Letter of Comment No: 159A File Reference: 1102-001 Date Received: 7-18-03

ition to Comment on Stock Compensation

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

From: lvolkert@aicpa.org [mailto:lvolkert@aicpa.org]

Sent: Friday, July 18, 2003 5:39 PM

To: Director - FASB

Subject: 2nd TIC Comment Letter on 11/18/02 FASB Invitation to Comment on Stock Compensation

On behalf of Steve McEachern, Chair of the PCPS Technical Issues Committee (TIC), I am pleased to submit TIC's 2<sup>nd</sup> comment letter on the FASB Invitation to Comment (ITC), Accounting for Stock-Based Compensation. TIC was unable to complete this letter by the specified deadline in the ITC and hopes the Board will have an opportunity to consider our comments.

If you have any questions on our letter, please contact me by phone or e-mail.

Thank you very much.

Linda Volkert AICPA Staff Liaison PCPS Technical Issues Committee Phone: 212-596-6040

Fax: 212-596-6233

July 18, 2003

Ms. Suzanne Q. Bielstein, CPA
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: 11/18/02 FASB Invitation to Comment: 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 (File Reference No. 1102-001),

Dear Ms. Bielstein:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the above-referenced Invitation to Comment (ITC) and is providing the following comments for your consideration.

#### GENERAL COMMENTS

Our January 31 comment letter set forth TIC's view that a stock-based compensation project should be added to the FASB agenda in the near future. Existing U.S. GAAP on this topic is not theoretically sound and needs improvement. The IASB's recent exposure draft entitled *Share-Based Payments* provides an ideal opportunity to promote international convergence and develop standards that are more representationally faithful for U.S. GAAP. TIC is therefore pleased that the FASB has decided to add a project on stock-based compensation to its agenda. This letter will discuss TIC's views on certain issues within the ITC for the Board's consideration as it continues its deliberations.

While TIC believes that the FASB should improve U.S. GAAP with respect to stock based compensation and work to achieve international convergence, TIC's most significant issue with the ITC is the IASB position on the minimum value method, an acceptable alternative measurement method currently permitted under FASB Statement No. 123 for nonpublic companies. TIC strongly opposes the IASB's proposal to eliminate the minimum value method at this time given the basis for the IASB's conclusion. The ITC suggests that option-pricing models would provide a closer approximation to true fair value compared to the minimum value method.

TIC questions the results of the IASB's research considering the difficulty nonpublic companies have in obtaining reliable "source data" for these models. TIC agrees with FASB's Statement 123 Basis for Conclusions that estimating the future volatility of a non-public entity's stock is not feasible. We believe that the benefit of estimating volatility of a non-public entity's shares would not exceed the detriment of the imprecision that would be introduced. We would further assert that the effect of volatility on the valuation of stock options of a non-public entity would be largely negated by the effect of the illiquidity of the security (the effect of volatility on the value of an option of a publicly-traded security depends largely on the immediate ability to "cash out.") TIC would only support an alternative to the minimum value method if an alternative method could achieve a more meaningful and reliable fair value measurement in a cost beneficial manner. TIC believes there would be little point in eliminating the minimum value method if the new method does not provide more reliable information to the stakeholders of private company financial statements.

Therefore, a critical issue in the ITC for TIC's constituency is the development of an appropriate methodology for determining the fair value of stock-based compensation issued by nonpublic companies. TIC does not believe that today's option pricing models are necessarily appropriate for use by nonpublic companies and would object to a rule-based standard that would mandate the use of any one particular model for all share-based compensation. The key assumptions underlying option pricing models are premised on studies that have been done on the trends and behaviors present in the public markets. TIC does not believe that analogizing the public market characteristics of those assumptions to the nonpublic environment is necessarily a logical approach to designing fair value methodology for stock-based compensation in the private sector.

TIC believes more research is needed to determine the appropriate assumptions for calculating the fair value of stock-based compensation issued by nonpublic companies. Ultimately, what is needed is a principles-based standard that outlines the components of compensation expense and guidance on the types of methods that would meet the stated objective. Then, the entity would have to exercise judgment to determine an appropriate method for his/her company.

