Letter of Comment No: 58 47

June 30, 2004 File Reference: 1102-100

Ms. Suzanne Q. 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. 1102-100

# FILED ELECTRONICALLY (director@fasb.org)

Dear Ms. Bielstein,

We appreciate the opportunity to respond to the Financial Accounting Standards Board's Exposure Draft, "Share-Based Payment: An Amendment of FASB Statements No. 123 and 95."

Detailed below are some general comments, and our responses to the specific questions highlighted in the Exposure Draft (ED) are included in an attachment.

We support efforts by the Board to improve U.S. financial accounting and reporting standards. Although we acknowledge employee stock options have value, 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. Also, expensing employee stock options will distort the company's statement of operations by recognizing an expense, which is unlike any other expense, as there will never be a cash outflow or any other outlay of assets. This also will distort the earnings per share calculation by changing the numerator and the denominator, thus causing a double counting of the impact of options on earnings per share. Furthermore, the ED appears one sided as it does not allow for any adjustments for canceled or expired options.

CSC continues to disagree with the premise of SFAS 123 that recording the value of stock options issued to employees as an expense is preferable to the guidance of APB Opinion 25. In our opinion, the intrinsic value method, as detailed in APB 25, adequately reflects the economic impact of employee stock options in the income statement through the fully diluted earnings per share figures reported in quarterly and annual disclosures. Having noted our disagreement, detailed below are some thoughts concerning the Exposure Draft, assuming the statement is adopted in its present form.

According to Financial Accounting Standards Board (FASB) Chairman Robert Herz's December 12, 2003 presentation at the National Conference on Current SEC Developments, one of the major issues before the FASB is the movement "toward a more principles-based approach." Part of moving toward a more principles-based approach is

to outline the expected benefit of any proposed change and let individual companies decide the methodology best suiting their need. If the FASB decides to require expensing of stock options at "fair value," it is CSC's opinion that FASB guidance should enable companies more latitude in determining how best to implement such guidance. Specific examples include:

- Valuation models—Ten years ago, the Black-Scholes model was considered to be a reasonable tool for determining fair value. Today, a lattice approach via a binomial model is thought to be preferable. Tomorrow, some other approach might become more popular. We have seen some respondents suggest a put-on-call model, for example. The Exposure Draft strongly suggests that a binomial model should be used, and for some companies this might be the most appropriate methodology. But for others, the more simplistic Black-Scholes might be adequate, particularly when considering the costs and risks of using a much more sophisticated model requiring numerous assumptions and estimates. For other companies, some other model might prove to be adequate. We recommend that the FASB simply provide the guidance that options should be recorded at fair value, and let companies decide how best to implement.
- Amortization periods—The Exposure Draft dictates a FIN 28 model be used to amortize options with graded vesting schedules. While this may be appropriate and reasonable for many companies, it may prove overly burdensome, with no real incremental added value to others. We recommend the Exposure Draft simply state the fair value be recognized over an appropriate period of time commensurate with the provision of services from the employee.
- Use of Estimates and Assumptions—The Exposure Draft explicitly requires companies to make predictions and forecasts for various assumptions to be input into a valuation model, most notably for volatility estimates. Companies are not allowed to simply rely on historical information for such assumptions. While use of historical data might not be appropriate for some companies (for example, those less than ten years old and with little history), it might be highly appropriate for other companies. We recommend the Exposure Draft state assumptions used should be reasonable and supportable, and then leave it up to individual companies to decide how best to determine such assumptions. Not only is the current draft's explicit requirement contrary to the FASB's stated intention of moving away from a rules-based approach, it may also have the unintended consequence of exposing companies to additional legal concerns when estimates invariably deviate from actual outcomes.

We commend the FASB and IASB in attempts at convergence in accounting standards. However, we do not think convergence should be had at any cost. For example, we strongly disagree with the provisions of the Exposure Draft concerning the unequal treatment of income taxes. We recommend that the original income tax guidance of SFAS 123 be re-incorporated into the Exposure Draft. Treatment of excess tax benefits and expenses should be consistent, and both should be reflected in the equity section.

We continue to think the cost of issuing employee stock options is borne by existing shareholders in the form of potential dilution, figures prominently disclosed in quarterly and annual reports under current accounting rules. In fact, with SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, the Board addressed the comparability of accounting for stock-based compensation by requiring disclosure of comparable information by all companies, and improved the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods.

Attached are responses to the specific questions in the Exposure Draft.

We appreciate the opportunity to comment on the FASB proposal.

Very truly yours,

Donald G. DeBuck

Attachment

# **ATTACHMENT - Responses to FASB Issues**

# Recognition of Compensation Cost

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.

Although we acknowledge employee stock options have value, we oppose the FASB 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. We think 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 the company's statement of operations, as employee stock options, unlike other expenses, will never call for an outlay of assets. Option grants dilute stockholders' interest, after considering the option cash proceeds and tax benefits, by potentially increasing the number of outstanding shares. Existing assets and liabilities, and profits and losses, are spread against a potentially greater number of outstanding shares.

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 do not agree. We think the current SFAS 123 disclosures of the "fair value" cost of employee stock options encompasses the difficulty and complexity of this issue and provides for sufficient financial reporting as it relates to employee stock option grants. Also, see our response to *Issue 1* above for further explanation of why we disagree with the proposed guidance surrounding the use of fair value accounting for stock options.

# Measurement Attribute and Measurement Date

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?

Though we agree grant date is the appropriate measurement date, we do not agree with the Board's view on measurement attribute. Utilizing fair value requires subjective judgment and introduces the risk of stockholder litigation if results of operations are negatively impacted by the numerous estimates and assumptions required.

# Fair Value Measurement

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?

