Gartner P.O. Box 10212
Stamford, CT 06904-2212
USA
gartner.com

Letter of Comment No: 3087 File Reference: 1102-100

June 7, 2004

Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

#### Ladies and Gentlemen:

Gartner appreciates the opportunity to comment on the FASB's exposure draft (ED), Share Based Payment, an amendment to FASB Statements No. 123 and 95. Gartner also welcomes the opportunity to participate in the FASB's June 29<sup>th</sup> roundtable on this ED.

56 Top Gallant Road

Gartner, Inc. is a public company, listed on the NYSE. The company has long issued stock options to its employees and to its corporate directors, which we continue to account for in accordance with APB 25. At December 31, 2003, Gartner had outstanding options to purchase 31,526,207 shares of the Company's Class A Common Stock. We also have an employee stock purchase plan (ESPP) that allows our U.S. employees and employees of certain foreign subsidiaries to purchase Gartner, Inc. Class A Common Stock at a 15% discount. Our ESPP is qualified under Section 423 of the Internal Revenue code.

#### Our comments are as follows:

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

While we agree the employee services received in exchange for equity instruments do give rise to recognizable compensation cost, we contend that that cost cannot be reasonably and consistently measured.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

#### We agree.

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

## We agree, but content that the value of the option/equity instrument given cannot be reasonably measured.

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the

underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

No, we do not believe that the statement provides sufficient guidance. The suggested lattice valuation method introduces many subjective elements that further obfuscates the valuation issue. Comparability between companies will be lost because each company could in effect develop a <u>different</u> valuation method. While the Black Scholes was deficient in terms of valuing employee stock options that were generally non-transferable and often subject to early exercise, there was some benefit to its use by virtually all public companies. We would also recommend that companies be allowed to expense on a straight-line basis the unamortized cost, as determined by the Black Scholes method, for the vesting portion of any existing option, once the new statement is in effect.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

We do not agree as for the reason stated above. Furthermore, the supposed flexibility of the lattice method significantly reduces its value. Also, Gartner has company-wide trading windows that effectively stop the exercise of options for significant parts of the year. The inability to effectively exercise an option should have a considerable impact on its valuation. It is not clear to Gartner how this situation can be factored into the valuation of an equity award. For our rank-and-file employees, the trading window is closed for approximately one-third of the year, and for insiders and certain managers, the trading window is closed for approximately one-half of the year. While optionees are not precluded doing a cash exercise while the trading window is closed, our experience is that virtually all optionees do cash-less exercises which are not possible when the trading window is closed.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

We strongly believe that the FASB should prescribe single method of estimating expected volatility that would be used for all companies. Under SFAS 123, companies generally used historical volatility, but there

were different methods of calculation: daily, weekly, monthly, etc. By requiring companies to make their best estimate of further volatility, the FASB is introducing substantial subjective elements that will make comparisons among firms meaningless. Gartner does NOT have any calculation or estimation of the future volatility for our common stock for which there are two classes. It would seem that the only way to satisfy this requirement would be to hire a consulting/valuation/investment-banking firm to perform an independent valuation of our stock. Such a project would be expensive and would be of limited value going forward as the volatility would be change continually over time. Gartner would recommend that companies be required to use historical stock volatility, calculated on a monthly basis, unless a predominance of information indicates that the historical volatility should not be relied upon.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

We do not agree. There many factors that impact the risk of forfeiture and few of these are under the company's control. To estimate the risk of forfeiture up-front again introduces more subjective elements, which further reduces the comparability of reported results.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

#### We agree.

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

We do not agree. Under the ED, virtual all ESPPs will be considered compensatory and this will require company's sponsoring such plans to record what may be a significant expense, and because the way taxes are handled for ESPP, the pre-tax cost will, at-least initially, equal the after-tax cost.

This requirement will have a significant adverse and unintended consequence in that many companies will terminate their ESPP. We've seen several surveys that have said this and Gartner is seriously evaluating its viability under the ED. ESPP is very different from stock options. It is not an executive compensation plan. Often, it is the only equity program that is open to the rank-and-file employees, and one that provides a limited benefit to the participant. Very few of our executives participate in ESPP, while almost 35% of eligible employees do. ESPP is viewed as a saving vehicle at our company, and it helps the company to align the long-term interests of our employees and our shareholders.

We would urge the FASB to NOT require expensing for any ESPP that is a qualified plan under Section 423 of the Internal Revenue Code.

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

We agree, but also believe that a company should not be required to recognize an non-cash expense for an option that vests, but never is exercised.

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

### No opinion.

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

We do not agree with the use of an accelerated amortization method (FIN28) for options/awards with graded vesting.

Gartner generally grants options that vest over three or four years. While part of the option grant vests each year, it is our general experience that options are not exercised immediately upon vesting. Our average holding period is close to four years. Yet, for an option that vests over four years, the application of FIN28 results in approx. 52% of the option's valuation being expensed in the first year and 80% over the first two years. This does not seem to be a proper matching of benefit and expense. Furthermore, it is unclear to Gartner, how FIN28 would be applied to the unvested portion of options granted prior to the effective date of the statement. To have to go back and recalculate the cost amortization on existing unvested options would be a clerical exercise of questionable benefit.

Gartner feels the cost of the option should be expensed ratably over the life of the option. Should the FASB mandate the implicit use of FIN28, we would then recommend that it apply ONLY to options granted in 2005 or later.

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

No opinion.

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

We feel the method of accounting for income taxes by this proposed Statement should be symmetrical.

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such

transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

### No opinion.

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

# We believe that there should be only one allowed method of transition and that the prospective method is the most appropriate.

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

## Gartner is a public company and has no opinion with respect to nonpublic entities.

Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

## Gartner is a public company and has no opinion with respect to nonpublic entities.

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

## Yes, we believe that cost-benefic considerations should be considered for ALL entities.

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

# We feel the method of accounting for income taxes should be symmetrical and this should also apply to the reporting of cash flows.

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and

certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

### Gartner is a public company and has no opinion with respect to nonpublic entities.

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

No.

Sincerely,

Kevin Feeney

Sr. Director Stock Equity and Retirement Programs 203.316.6684 kevin.feeney@gartner.com