

Karen Salmansohn

From: Len Tatore
Sent: Monday, February 03, 2003 1:30 PM
To: Karen Salmansohn
Subject: FW: Revised Commr

Letter of Comment No: 176
File Reference: 1102-001
Date Received: 2-1-03

Importance: High



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Karen, a revised comment letter.

Len

-----Original Message-----

From: Donald G. DeBuck [mailto:ddebuck@csc.com]
Sent: Monday, February 03, 2003 1:30 PM
To: Len Tatore
Cc: Director - FASB
Subject: Revised Comment Letter - File Reference No. 1102-001

We would like to replace the previously submitted Exhibit to our comment letter regarding the Invitation to Comment on the Financial Accounting Standards Board's Accounting for Stock Based Compensation: a Comparison of FASB Statement No. 123, "Accounting for Stock Based Compensation", and Its Related Interpretations, and International Accounting Standards Board ("IASB") proposed International Financial Reporting Standards ("IFRS"), "Share Based Payment," File Reference No. 1102-001. The attached Exhibit includes certain typographical corrections. We have again attached our comment letter, as well, for your convenience although there are no changes to the letter itself. Thank you again for the opportunity to comment on this issue.

Feel free to contact me at 310.615-1686 for any questions that you may have.

Sincerely,

Donald G. DeBuck
Vice President and Controllor
Computer Sciences Corporation

(See attached file: FASB Invitation for Comment Stock Options.doc)

(See attached file: FASB Invitation for Comment Stock Options Exhibit.doc)

February 1, 2003

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

Re: File Reference No. 1102-001

FILED ELECTRONICALLY (director @fasb.org)

Dear Ms. Bielstein,

We appreciate the opportunity to respond to this Invitation to Comment on the Financial Accounting Standards Board's ("FASB" or "the Board") Accounting for Stock-Based Compensation: a Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and International Accounting Standards Board ("IASB") proposed International Financial Reporting Standards ("IFRS"), *Share-Based Payment*. This letter summarizes our views on differences between Statement 123 and the proposed IFRS. Additionally, we have also included some of our general concerns regarding stock-based compensation.

We support efforts by the Board to improve U.S. financial accounting and reporting standards and to promote international convergence of high-quality accounting standards. Although we acknowledge employee stock options have value, we oppose the IASB proposal to mandate recognition of compensation expense in the income statement in accordance with the "fair value" method. We think recognizing option grants as an expense will not provide more useful or meaningful financial information to readers of financial statements, as employee stock option information is already disclosed in the footnotes. On the contrary, it will distort the profile of a company's financial performance, since current option pricing models do not accurately reflect the fair value of employee stock options. Also, expensing employee stock options will distort investor understanding of after tax cash flows, as employee stock options, unlike other expenses, will never call for an outlay of assets.

Current Disclosure

Currently, companies are required to disclose detailed data about option grants in the footnotes to their financial statements, providing investors information to evaluate the impact of the option grants on the company's overall capital structure and financial performance. In addition, entities electing to stay with the APB Opinion No. 25 "intrinsic value" method are required to disclose pro forma information as if the "fair

value” method had been used. Moreover, the impact of “in the money” options is included in the diluted earnings per share calculations through the share base.

Limitation of Current Valuation Models

Current option pricing models do not accurately reflect the fair value of employee stock options with any reasonable degree of precision and, in many cases, may be materially inaccurate and will likely tend to overstate compensation expense. Even the widely used Black Scholes model has highly publicized drawbacks. For example, the Black Scholes model does not take into account the direction of stock price movement when calculating volatility. That is, negative volatility has the same effect on valuation as positive volatility. Accordingly, if a company’s stock price experiences negative volatility due to overall market fluctuations, the model will attribute a higher fair value to the options, even though the negative movements of the stock price do not increase the likelihood such options will be exercised. In addition, studies indicate that employee option exercise patterns do not follow the Black Scholes model assumptions for risk aversion, maturity, transferability and liquidity. Generally, we think the Black Scholes model will overestimate the value of employee options and resulting compensation. For example, the time value of the Black Scholes model generally assumes it is never a good strategy to exercise the option early. However, according to a study conducted by Credit Suisse First Boston, employee exercise behavior indicates employees typically exercise options sooner than assumed under the Black Scholes model, on average, foregoing 24% of the Black Scholes calculated value. Further, employee stock options generally have a longer term than exchange-traded options. With a longer term, they are more difficult to value accurately since estimates are based on several variables, including expected volatility, expected dividend yield and risk free rate, which can fluctuate significantly during the course of the term, especially as demonstrated in recent years.

