

Microsoft Corporation  
One Microsoft Way  
Redmond, WA 98052-6399

Tel 425 882 8080  
Fax 425 936 7329  
<http://www.microsoft.com/>



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

Letter of Comment No: 253  
File Reference: 1102-001  
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Re: File Reference No. 1102-001

Dear Sue:

Microsoft appreciates the opportunity to respond to the Invitation to Comment (ITC), "Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed IFRS, *Share-based Payment*". We commend the FASB staff for what we believe is a thorough and well written ITC. In connection with drafting our response to this ITC, we are also in the process of drafting a response to the IASB's Exposure Draft (ED). In drafting our response to that ED, we found ourselves confused on a number of the proposals and, instead of referring to the ED's Basis for Conclusions and Implementation Guidance, we found ourselves referring to the ITC for the much needed clarity. Going forward, this ITC should serve as the model for comparing U.S. GAAP to proposals from the IASB. In addition, as indicated in the ITC that the FASB is not seeking comments on certain issues at this time, this response letter does not comment on whether stock options granted to employees results in compensation expense for the issuing entity.

As indicated in FASB Concepts Statement 2, *Qualitative Characteristics of Accounting Information*, relevance and reliability are the two primary qualities that make accounting information useful for decision making. However, as also indicated in CON 2, comparability is a quality that interacts with relevance and reliability to contribute to the usefulness of information. Microsoft is a strong proponent of principles-based accounting standards and we believe that the amount of interpretive and implementation guidance in accounting standards to try to ensure comparability between entities is the biggest culprit in driving much of the detail and complexity in current accounting standards. However, we do recognize that the relative weight to be given to relevance, reliability, and comparability must vary according to circumstances.

We are aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options at grant date and believe it is incumbent on the FASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Given this comparability issue, Microsoft believes that an accounting standard should mandate an option-pricing model for valuation purposes that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

Microsoft believes that expected volatility should be excluded from the current Statement 123 calculation of the fair value of an employee stock option for public entities, similar to the current Statement 123 calculation for nonpublic entities. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life under Statement 123, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account in Statement 123 when valuing employee stock options, such as the effect of blackout periods.

In addition, excluding volatility for public entities would create a level playing field with nonpublic entities under Statement 123. While not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. Accordingly, we are opposed to the IASB's requirement that all entities include expected volatility in calculating the fair value of employee stock options. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy for estimating share price volatility.

Also, Microsoft is strongly opposed to the IASB's units-of-service method and the IASB requirement that all of the tax benefits derived from stock-based compensation arrangements be recognized in the income statement. Our comments on those issues as

well as our responses to the other primary issues raised in the ITC are attached. If you have any questions, please do not hesitate to contact me at (425) 703-6094.

Sincerely,

Bob Laux  
Director, External Reporting

*Issue 1: Statement 123 provides a scope exclusion for ESOPs and certain ESPPs, and the Proposed IFRS does not. Which view do you support and why?*

Response: Microsoft supports the IASB's view. With respect to ESPPs and in the spirit of principles-based standards, if these rights given to employees are truly immaterial, there is not a need for a specific exclusion.

*Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions.*

*Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?*

Response: As indicated in FASB Concepts Statement 2, *Qualitative Characteristics of Accounting Information*:

*Relevance and reliability* are the two primary qualities that make accounting information useful for decision making. Subject to constraints imposed by cost and materiality, increased relevance and increased reliability are the characteristics that make information a more desirable commodity — that is, one useful in making decisions. If either of those qualities is completely missing, the information will not be useful. Though, ideally, the choice of an accounting alternative should produce information that is both more reliable and more relevant, it may be necessary to sacrifice some of one quality for a gain in another.

However, as also indicated in CON 2, comparability is a quality that interacts with relevance and reliability to contribute to the usefulness of information:

Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the applicability of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

Microsoft is a strong proponent of principles-based accounting standards and we believe that the amount of interpretive and implementation guidance in accounting standards to try to ensure comparability between entities is the biggest culprit in driving much of the detail and complexity in current accounting standards. However, we do recognize that the

relative weight to be given to relevance, reliability, and comparability must vary according to circumstances.

Microsoft is aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options and we believe it is incumbent on the FASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Accordingly, at the present time and as elaborated upon in our response to the following subissues, Microsoft believes an accounting standard should mandate the use of an option-pricing model for measurement purposes. However, the FASB should continuously monitor developments in this area and revisit this requirement if it becomes apparent that other methods become acceptable that do not cause significant comparability issues.

*Issue 2(b): If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why?*

Response: Microsoft believes that an accounting standard should mandate an option-pricing model that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate. Again, consistency and comparability between entities weighs heavily upon our position on this issue. Our reasons for excluding the expected volatility of the underlying stock are discussed in the subissue below.

*Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?*

Response: Disclosures should include the option-pricing model used and the inputs to the model.

*Issue 2(d): Statement 123 and the Proposed IFRS require that certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required.*

Response: Microsoft believes that expected volatility should be excluded from the current Statement 123 calculation of the fair value of an employee stock option for public entities,

similar to the current Statement 123 calculation for nonpublic entities. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life under Statement 123, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account in Statement 123 when valuing employee stock options, such as the effect of blackout periods.