Our specific comments on the issues presented in the ITC follow. TIC has limited its response to those issues in the ITC that would be most important to our constituency. In some cases, we have grouped similar issues together and issued a combined response. Our specific comments below relate only to those issues or parts of issues on which we wish to comment.

#### SPECIFIC COMMENTS

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. TIC disagrees with the underlying rationale used by the IASB to justify the climination of the minimum value method as discussed in paragraph 38 of the ITC. The IASB contends that the minimum value method cannot equal the fair value of equity instruments granted to employees because it fails to take into account expected volatility in the stock. Without an estimate of volatility, the IASB believes the minimum value measure will be understated, often by a significant amount. The IASB also believes that expected volatility can be reasonably measured and suggests several methods for doing so, including:

- Valuing shares based on net assets,
- · Valuing shares based on earnings, and
- Valuing shares based on share prices of similar public companies.

TIC acknowledges that the volatility factor can represent a significant portion of the total fair value of the option. However, TIC does not believe that either historical or expected volatility of a nonpublic entity's stock can be measured with any reasonable degree of accuracy. The dynamics are not the same as in the public arena. Fluctuations in earnings do not follow trends and are subject to wide variances that do not necessarily affect the value (i.e., the stock price) of those entities. In addition, the measurement methods listed above are not relevant as alternative measures of volatility, as more fully described below.

The operating environment and forces driving non-public companies are often different than those for public companies. Public companies are primarily driven by a need to maintain or increase their stock prices, which is generally done by a steady increase in earnings over time. Non-public companies are often driven by other factors, which include tax motivations and optimization of wealth maintained within the company (minimal) and by its owners (maximum).

Option pricing models are premised by many assumptions which have been incorporated as a result of studies of public markets. These assumptions include: that short-term interest rates are known and will remain constant through time, that stock prices follow a random walk in continuous time with a rate of variance in proportion to the square of the stock price, that the variance of the rate of return on stock is constant, and others. The essential overall assumption behind these models is that price of the underlying stock behaves in such a way that future prices can be accurately modeled by some probability distribution. It should be obvious that certain of these assumptions, such as the constancy of interest rates, can be easily disputed based on current market conditions. Certain other assumptions inherent in the models can also be rebutted.

The overall assumption of market behavior is based on research done on public markets. TIC is not aware of any published research that justifies these assumptions for non-public companies. Based on experience, earnings and values of non-public companies do not follow this "random walk" over time, but are more based on the exigencies of the moment. Since the models imply a trend in stock prices over time, and this premise cannot be shown to exist for non-public companies, its use should not be required if the underlying assumptions are not relevant.

The degree of liquidity of the underlying stock is not addressed in these models either. Any value determined by these models should be discounted to reflect the fact that neither the option nor the stock of a non-public entity is liquid.

Volatility is a factor that substantially affects option price valuations. However, accurate historical prices of non-public stocks are not available sufficient to determine a true volatility, even if volatility were considered relevant to them, as discussed earlier. Estimating volatility based on net assets or current earnings is not an acceptable alternative since these factors, by themselves, do not constitute stock valuations, nor are they necessarily representative of trends in stock prices Estimating volatility based on share prices of similar public companies may be an alternative if it were possible to do. To find a company that is sufficiently similar in its business objectives, operations, financing and management structure to the non-public company would be impossible or difficult, at best, to accomplish.

We understand that the requirement to use a model imparts some degree of consistency, (which we do not agree with), and makes the burden of determining how to value options easier for public companies. However, since the overall concepts behind the models do not necessarily apply to non-public companies, we believe the elimination of the most egregious requirement (i.e., estimating expected volatility) would be appropriate. It is important with these computations, as with all computations affecting the reported financial statements, that the cost of compliance be weighed against the benefit to the users of the financial statements.

TIC noted that paragraph BC143 of the proposed IFRS (Appendix G of the ITC) promises that the final IASB standard will provide "implementation guidance on estimating expected volatility for the purposes of applying an option pricing model to options granted by unlisted and newly listed entities." TIC would be very interested in reviewing such implementation guidance, particularly to observe how this guidance will demonstrate how the lack of verified or supportable market valuations will produce a true and representational factor of volatility with sufficient accuracy to support accounting measurement criteria. Until that time, TIC continues to believe that the FASB's conclusion in Statement 123, paragraph 178, is still valid:

The use of minimum value by nonpublic entities is a practical solution to the difficulties of estimating expected volatility for a nonpublic entity.

