Letter of Comment No: 584) File Reference: 1102-100

June 30, 2004

Ms. Suzanne Bielstein Director of Major Projects Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856

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Dear Ms. Bielstein:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants is pleased to offer comments on the FASB's March 31, 2004, exposure draft (ED) of a proposed Statement of Financial Accounting Standards, Share-Based Payment—an amendment of FASB Statements No. 123 and 95.

AcSEC indicated in its March 3, 2003, letter (attached as Appendix A) on the IASB's November 7, 2002, exposure draft, *Share-Based Payment*, that preparers, auditors, and users of financial statements have become more familiar over the past decade with share-based payment transactions and related valuation issues. Additionally, AcSEC indicated that it had observed (1) that considerable progress has been achieved in understanding the use of models to measure option values and their use in the design of compensation arrangements and (2) that pro forma disclosures made in accordance with FASB Statement No. 123, *Accounting for Stock-Based Compensation*, have provided financial statement users with information that has been increasingly used to evaluate company performance. Accordingly, AcSEC supports the objective of the ED to account for the cost of employee services received in exchange for equity instruments based on the fair value of those instruments. In addition, we commend the Board for its willingness to address this controversial topic.

In AcSEC's discussion of the ED, AcSEC identified the following areas that AcSEC believes should be clarified or reconsidered by the Board in developing the final Statement:

- The ED is unclear as to whether a company has the option to use either a lattice model or a closed-form model. That is, it is unclear whether a lattice model is required.
- The minimum value method described in FASB Statement No. 123 should be retained for nonpublic entities.
- The ED should be clarified to indicate that the service inception date could be prior to the grant date only if board or shareholder approval is perfunctory.

- Tax deficiencies and excess tax benefits that result from equity instruments should be adjustments to additional paid-in capital (APIC).
- Disclosures of intrinsic value may not be relevant under a fair-value-based model.

The above concerns and other matters are discussed below.

VALUATION METHOD—IS THE USE OF THE LATTICE MODEL OPTIONAL? (ISSUE No. 4)

The ED indicates that the Board decided not to require the use of a lattice model at this time. Paragraph B9 of Appendix B, Implementation Guidance indicates that several valuation techniques, including a lattice model and a closed-form model, meet the criteria for estimating the fair value of employee share options and similar instruments. AcSEC observes that the guidance appears to indicate that one may elect a valuation technique.

However, paragraphs B10-B11 indicate that the selection of a valuation method will depend on the substantive characteristics of each arrangement and the availability of data necessary to use the model. The ED also indicates that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share-based payments, and that the lattice model is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. Further, the ED states that, although the lattice model is preferable, it may not be practicable to use such a model because of the lack of historical data on employee exercise patterns and that, for entities for which the cost of share-based compensation is not a significant element of the financial statements, one may conclude that the closed-form model produces estimates of fair value that are not materially different from those produced by the lattice model. It appears to AcSEC that the intention of paragraphs B10-B11 is to require a company to use the lattice model unless:

(1) it is not practicable to use the lattice model or (2) the closed-form model produces estimates of fair value that are not materially different from the lattice model.

AcSEC notes that the guidance in paragraphs B10-B11 appears to be inconsistent with the Board's stated intention to not require the use of the lattice model. Additionally, AcSEC observes that paragraphs B10-B11 imply that, to use the closed-form model, a company would have to estimate fair value by using the lattice model to determine if the results are not materially different. Therefore, it is unclear to AcSEC whether a company has the option to use either a closed-form model or the lattice model to value share-based payments.

AcSEC members generally believe that a specific model should not be required. Rather, those members believe the standard should allow the use an acceptable option-pricing model, as determined by company management. Additionally, AcSEC believes that the option-pricing model used to estimate the fair value of employee share options and similar instruments should incorporate key criteria, such as the criteria indicated in paragraph B5 of the ED. This would allow companies to exercise judgment in selecting different models based on their particular facts and circumstances. AcSEC also believes

that this approach will allow for further development of models as they evolve. Furthermore, AcSEC believes that disclosure of the model used should be required.