Inconsistency with Changes in Cash Flow

We think company’s earnings should closely correlate with cash flow from operations over time. Theoretically, net income should equate to cash flow from operations over the life of a corporation. Employee stock options will never result in any operating cash outflow. Conversely, options result in positive cash flow from exercise proceeds and associated tax savings. Thus, expensing options which depresses income while cash flow is actually increasing will distort investor understanding of after tax cash flows.

We understand the idea of expensing employee stock options in financial statements may appeal to investors in the wake of recent corporate financial misstatements and frauds characterized by allegations of executive misconduct. However, we do not think expensing employee options will deter fraudulent business practices, executive irresponsibility or misleading financial reporting. Rather, we need to reinforce ethical business practices and executive leadership, responsible governance, compliance with existing reporting requirements and effective internal controls to avoid such corporate scandals. We are concerned that, because of the pressure from the general public, companies are rushing to expense stock options in their financial statements, the effect of which may actually diminish the accuracy and transparency of financial reporting.

In addition to our general views on expensing stock options, we also have provided a summary of our more significant comments, concerns and suggestions regarding the comparison between Statement 123 and the proposed IFRS in the following paragraphs. The attached Exhibit includes our detailed response to each request for comment in the Invitation to Comment.

Mandate the Use of an Option-Pricing Model

We agree the accounting standard should mandate one option-pricing model to promote consistency and comparability. However, as indicated above, we think there is no option-pricing model currently available that is appropriately designed to properly reflect compensation expense. Even the widely accepted Black Scholes model is far from ideal and the inherent limitations of the model will distort the profile of a company's financial performance.

Modifications to the Outcome of an Option Pricing Model

Due to the differences between employee stock options and exchange-traded options, we think the following features of employee stock options have to be addressed: nontransferability, expected life, liquidity and volatility assumptions. In addition, guidance concerning assumptions related to these features should be provided to enhance consistency and reliability of outcomes.

Effect of Forfeitures

We agree that the effect of forfeitures must be incorporated in the recognition of compensation expense associated with options granted. However, contrary to the IASB suggested approach, we think previously recognized compensation expense should be adjusted based on the actual options exercised through the end of the vesting period. Based on the notion of issuance adopted by Statement 123, compensation expense should reflect the value of equity instruments ultimately issued (that is, total options awarded less forfeitures). As such, companies should reverse over-accrual of compensation expense due to underestimation of forfeiture rates. It is conceptually unsound to require a company to recognize expense for employee services never received or to recognize cost for unexercised options of terminated employees. Moreover, since forfeiture rates are affected by the stock price and many other factors, they are difficult to estimate. It is unreasonable to penalize companies for incorrectly underestimating forfeiture rates, while rewarding those which forecast higher forfeiture rates.

Furthermore, the recognition of compensation expense associated with stock options should be consistent with compensation recognized for other types of compensation plans. For example, assume a company promises to pay an employee deferred compensation after two years of service, rather than awarding nontransferable stock options of an equal value with a two-year vesting period. If an employee leaves the company after one year, the company will reverse previously accrued deferred compensation expense. We think it is inappropriate and inconsistent to reverse compensation expense in one case, but not the other. In short, we agree with the approach under Statement 123. The company should be allowed to estimate expected

forfeitures at the grant date, with subsequent adjustments if actual forfeitures differ from estimates.

Performance Based Compensation

Analogous to the treatment of forfeitures, compensation expense should be adjusted based on actual outcome of performance awards. Compensation expense for a performance award should be adjusted for subsequent performance through the vesting date. We think this approach is more nearly consistent with the issuance concept under Statement 123.