In addition, excluding volatility for public entities would create a level playing field with nonpublic entities under Statement 123. While not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. Accordingly, we are opposed to the IASB's requirement that all entities include expected volatility in calculating the fair value of employee stock options. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy in estimating share price volatility.

*Issue 2(e): Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas?*

Response: Microsoft believes that an in-depth discussion of the factors and the use of examples with specific fact patterns would be useful guidance in trying to provide added consistency and comparability of reported results. For instance, guidance such as the items to consider when estimating the expected life of an option along with fact specific examples would be useful.

*Issue 3: Do you believe that employee and nonemployee transactions are distinct and, therefore, warrant different measurement dates for determining the fair value of equity instruments granted? If so, why? If not, why not?*

Response: While we believe employee and nonemployee transactions are somewhat distinct, the fair value for both transactions should be determined at the grant date, as the complexity inherent in guidance such as EITF Issue No. 96-18 is not justified based on the somewhat limited distinction between these two types of transactions. To be quite frank, we do not believe the use of stock options for nonemployee transactions is all that prevalent as to justify the time and effort that has been expended debating this issue.

*Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not?*

Response: Yes, as we would hope both counterparties to the transaction would have thoroughly considered the performance conditions before entering into such a transaction.

*Issue 5: Do you believe the notion of issuance is conceptually of importance in the design of a standard on stock-based compensation? If so, why? If not, why not?*

Response: Yes, Microsoft believes that if an accounting standard defers to the expected value of options to be issued in measuring services received, the notion of whether the options are actually issued is conceptually important.

*Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined by Statement 123, at the grant date? If so, why? If not, why not?*

Response: No, equity instruments are not issued until the issuer has received valuable consideration in exchange for the equity instruments.

*Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimate of fair value per equity instrument (IASB approach)? If so, why? If not, why not?*

Response: As indicated previously, we believe there are a number of items that could be incorporated into the estimate of fair value per equity instrument. However, with regards to the important issues of consistency and comparability, Microsoft believes that an accounting standard should mandate an option-pricing model that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

*Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that award? If so, why? If not, why not?*

Response: Absolutely, if an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instruments, we fail to see a recognition event requiring recording in the financial statements.

*Issue 9: Do you agree that the result of the IASB's approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value? If so, why? If not, why not?*

Response: We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account when valuing employee stock options. Also, while not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy in estimating share price volatility.

*Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why?*

Response: The attribution method prescribed by Statement 123. While there are a number of reasons we believe the attribution method prescribed by Statement 123 is more representationally faithful, it is also important that standard setters recognize the complexity inherent in the IASB's units-of-service method. As indicated in the FASB's Proposal, "Principles-Based Approach to U.S. Standard Setting", an increase in the complexity of accounting standards negatively impacts the quality and transparency of financial accounting and reporting. For instance, we observe that it takes ten pages (noting the actual standard is only sixteen pages) to provide four examples with somewhat straight forward fact patterns for the IASB to try and explain the units-of-service method in their ED. In addition, the FASB found it necessary to provide yet more examples in the ITC in order to illustrate the difference between the two standards.

*Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not?*

Response: Microsoft is strongly opposed to the IASB's units-of-service method.

*Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by an enterprise? If so, why? If not, why not?*

Response: Yes, if an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instruments, we fail to see a recognition event requiring recording in the financial statements.

*Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not?*

Response: Yes, for reasons elaborated upon above.

*Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not?*

Response: The fair value for transactions with employees and nonemployees should be determined on the grant date, as the complexity inherent in the guidance in EITF Issue No. 96-18 is not justified based on the somewhat limited distinction between these two types of transactions.

*Issue 15: Do you believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not?*

Response: No, when realized tax benefits from equity awards differ from the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference should be directly recorded to additional paid-in capital. This is consistent with paragraph 35 of FASB Statement No. 109, *Accounting for Income Taxes*, which indicates the following:

Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders . . . The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

Accordingly, the income tax benefit reflected in the income statement related to stock-based compensation should be based on the expense for stock-based compensation actually recognized in the income statement. Assuming there are no discontinued operations or extraordinary items, any differences between the tax benefit recognized on the income statement and the actual income tax benefit received should be recorded directly to shareholders' equity.

*Issue 16: As discussed in paragraph 83 of this Invitation to Comment, the Proposed IFRS expands on the disclosure requirements in Statement 123. Do you believe that those expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?)*

Response: The incorporation in the IASB ED of financial reporting disclosures currently required under Statement 123 indicates to us a lack of a 'clean sheet' approach in examining what information would be most informative to users of financial statements. For instance, if standard setters decide that the fair value of stock options should be recognized in the financial statements based on grant date fair value using an option pricing model, we fail to see the need for the extensive disclosure of the weighted average exercise price of options outstanding at a particular point in time. The earnings per share footnote already provides information on the dilutive effect of stock options and we find it somewhat curious that if standard setters reject intrinsic value as a measurement of the fair value of stock options, that disclosures that convey that information would still be so prevalent.

*Issue 17: Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.*

Response: With respect to Statement 123 and entities that elect to estimate at grant date the amount of equity instruments expected to be forfeited, we believe a disclosure of the percentage of equity instruments expected to be forfeited would be useful for purposes of comparability between entities.