Whether the Board's intent is to allow for the election of a valuation technique or to require that a lattice model be used to estimate the fair value of employee share options and similar instruments, the wording should be clarified accordingly. Additionally, if the Board requires the use of the lattice model except under certain circumstances, AcSEC suggests that the final Statement provide additional guidance that would clarify which circumstances would permit the use of another valuation model.

APPROPRIATENESS OF THE PROPOSED MEASUREMENT MODELS FOR NONPUBLIC ENTITIES (ISSUE NO. 14)

The ED proposes to permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at settlement date) rather than the full fair-value-based model.

Some AcSEC members believe that the minimum value method described in FASB Statement No. 123 should be retained for nonpublic entities. This would allow for measurement of compensation cost at the grant date.

The intrinsic value method (with remeasurement) and the full fair-value-based model (as proposed) may not be appropriate for nonpublic entities. The full fair-value-based model in the ED requires a volatility input, which is difficult to reliably estimate for nonpublic entities. Therefore, some AcSEC members believe that the fair-value-based model, as proposed in the ED, should not be required for nonpublic entities.

The ED proposes that entities electing not to use the full fair-value-based model to measure compensation cost resulting from equity share options must use the intrinsic value method. AcSEC observes that the intrinsic value method (with final measurement of compensation cost at settlement date) is inconsistent with the concept of a grant date measurement. Additionally, AcSEC notes that the proposed guidance may drive many nonpublic entities towards electing the full fair-value-based model, including volatility estimates that may be arbitrary, due to the results of the intrinsic value method (with remeasurement).

Other AcSEC members agree with the proposed Statement, which would permit nonpublic entities to elect to use either an intrinsic value method with remeasurement or the full fair-value-based model. Those AcSEC members believe that nonpublic entities, when measuring compensation cost using the fair-value-based model, should be required to factor in volatility. Although they acknowledge that it might be more difficult for nonpublic entities to estimate volatility, they believe that procedures could be developed to produce reliable results. Additionally, they believe that the Board has provided sufficient transition provisions to mitigate the incremental costs of complying with the proposed Statement.

SMALL BUSINESS ISSUERS (ISSUE NO. 15)

AcSEC believes that small business issuers should not be afforded the same cost-benefit considerations as nonpublic entities. AcSEC believes that one of the costs of being a public reporting entity is the requirement to report under the same generally accepted accounting principles that are applicable to other public entities.

ATTRIBUTION OF COMPENSATION COST - SERVICE INCEPTION DATE SHOULD BEGIN WHEN THE ENTITY HAS AN OBLIGATION (ISSUE NO.7)

Paragraph B53 of the ED indicates that ". . . the service inception date can precede the grant date . . . because . . . (b) there is a mutual understanding of the key terms and conditions but the necessary authorizations have not been obtained." AcSEC believes that the service inception date (that is, the date that the company begins to recognize compensation costs) is the date when the entity has an obligation. AcSEC believes that an obligation begins when the board or shareholders have approved the share-based award, and any contract made prior to board or shareholder approval is contingent. Therefore, AcSEC believes that the service inception date should be the same as the grant date unless the board or shareholder approval is perfunctory.

AcSEC suggests that the wording in paragraph B52, as well as the definition of service inception date in Appendix E, Glossary, should be clarified to indicate that service that will count toward vesting begins before the necessary board or shareholder approval of the share-based award only if that approval is deemed to be perfunctory.

ACCOUNTING FOR INCOME TAXES (ISSUE NO. 11)

The majority of AcSEC members disagree with the ED's requirement that, in all cases, a company must write-off the excess deferred tax asset related to an individual award with a corresponding charge to income, regardless of whether there is any remaining additional paid-in capital arising from other equity awards. Those members believe that tax deficiencies and excess tax benefits that resulted from equity instruments should be recorded as additional paid-in capital. At a minimum, those members believe that the guidance in FASB Statement No. 123, which first allocates any effect of an income tax deficiency to additional paid-in capital to the extent that excess tax deductions have been recognized in additional paid-in capital, should be retained.