The guidance probably would provide consistency in the methodology a company uses to gather the historical data for the input assumptions from period to period. However, as no model will accurately project the actual expense a company will incur, the FASB should focus on ease of use and transparency rather than unachievable precision. Existing Black-Scholes variables, while not preferred, are understood and facilitate comparisons across companies.

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 think neither closed-end models nor the lattice model project the actual value derived from an employee stock option. We do think for many companies the ease of use of Black-Scholes outweighs the additional incremental "accuracy" of the lattice model approach. Grant date fair value measurement will always result in measurement error because observable historical data are not always relevant and data based on expectations about the future inherently introduce measurement bias and are not reliable. Therefore, we recommend that the Exposure Draft simply state that options be recorded at fair value, and let companies decide how best to determine fair value.

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 are particularly concerned about this point. We think the Board should consider historical volatility as an appropriate default for established companies and not dictate how companies calculate volatility nor use pejorative words implying one method or another is best. We acknowledge it may be appropriate for companies with less than 10 years of experience to apply the necessary estimates of future volatility due to limited history.

We think the models used to estimate fair value rely on too many judgments about future expectations. Introducing expectations about the future requires significant management judgment and increases the risk of after the fact challenges, a particular concern in a litigious environment.

Also, the use of historical volatility by established companies may address speculative estimates by management in estimating fair value at the grant date.

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 non-transferability 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 generally agree with the ED's requiring fair value be estimated using the expected term rather than the option's contractual term. Employees typically suboptimize their equity plans as they have different goals and profiles and exercise earlier than the theoretical optimal end of term. But, we are concerned about never exercised options. With cash compensation, if the accrued compensation is never paid those expenses are reversed. At a minimum, we propose the standard include a reversal of expense, or a credit in the year of expiration, for options which had previously been expensed, but never realized.

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 re-measurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with re-measurement 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 disagree with the Board's proposal to use the intrinsic value method with remeasurement through the settlement date as the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value. We think using intrinsic value method at grant date is the appropriate method.

# **Employee Stock Purchase Plans**

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?

No comment.

## Attribution of Compensation Cost

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 the service period, with any appropriate true-ups, is the appropriate basis for attribution.

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?

We think the guidance provided is sufficient.

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 disagree with the Board's conclusion requiring a single method of accruing compensation cost for awards with a graded vesting schedule. We think the Exposure Draft should simply state fair value should be recognized over an appropriate period. For some companies, this may mean graded vesting awards should be attributed to income on a straight-line basis and for others it may mean an accelerated basis might be more appropriate.

#### Modifications and Settlements

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.

We think the modification principles discussed in paragraphs C96-C115 are appropriate.

#### Income Taxes

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 could not more strongly disagree with the modified two-event approach reflected in the ED whereby excess tax benefits are credited to shareholder's equity, while any uncollected deferred tax asset as a result of "tax deficiencies" (caused by tax deductions that are less than the related book expense for an equity-based award) are debited to the income statement as increased tax expense. This approach is almost certain to lead to a higher reported tax expense and increased effective tax rate volatility given that even one employee realizing a taxable benefit (the bargain element at exercise) less than the related book compensation charge will lead to an uncollected deferred tax asset that must be written off to tax expense.

Additionally, it seems inconsistent to require excess tax benefits be credited directly to equity while tax deficiencies have to be recognized as additional tax expense on the income statement. Both the excess tax benefit and the tax deficiency result from the same phenomenon: share price changes between the date the option is granted and date the option is exercised. Either the effect of a share price change subsequent to option grant is an equity item or it is not.

Furthermore, to properly perform the accounting at the time an award is settled, we would need to have a system that tracks, on a grant-by-grant and employee-by-employee basis, the actual tax deduction compared with the cumulative "book" expense since adoption. The requirement to account for the deferred tax consequences at an individual employee level is not practical without a prohibitive amount of effort and cost.

We think any difference between the deferred tax asset recognized during the vesting period and the eventual tax benefit should be recorded in equity, regardless of whether the difference is an excess or a shortfall. This approach, which the Board itself preliminarily endorsed, would be much more consistent and understandable by financial

statement users.

#### **Disclosures**

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.

Given the guidance as proposed, the effect of the stock-based compensation arrangements will not only be the compensation expense recognized in the income statement for costs in which no economic transaction has occurred, but also the effect it has on earnings per share. It will distort the earnings per share calculation by changing both the numerator and the denominator, causing a double counting of the impact of options on EPS. Accordingly, we fail to see the need for the extensive disclosure of intrinsic value.

#### **Transition**

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 support the Board's decision to require one method of adopting the new rules.

# Nonpublic Entities

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?

#### No comment.

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?

No comment.

## Small Business Issuers

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?

No comment.

## **Cash Flows**

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 do not agree with the Board's conclusion. Excess tax benefits simply result in a reduction of otherwise payable taxes. Accordingly, we do not understand treating excess tax benefits differently from operating cash flow impacts of other investing/financing transactions like interest expense on outstanding debt.

## Differences between This Proposed Statement and IFRS 2

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?

The Board should consider adopting the accounting treatment prescribed in IFRS 2 if it is the highest quality standard. However, adoption for the sole purpose of convergence on such a controversial topic is not appropriate.

## Understandability of This Proposed Statement

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?

Given the complexity of the measurement requirements in this proposed Statement, it will require a significant level of sophistication on the part of users of financial statements and will require more than "a willingness to study the standard with reasonable diligence." It is unlikely most preparers of financial statements will be able to implement the proposed Statement without the use of costly outside experts and significant internal resources. As proposed, we think the standard is complex, costly to implement, and will reduce, not increase, comparability of enterprises. In conclusion, we think the proposed standard will not be beneficial to the average financial statement user due to its complexity, nor will it provide greater transparency in financial reporting.