Issue 1: Statement 123 provides a scope exclusion for employee stock ownership plans (ESOPs) and certain employee stock purchase plans (ESPPs), and the Proposed IFRS does not. Which view do you support and why?

TIC believes that ESOPs and certain ESPPs should continue to be excluded from the scope of Statement 123 based on the reasons discussed in paragraphs 15-16 of the ITC. ESOP accounting principles contained in SOP 93-6 resemble the fair value model advocated by the IASB and are directed to the special characteristics of these plans, which are unique to the U.S. To rescind SOP 93-6 in favor of a broader standard would create needless implementation questions and issues that could affect the comparability of financial statements.

Similarly, TIC supports the FASB's position on ESPPs stated in the basis for conclusions of Statement No. 123. Small stock purchase discounts granted to employees should be considered noncompensatory since the employer's intent is not to compensate employees for services rendered.

Rather, broad-based plans are aimed at encouraging employees to become stakeholders, thereby leading to greater employee loyalty and an interest in increasing shareholder value, and at raising capital over time without incurring the stock issuance costs related to a public offering [Statement 123, paragraph 235].

Although the IASB has taken issue with the above arguments from Statement 123, TIC continues to believe that cost/benefit considerations are paramount to this issue. A threshold approach to exempting certain ESPPs from the new stock compensation standard is an important practical expedient for handling immaterial discounts. If all entities with ESPPs need to determine the materiality of the discount on a case-by-case basis, interpretations may vary for identical situations leading to lack of comparability and possible abuse of the intent of the standard. Since the IASB stated some reservations about the existing 5% threshold, the specific guidance may need re-examination, but TIC firmly believes that ESPPs should not be incorporated into the scope of the stock compensation standard.

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.

- Should an accounting standard mandate the use of an option-pricing model for measurement purposes? (Issue 2a)
- If not:
  - What other approaches would provide more consistent and reliable estimates of the fair value of employee stock options granted and why? (Issue 2a)

- Should additional disclosures be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what disclosures should be required? (Issue 2c)
- If yes:
  - Should a particular option pricing model be mandated? If so, which model should be required to be used and why? (Issue 2b)
  - Is additional guidance necessary for selecting the factors used in optionpricing models to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas? (Issue 2e)

TIC believes that the standard should not mandate the use of any particular methodology or model for two reasons. First, requiring only one model would seem to be consistent with rule-based standard setting, which is contrary to the preferences expressed in the 10/21/02 FASB proposal, *Principles-Based Approach to U.S. Standard Setting*. The ideal principles-based stock compensation standard would provide the theory for recognition and measurement of share-based payments and clearly state the necessary objectives and characteristics of acceptable methods for measuring fair value. The standard should also describe the approaches or models that would be appropriate in different circumstances and then let companies determine the most appropriate method for them. Mandating only one acceptable method now would render the standard out-of-date as soon as new and better methods are developed. Standards should be written with the flexibility to accommodate the best practices for achieving stated objectives.

Second, TIC is not satisfied that current option-pricing models are achieving appropriate fair value measurements for all entities. If only one model is to be required, it has to have a proven track record of working equally well for all kinds of stock compensation arrangements that may be written by public and nonpublic companies. Each option-pricing model has its advantages and drawbacks, as well as limitations as evidenced by market research. One may be most appropriate in a given situation and another may be more appropriate in a different set of circumstances. To mandate the same model in every situation would be inappropriate and may produce valuations that are not supported in theory. While consistency may be achieved among entities, the true impact on an individual entity would be distorted. Since the goal should be to achieve accurate and representative reporting for a particular entity, consistency among entities has little value unless all other factors are equal. This is rarely the case.

Until the patterns of "expected volatility" in nonpublic entities can be better understood, TIC advocates retention of the minimum value method. A stock compensation standard should identify indicators of "expected volatility" to help these entities choose the best method for their unique circumstances.

TIC does not believe that permitting the use of multiple option-pricing models would necessitate additional disclosures to allow users to "compare the reported financial results of different enterprises." The financial statement user should be given a description of the methodologies employed, but additional disclosures would not serve any purpose or be cost effective. An entity should not be required to give users all the information they

would need to recompute fair value. What may be the right method for one entity, may not be for another, so there is little basis or need for comparability of methods.