DISCLOSURES – (ISSUE NO. 12)

The ED proposes to require intrinsic-value disclosures with the objective of disclosing the potential effects of the transfer of value from existing shareholders to option holders upon option exercise. AcSEC members question the appropriateness of the proposed intrinsic-value disclosures given that the ED is based on a fair-value-based model of accounting.

OTHER COMMENTS

NEW STANDARD

AcSEC observes that the Board has taken the approach of revising FASB Statement No. 123 by incorporating the new proposed guidance and deleting superseded guidance, rather than issuing a new FASB Statement. AcSEC believes that approach will be confusing. Therefore, we suggest that the Board issue a new standard and rescind previous guidance.

DEFERRED TAX - TRANSITION - REVERSAL OF TAX

Footnote 29 to paragraph B67 of Appendix B, *Implementation Guidance*, would require that the tax benefit associated with the deduction taken for the exercise of a share option be recorded only in the period that it reduces income taxes payable. Some AcSEC members noted that this provision may result in a significant change in practice for certain entities. AcSEC suggests that, if the Board wishes to change this practice, the underlying basis for the change needs a much more robust discussion than simply an inclusion of a footnote to an appendix. In addition, the final Statement should address transition issues related to this change in practice.

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We appreciate the opportunity to comment on the ED. Representatives of AcSEC would be pleased to discuss our comments with the Board members or staff.

Sincerely,

Mark Bielstein, Chair Accounting Standards Executive Committee Carl Kampel, Chair Share-Based Payment Task Force March 3, 2003

Ms. Kimberley Crook Project Manager International Accounting Standards Board 30 Cannon Street London EC4M 6XH, United Kingdom

Dear Ms. Crook:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants appreciates the opportunity to comment on the IASB's Exposure Draft, Share-Based Payment (ED). Because of the increasing use of share-based compensation by entities world-wide, AcSEC believes that development of an international standard addressing the accounting for share-based payments will improve financial reporting.

Overall Comment

AcSEC agrees that all share-based payment transactions should be recognized in financial statements and measured at fair value. While AcSEC continues to have concerns about the reliability of valuations of share-based arrangements, AcSEC believes that, all things considered, share-based payment transactions measured at fair value result in more relevant financial information.

Reconciliation to Past AcSEC View

In its January 19, 1994 comment letter on FASB's ED Accounting for Stock-based Compensation, a majority of AcSEC did not support "recognition of compensation cost for fixed stock options with an exercise price not less than market price at date of grant." That majority of AcSEC set forth two principal reasons for its position: "(1) the models used to calculate the fair value of such options were designed for use with traded options and (2) the expense amount for such options based on those models cannot be validated by reference to transactions with third parties and therefore lacks sufficient reliability for recognition in financial statements."

AcSEC believes that, over the past decade, preparers, auditors, and users of financial statements have become more familiar with transactions that include share-based payments and the related valuation issues. Considerable progress has been achieved in understanding the use of option models to measure option values and their use in the design of compensation arrangements. In addition, pro forma disclosures made in accordance with FASB Statement No. 123, Accounting for Stock-Based Compensation, have provided analysts and other users with alternative stock compensation information that has been increasingly used to evaluate company performance. Accordingly, AcSEC now believes that entities should recognize those transactions in financial statements at fair value.

Specific Comments

Employee Stock Purchase Plans. AcSEC agrees with the inclusion of employee stock purchase plans in the scope of the ED for practical and conceptual reasons. To do otherwise would result in an arbitrary exclusion, and AcSEC finds no overwhelming basis to support such exclusion.

<u>Measurement Presumption</u>. Paragraph 7 of the ED includes the concept that the fair value of equity instruments granted is a surrogate (or indirect) measure of the fair value of goods or services received. AcSEC recommends that the IASB drop this concept from the final standard, and instead require an entity to measure fair value using the more readily determinable of what is given up or received in the transaction, with no presumptions indicated.