Measurement Date Criteria

We think the modified vesting-date approach established under EITF Issue No. 96-18 (Issue No. 96-18) most accurately reflects the economic substance of transactions with nonemployees. Under Issue No. 96-18, if the value of the equity instruments granted is more reliably measurable, fair value should be measured using the stock price for the equity instruments granted as of the measurement date which is defined to be the earlier of the performance commitment date or the performance-completion date. We think this approach, which recognizes the transaction in the same period and in the same manner as if the enterprise had paid cash for the goods or services received, is more consistent with other existing accounting standards and more accurately represents the economic substance of such transactions with nonemployees.

Deferred Tax Benefits

Under Statement 123, a company credits the portion of realized tax benefits from equity awards that exceed the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized directly to additional paid-in capital. Comparing to the IASB proposed approach which requires such a difference to be recognized in the income statement, Statement 123 is more appropriate and more nearly consistent with FASB Statement 109, *Accounting for Income Taxes*. We think exercise of stock options simply converts one form of equity interest into another. As a result, tax benefits arising from the exercise of stock options are directly attributable to contributed capital and, therefore, such tax benefits should not be recognized in the income statement consistent with the principles applicable to accounting for income tax expense under FASB Statement 109. Further, we think the current tax deductions taken by employers, which is symmetrical to tax paid on compensation by employees, should be kept intact.

We think expensing options using an imperfect pricing model will not provide better financial information for investors. On the contrary, it will distort the profile of a company's financial performance. Until there is a model that can more accurately measure the fair value of stock options and reliably account for the economic substance of the compensation, we recommend retention of the "intrinsic value" method. In addition, we think stock options are a cost effective compensation method, which aligns employee interests with shareholder value. Stock options assist companies in attracting talented personnel and have contributed in a very significant way to the unprecedented economic prosperity in the United States. Expensing options will discourage companies from using this effective compensation method to recruit and retain qualified employees.

Rather than expensing options, we think expanded disclosure could serve as a viable alternative. In fact, with the recently issued FASB Statement No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, the Board has addressed the comparability of accounting for stock-based compensation by requiring disclosure of comparable information by all companies, and has improved the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods.

We thank you for the opportunity to express our views in this letter. If you have any questions regarding our comments, please feel free to contact me at (310) 615-1686.

Sincerely,

Donald G. DeBuck
Vice President and Controller

Exhibit

**Financial Accounting Standards Board (“FASB”)’s Accounting for Stock-Based Compensation: a Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and International Accounting Standards Board (“IASB”) proposed IFRS, Share-Based Payment Reference File No. 1102-001
Invitation for Comment**

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?

We support the view of IASB to include ESOPs and ESPPs in the scope. We do not think there is a conceptual difference between using options for compensation in ESOPs / ESPPs and using options for compensation in other employee stock purchase plans. Therefore, they should be subject to the same standards and rules.

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?

Although we acknowledge employee stock options have value, we oppose the IASB proposal to mandate recognition of compensation expense in the income statement in accordance with the “fair value” method. We think current option pricing models do not accurately reflect the fair value of employee stock options with any reasonable degree of precision and, in many cases, may be materially inaccurate and will likely tend to overstate compensation expense. Even the widely used Black Scholes model has highly publicized drawbacks. For example, the Black Scholes model does not take into account the direction of stock price movement when calculating volatility. That is, negative volatility has the same effect on valuation as positive volatility. Accordingly, if a company’s stock price experiences negative volatility due to overall market fluctuations, the model will attribute a higher fair value to the options, even though the negative movements of the stock price do not increase the likelihood such options will be exercised. In addition, studies indicate that employee option exercise patterns do not follow the Black Scholes model assumptions for risk aversion, maturity, transferability, and liquidity. Generally, we think the Black Scholes model will overestimate the value of employee options and resulting compensation. For example, the time value of the Black Scholes model generally assumes it is never a good strategy to exercise the option early.