TIC believes the goal should be to allow the entity to determine the best model to derive fair value. We should presume that if appropriate factors are considered, and valid methodologies are employed, "fair value" will be the same (or not materially different) no matter how determined. If it were not, then the underlying premise behind allowing the use of multiple models to derive a fair value would be flawed. There should be one value, within a limited range, or else the requirement to record compensation based on these models is without value and purpose.

TIC recommends that additional guidance be provided to address the factors involved in each model so that an entity can determine when a particular model may be the most appropriate for them. As stated above, TIC believes the objective is to get the right answer for a particular entity given its circumstances. To expect that all entities have those same circumstances is not realistic. Therefore, to achieve "consistency" and "comparability" of methods is not an appropriate goal. Providing the means and guidance to allow an entity to determine appropriate fair values, no matter the method, is paramount. This will allow users of those statements to compare operating results on a comparable basis, even if different methods to get there are employed.

Issue 3: Do you believe that employee and non-employee 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?

No. TIC concurs with paragraphs BC122-BC128 in the proposed IFRS supporting the conclusion that employee and non-employee transactions are not distinct and therefore do not warrant different measurement dates. Paragraph BC122 is consistent with TIC's view:

...any conclusions about which measurement basis and measurement date should be applied are, in principle, equally applicable to share-based payment transactions with parties other than employees.

Adopting similar standards for employee v. non-employee transactions would also have the added benefit of being less confusing.

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

#### and

. ...

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? If not, why not?

In theory, the fair value of most equity awards is measurable on or before the grant date and should be recognized when contract terms are finalized between the parties to the transaction whether or not a true "performance commitment" exists as defined by EITF Issue 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with, Selling Goods or Services. The existence of performance conditions for either employees or nonemployees should not, as a general rule, change the general principles surrounding the measurement date.

Theory would also suggest that the fair value of the conditional terms in equity compensation to a nonemployee should be estimable at the commitment date. It would seem logical that the company and service provider would come to the table with an estimate of the value of the performance clause. The company and the nonemployee would each have some notion of the value of the award, including the performance-based conditions, and presumably would have actively negotiated its terms. Otherwise, how could they have reached an agreement? Failure to perform under the agreement may require subsequent re-measurement depending on the circumstances, but should not delay it.

However, what TIC has found in practice is that nonpublic companies cannot always articulate how they derived the terms of equity awards. Good business practice would dictate that they should know at least the per-unit value of an option or other equity award, but they often do not. There rarely are recent transactions in the stock, and management often has no objective idea what the company is worth. In these cases, stock options are often issued using factors that are highly subjective and that are based more on appearances than verifiable, objective current values. This very practical issue drives TIC's call for redeliberation of some of the key assumptions underlying FASB Statement 123. We can't know if an option-pricing model will significantly understate or overstate the real fair value of the award because the real value is so elusive.

# 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?

Yes. TIC believes the instrument is issued at grant date even if the underlying shares have not been issued. A commitment has been incurred at the grant date and, consistent with FASB's current thoughts on the liability vs. equity issue, the related expense should be recognized. While the exact amount of the ultimate obligation may not be known, a transaction has occurred that should be recognized in the financial statements.

#### Issues 7-8 and 10-11:

• 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?

- 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?
- 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 arrangements and why?
- Issue 11: If you support the Proposed IFRS's view on the method of ascribing value to services in exchange for equity instruments that are later forfeited, 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?

TIC believes forfeitures relating to employee equity awards should continue to be accounted for in accordance with FASB Statement 123. Our current standard calls for recognition of compensation cost at the grant date based on the:

Fair value of each equity instrument granted (without considering forfeitures) x the expected number of options to be vested during the service period (i.e., options granted less estimated forfeitures).

Under Statement 123, no compensation cost is recognized for the estimated number of options that will be forfeited. Under the proposed IFRS, however, the entity must consider the effect of forfeiture on the grant-date estimate of fair value per equity instrument and allocate that lower fair value to all equity instruments granted as follows:

(Fair value of each equity instrument granted x % of instruments expected to vest) x number of options granted without regard for expected forfeitures.