<u>Measurement Date</u>. AcSEC agrees with the IASB proposal that the grant date is the most appropriate date to measure the fair value of exchange transactions with employees and nonemployees, regardless of whether an entity measures what is given up or received in a transaction.

Forfeitures. AcSEC disagrees with the ED's requirement that an entity consider the effect of forfeitures in determining the fair value of an equity instrument. AcSEC believes that forfeitures do not affect the value of an equity instrument at the time of issuance and that estimates of the effect of forfeitures on the fair value of an award may not be reliable. However, AcSEC believes that the effect of subsequent forfeitures should be accounted for as a reversal of expense previously recognized. AcSEC believes that there should be comparability in the principles of recognition for cash-based and equity-based compensation arrangements. Therefore, forfeitures should have accounting consequences similar to cash awards that are forfeited, that is, any amounts previously recognized should be reversed. Recognizing an adjustment to compensation expense for the effect of forfeitures is consistent with accounting for other compensation arrangements.

<u>Performance-Based Awards.</u> Consistent with its views on forfeitures, AcSEC believes that compensation cost for performance-based awards should be adjusted for changes in expected outcome until vesting date. AcSEC believes that the initial reported compensation cost should be based on the best estimate of the outcome of a performance condition. AcSEC believes that compensation cost for performance-based awards should be adjusted based on the final outcome of the awards because it is uncertain whether the awards will vest and it would be inappropriate to recognize compensation expense when conditions are not met and awards do not vest. AcSEC's suggested approach is consistent with accounting for other performance-based compensation arrangements.

<u>Volatility Input.</u> Paragraphs BC137-143 of the ED note that unlisted entities are required to use the volatility input to an option-pricing model. AcSEC believes that unlisted entities should be permitted to use the minimum value method, which excludes the effects of expected volatility from an option-pricing model, because of the difficulties in making reliable estimates of the expected volatility of the share price of unlisted entities. AcSEC believes that the minimum value method for unlisted entities will result in useful information for those entities and users of the related financial statements.

Although a majority of AcSEC members agrees with the IASB proposal to include volatility in the option-pricing model for listed entities, other AcSEC members believe that volatility should be excluded from the option-pricing model for both listed and unlisted entities because of difficulties in making reliable estimates of volatility. Some AcSEC members cite studies that demonstrate that the implied volatility tends to overstate fair values of traded equity securities.

<u>Valuation models.</u> AcSEC supports mandating the use of an option-pricing model at this time to obtain a level of comparability and consistency in practice. However, AcSEC recommends that the final standard explicitly acknowledge and allow for improvements to current valuation models. AcSEC believes that the final standard will have a longer useful life if it acknowledges inevitable improvements in finance theory.

<u>Income Tax Effects.</u> AcSEC disagrees with the ED's requirement that all tax effects related to equity instruments granted should be recognized in the income statement. AcSEC believes realized tax benefits from equity instruments granted that exceed the tax benefits based on

cumulative stock compensation expense recognized for financial reporting purposes should be credited directly to equity. AcSEC believes that the excess tax benefits resulting from different measurement dates and methods for financial reporting and tax purposes are attributable to an equity transaction for financial reporting purposes. In addition, the IASB proposal to report tax benefits for tax deductions in excess of the compensation expense recognized for financial reporting purposes is inconsistent with the overall approach to intraperiod tax allocation. AcSEC believes that the excess tax benefits should not be reported as an income tax benefit attributable to continuing operations because the related excess tax deduction was not reported in operations.

<u>Disclosures</u>. Although AcSEC agrees with the IASB proposal that an entity should disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements, AcSEC questions whether all of the extensive disclosures set forth in the ED following that general principle are necessary. AcSEC recommends that the IASB obtain specific recommendations from analysts, creditors, and other users of financial statements to ensure that the disclosures meet their needs and that unnecessary disclosures do not detract from useful disclosures.

Representatives of AcSEC are available to discuss these comments with the IASB Board members or staff.

Sincerely,

Mark V. Sever, Chairman Accounting Standards Executive Committee Mark M. Bielstein, Chairman Comment Letter Task Force