However, according to a study conducted by Credit Suisse First Boston, employee exercise behavior indicates employees typically exercise options sooner than assumed under the Black Scholes model, on average, foregoing 24% of the Black Scholes calculated value. Further, employee stock options generally have a longer term than exchange-traded options. With a longer term, they are more difficult to value accurately since estimates are based on several variables, including expected volatility, expected dividend yield and risk free rate, which can fluctuate significantly during the course of the term, especially as demonstrated in recent years.

As detailed information regarding options granted has already been disclosed by companies in footnotes, we think expensing options using an imperfect pricing model will not provide better financial information to investors. On the contrary, it will distort the profile of a company's financial performance. Until there is a model that can more accurately measure the fair value of stock options and reliably account for the economic substance of the compensation, we recommend the retention of the "intrinsic value" method.

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?

Yes, we agree the accounting standard should mandate one option-pricing model to promote consistency and comparability. However, as indicated above, we think there is no option-pricing model currently available that is appropriately designed to properly reflect compensation expense. Even the widely accepted Black Scholes model is far from ideal and the inherent limitations of the model will distort the profile of a company's financial performance.

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?

N/A.

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.

Due to the differences between employee stock options and exchange-traded options, we think the following features of employee stock options have to be addressed: nontransferability, expected life, liquidity and volatility assumptions. In addition,

guidance concerning assumptions related to these features should be provided to enhance consistency and reliability of outcomes.

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?

Refer to our response to Issue 2 (d).

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?

We think the modified vesting-date approach established under EITF Issue No. 96-18 (Issue No. 96-18) most accurately reflects the economic substance of transactions with nonemployees. Under Issue No. 96-18, if the value of the equity instruments granted is more reliably measurable, fair value should be measured using the stock price for the equity instruments granted as of the measurement date which is defined to be the earlier of the performance commitment date or the performance-completion date. We think this approach, which recognizes the transaction in the same period and in the same manner as if the enterprise had paid cash for the goods or services received, is more consistent with other existing accounting standards and more accurately represents the economic substance of such transactions with nonemployees.

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?

CSC has no experience in granting stock options to parties other than employees or directors, so we are not in a position to assess whether the fair value of equity awards granted to nonemployees that include complex contractual performance conditions can be measured with sufficient reliability to justify a grant-date measurement method.

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?

Yes, we think the notion of issuance is very important in the design of a standard on stock-based compensation, because it provides the conceptual basis necessary to appropriately incorporate forfeitures and account for performance-based awards.

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?

We think the approach adopted by Statement 123 is more faithful to the economic substance of stock-based compensation arrangements. Since equity instruments subject to service or performance conditions essentially represent conditional obligations to issue equity instruments in exchange for valuable consideration at a later date, companies should be allowed to reverse or adjust compensation expense based on the actual number of options exercised by employees.

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?

We agree that the effect of forfeitures must be incorporated in the recognition of compensation expense associated with options granted. However, contrary to the IASB suggested approach, we think previously recognized stock option compensation expense should be adjusted based on the actual options exercised through the end of the vesting period. As mentioned above, based on the notion of issuance adopted by Statement 123, compensation expense should reflect the value of equity instruments ultimately issued (that is, total options awarded less forfeitures). As such, companies should reverse over-accrual of compensation expense due to underestimation of forfeiture rates. It is conceptually unsound to require a company to recognize expense for employee services never received or to recognize cost for unexercised options of terminated employees. Moreover, since forfeiture rates are affected by the stock price and many other factors, they are difficult to estimate. It is unreasonable to penalize companies for incorrectly underestimating forfeiture rates, while rewarding those which forecast higher forfeiture rates.

Furthermore, the recognition of compensation expense associated with stock options should be consistent with compensation recognized for other types of compensation plans. For example, assume a company promises to pay an employee deferred compensation after two years of service, rather than awarding nontransferable stock options for a equal value with a two-year vesting period. If this employee leaves the company after one year, the company will reverse previously accrued deferred compensation expense. We think it is inappropriate and inconsistent to reverse compensation expense in one case, but not the other. In short, we agree with the approach under Statement 123. The company should be allowed to estimate expected forfeitures at the grant date, with subsequent adjustments if actual forfeitures differ from estimates.

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 reward? If so, why? If not, why not?

Yes, we think failure of an award holder to satisfy the conditions that entitle them to retain the promised benefits should affect the amount of compensation expense that should be recognized related to that reward. As indicated above, we think companies should be permitted to adjust stock options compensation expense based

on the actual number of options exercised through the vesting period, since companies do not realize the benefit of future employee services or have enforceable rights to such services until the awards are vested.

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?

No, we do not 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. As we mentioned in our response to Issue 2(a), we think there are drawbacks to incorporation of a volatility factor in the option pricing model, which may cause compensation expense recognized using the model to differ from the underlying economic substance. We think it is even more difficult to justify that including an estimated expected volatility can improve the calculation of fair value for non-public companies.

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?

We think the attribution method prescribed by Statement 123 is more representationally faithful to the economic substance of stock-based compensation arrangements because the compensation expense recognized is adjusted based on the actual number of options vested. Companies should not be penalized for incorrectly underestimating forfeiture rates or projecting performance result.

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?

No, we do not support the Proposed IFRS's view of ascribing value to services received in exchange for equity instruments that are later forfeited. Refer to our response to Issue 10 for additional information.

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?

We think the actual outcome of performance awards should affect compensation expense ultimately recognized over the life of the award. Compensation cost for a performance award should be adjusted for changes in the expected or actual outcome of the performance conditions through the vesting date consistent with the

approach adopted under Statement 123. Since equity instruments are not issued, changes in the actual outcome that impact the fair value and quantity of equity instruments issued should be recognized. In general, we think the issuance concept is more conceptually correct and more representationally faithful to the economic substance of stock-based compensation arrangements.

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

We think compensation cost should be attributed over the expected life of the option instead of the vesting period. The standards specify that the expected option life must be estimated and used to measure the stock option's fair value; therefore, the fair value of a stock option at grant date captures the time value of the option over the expected option life. If companies are required to calculate fair value of the option based on the expected option life but required to amortize it over the vesting period, the cumulative expense over the vesting period will be overstated. We think companies should only recognize the expense related to the time value of the option up to the vesting date.

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?

Refer to our response to Issue 3 above.

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?

No, we do not agree all tax benefits derived from stock-based compensation arrangements should be recognized in the income statement as proposed by the IASB. Under FASB Statement 123, a company credits the portion of realized tax benefits from equity awards that exceed the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized directly to additional paid-in capital. Comparing to the IASB proposed approach which requires such a difference to be recognized in the income statement, FASB Statement 123 is more appropriate and more nearly consistent with the FASB Statement 109, *Accounting for Income Taxes*. We think exercise of stock options simply converts one form of equity interest into another. As a result, tax benefits arising from the exercise of stock options are directly attributable to contributed capital and, therefore, such tax benefits should not be recognized in the income statement consistent with the principles applicable to accounting for income tax expense under FASB Statement 109.

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?)

We think some of the expanded disclosures required by the Proposed IFRS would be useful for financial statements users. Additional disclosure such as an explanation of any difference between historical volatility and expected volatility used to determine the fair value of equity instruments granted, assumptions made with regard to vesting conditions, and a comparison of the percentage of equity instruments that vested and the grant-date estimate of the percentage or number of equity instruments expected to vest can provide further information as to the manner in which estimates are established for the valuation of equity instruments granted, and the extent to which actual outcomes differ from original estimates.

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.

As we mentioned in our letter, we do not think, given the drawbacks of current option-pricing models, expensing stock options will improve the clarity of financial reporting. Rather than expensing options, we think expanded disclosure could serve as a viable alternative. In fact, with the recently issued FASB Statement No.148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, the Board has addressed the comparability of accounting for stock-based compensation by requiring disclosure of comparable information by all companies, and has improved the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods. In addition, we think the proposed disclosure requirements under the IFRS are comprehensive and informative enough to give users of financial statements a sufficiently complete understanding of the effect of these compensation arrangements on capital structure and financial performance.