have recognized a deferred tax asset at December 31, 20X2 of \$180,000 and an increase in additional paid in capital of \$360,000.

When ABC Company adopts the fair value method, it will record the following adjustment to the beginning balances as of January 1, 20X1:

Deferred tax asset	15,000	
Additional paid in capital	345,000	
Deferred compensation		360,000

⁴ Compensation expense is based on straight-line amortization of the intrinsic value of \$450,000 (\$10 market price per share - \$5.50 per share exercise price) determined on the measurement date.

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ABC Company will then restate its reported results for 20X1 and 20X2 to reflect additional compensation expense of \$30,000 in each period, with a corresponding increase to additional paid in capital. In addition, ABC Company will increase its recorded deferred tax asset at the end of each year by \$15,000, with a corresponding increase in the deferred tax benefit \$15,000.