TIC applauds the Board's recent decision to retain the SFAS 123 measurement method for forfeitures. The primary reason that TIC favors the Statement 123 approach for equity instruments granted to employees is the committee's belief that compensation is earned ratably over the service period and should not be based on "units-of-service," which also may be impractical to implement.

For some equity awards to nonemployees, however, the units of service approach may be applicable if the economic benefits provided to the entity are not provided on a straight-line basis over the service period. Therefore, for certain nonemployee equity awards, wherein the services provided can be clearly identified and related to a particular time period, the IASB approach may be representationally faithful and possible to implement.

TIC believes that, in the case of employees, an entity is simply buying services over a period of time, rather than for discrete services rendered during that period of time. The cost incurred should be amortized over that period on a straight-line basis consistent with the perceived intent of the options—a continuous period of service at the same level of service.

### 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?

Yes, when an award is conditional upon the attainment of certain performance standards, other than length of service, the compensation cost associated with it should be adjusted by actual performance. The employees who failed to reach their performance goals did not earn additional benefits nor did the employer incur any additional cost. We believe TIC's view is consistent with the "issuance concept" in Statement 123. That is, "since the equity instruments are not issued, changes in the actual outcome that impact the fair value and quantity of the equity instruments issued should be recognized." [ITC, par. 50]

# 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?

TIC believes the tax effects of options transactions should be reported as an element of income. The tax difference arises as a result of the determination of compensation expense under generally accepted accounting principles in a manner differing from the determination of compensation expense by the taxing authorities. The tax effect of such differences, therefore, is related to an item affecting the determination of income and not to the amount of an employee's investment in the stock of the employer corporation. Accordingly, the tax effect should be reflected as a reduction of income tax expense. (Source: Dissenting opinion to APB Opinion 25)

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?)

No, as discussed earlier, an entity should not have to provide sufficient information to enable a user to recalculate the effect of share-based payments. General information should suffice. Providing these additional disclosures would not be cost effective, nor could they ever provide enough information to reach a "recalculation" standard. Specifically, disclosure requirements that provide information on how estimates were established should be eliminated. (Example: the first two additional disclosures cited in paragraph 83 that are taken from the Proposed IFRS.)

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.

No additional disclosures should be required.

### APPENDIX A ISSUES: SECONDARY SIMILARITIES AND DIFFERENCES West

Issue A1: Statement 123 distinguishes between a principal stockholder and a stockholder for certain transactions, and the Proposed IFRS does not. Which view do you support and why?

TIC supports the guidance contained in Statement 123 on this issue. To require otherwise would be impractical, impossible to measure and not representationally faithful. Further, it would be nearly impossible to audit the potential magnitude of such transactions.

Issue A2: Do you believe that a probability-weighted average amount of the range [of a factor or factors in an option pricing model] should be used when no amount in the range is better than any other? If so, why? If not, what other amount within the range would you propose when no amount in the range is better than any other? Why?

Using a probability-weighted average amount of the range in question would seem to be consistent with other recently issued standards. FASB Statement of Financial Accounting Concepts 7, Using Cash Flow Information and Present Value in Accounting Measurements, which was issued after Statement 123, incorporated probability-weighted amounts as part of the definition of "expected cash flows." Concepts Statement 7 sets up the conceptual framework for probability-weighted amounts to be used when the objective is determination of fair value and should be consistently followed.

Issue A3: Do you agree that option-pricing techniques have sufficiently evolved since Statement 123 was issued to address reload features and, if so, should Statement 123's requirements be changed? If not, why not?

Option pricing techniques have probably evolved, but are still inherently imprecise. If sufficient evidence exists that reload options can be reliably valued at the grant date, then current guidance should be changed to incorporate reload features in the initial valuation.

Issue A8: Do you believe that an accounting standard on stock-based compensation should include provisions for distinguishing between repricing and other modification events? Why?

We believe that an accounting standard should include provisions for distinguishing between repricing and other modification events if they are to be treated differently under the standards. Standards should provide the theoretical basis for distinguishing between the two and the rationale for any difference in accounting, if there is to be one. While we cannot provide examples where there should be a difference in treatment, the standard should be broad enough that a sound and well reasoned conclusion can be reached for any given fact pattern, consistent with the theory presented in the standard.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees