Letter of Comment No: 3075 File Reference: 1102-100

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Richard Carroll IBM Chief Accounting Officer New Orchard Road Armonk, NY 10504

Mr. Robert Herz – File Reference No. 1102 - 100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

IBM appreciates the opportunity to provide our views on the Exposure Draft (ED), Share-Based Payment, an amendment of FASB Statements No. 123 and 95, (the proposed Statement). While we request the Board consider each of our recommendations, the following points are those that we consider the most important.

- We believe the Board should allow ratable attribution for awards with graded vesting because the
  attribution should coincide with the employee service period, not the vesting pattern of the award.
  Additionally, we disagree with the Board's position that each tranche must be treated (and
  valued) as a separate award.
- We contend that both excess and "shortfall" tax benefits from equity-based awards should be
  recorded in additional paid-in capital because they relate to an equity transaction at exercise.
  Further, we disagree that all "true-ups" should be performed on an individual employee basis
  because the initial valuation of these awards (and the related grant date tax accounting) is
  performed on a portfolio basis.
- We believe there is insufficient guidance provided in the proposed Statement as it relates to the
  accounting for share-based awards exchanged in a business combination, specifically the impact
  that such exchanges will have on the purchase price. We recommend that the Board consider our
  recommended guidance on page 11 for inclusion in the final Statement.
- Additionally, we believe the Board should permit entities to adopt the final Statement under a
  retroactive transition method in an effort to provide for greater consistency when evaluating a
  company's financial statements period-to-period.

The following are our detailed recommendations. To the extent we are addressing one of the ED's Issues, we included the Issue in bold and italics immediately preceding our related response.

## Fair Value Measurement

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 do not believe that the Board should require a specific method of estimating expected volatility and moreover concur with the Board's view that would require entities to make their best estimate of expected volatility (as well as other assumptions) in computing the fair value of share-based awards. Such an approach supports the FASB's movement towards principles-based standards and would provide entities the ability to make judgments and estimates that would be representative of the unique features of their business. These judgments and estimates would ultimately yield an increased degree of accuracy and reliability with respect to fair value measurements of such instruments. Further, requiring entities to use specific methods of estimating inputs could potentially prohibit the use of more precise valuation techniques as valuation models continue to evolve.

Recommendation: The Board should not require a specific method of estimating expected volatility.

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 concur with the Board's conclusion that compensation cost should be recognized only for those equity instruments that are not forfeited. We disagree, however, with the Board's decision to eliminate the alternative that would permit companies to record forfeitures as they occur. We agree with the decision reached by the Board in Statement 123 that this alternative should be allowed for cost-benefit reasons. For certain companies with a low turnover rate and historical forfeiture data that is indicative of future expectations, there does not appear to be a cost-benefit argument to require these companies to estimate a forfeiture rate (or multiple rates based on the characteristics of grants and grantees). As such, we recommend that in those situations, companies should be allowed to record forfeitures based on actual results.

Additionally, the ED does not address the transition for companies that were recording forfeitures based on actual results. If this alternative is eliminated by the final Statement, we recommend that these entities begin estimating a forfeiture rate (or rates) for unvested awards (and new grants) upon adoption of the new Statement, as opposed to recording actual results for the remaining vesting term.

<u>Recommendations:</u> The Board should (1) permit entities to choose a forfeiture alternative based on their specific facts and circumstances; and (2) provide transition guidance for entities that had been recording forfeitures based on actual results, as discussed above.

# **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?

We do not agree with the provisions of paragraph 9 of the ED for the reasons discussed in the Basis for Conclusions of Statement 123. In Statement 123, the Board concluded that as long as the discount on a broad-based plan met the criteria stated in paragraph 236, the plan would receive non-compensatory treatment. We believe that a discount offered to employees in a broad-based employee stock purchase plan is aimed at encouraging employees to become shareholders rather than compensation for employee services. We concur with the Board's conclusions in Statement 123 that a small percentage (i.e., 5%) discount is an inducement that is analogous to stock issuance costs avoided by issuing stock to employees rather than the public.

<u>Recommendation:</u> The Board should retain the 5% rule from Statement 123 relating to employee stock purchase plans.

# **Attribution of Compensation Costs**

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?

The proposed Statement prescribes a single method of attribution for awards with graded vesting (and eliminates the straight-line alternative allowed by Statement 123). While a theoretical argument can be made for a method of attribution that matches to the vesting pattern of each tranche, we believe that a stronger theoretical argument can be made that compensation costs should be recognized in a pattern that is representative of the value of the employees' services rendered. We support the view that transactions, in which services are received as consideration for equity instruments of the entity, should be measured at the fair value of the equity instruments to the extent the fair value of the services cannot be reliably measured. In a share-based payment arrangement, although entities measure the value of employee services received based on the fair value of the equity instruments exchanged, that value should be recorded over the employees' requisite service periods, not the equity instruments' vesting periods. Given the fact that employees' services are performed uniformly over the vesting period, (regardless of

whether the award's terms are cliff or graded) we believe a ratable attribution pattern is more appropriate and conceptually pure. If the objective of accounting for grants of share-based awards to employees is to recognize a charge in the income statement for the fair value of employee services rendered, then although awards may have different vesting terms, they should still yield the same expense attribution patterns. Additionally, we view an award with graded vesting as a single award, not a series of individual awards. In paragraph 202 of Statement 123, the Board acknowledged that the graded vesting attribution method is more complicated and may be illogical if the award with graded vesting is considered a single award. As a result, we believe that straight-line amortization is appropriate for both cliff and graded vesting awards.

Concurrently, we disagree with the proposed Statement's view that an award with a graded vesting schedule is considered to be, in substance, separate awards, requiring different fair value measurements. Instead, we believe that a lattice valuation model can be built to address the issue of multiple vesting tranches within an award. The valuation framework inherent in a lattice model takes into account the exercise behavior of employees. Exercise behavior is dependent not only on employee demographics, expected future stock price, and economic and industry conditions, but the ability to exercise (i.e., if an award has four-year graded vesting, the model can be built such that the third tranche cannot assume exercise any earlier than the beginning of year four).

As a result, we contend that one option value, that gives appropriate consideration to the graded vesting pattern, can be assigned to a grant if a company utilizes a lattice valuation model. We believe a single value of compensation expense can be assigned to a graded vested award and yield an amount of compensation expense that is equal to the sum of the separate valuation of each of the tranches. For example, in the Illustration included in paragraph B72 of the proposed Statement, a single value of \$14.23 could be assigned to this award as opposed to three separate values (\$13.44 for Tranche 1, \$14.17 for Tranche 2, and \$14.69 for Tranche 3). Building the graded vesting exercisability into the lattice model eliminates much of the complexity that results from having to assign and track separate values for each tranche of an award. As a result, the tracking and true-up of the tax benefit associated with each tranche would be simplified.

For instance, in our discussion of Issue 11 on income taxes, we have included an example of a four-year graded vested award with separate fair values assigned to each tranche. (That example assumes an award of 4,000 options with four-year graded vesting is granted to an employee with a tax rate of 40%.) Instead of using four separate values, the lattice model would generate a single value of \$113.75 for the award. By assigning a single value to the award, the tax true-up is less complex, as each option is assigned a fair value of \$113.75 and a deferred tax asset of \$45.50. If 1,400 options are exercised, the recorded deferred tax asset associated with those awards is \$63,700 (1,400 x \$45.50). There is no need to track data by tranche, nor use a first-in first-out (FIFO) application back to the tranches. Additionally, tracking becomes even less complex if the Board agrees that the appropriate method of attribution is straight-line.

Further, we do not believe that any potential benefits associated with a graded vesting model outweigh the significant costs that will need to be incurred by companies to apply this model. As proposed, the graded vesting model (for both attribution and valuation) will require significant overhaul/development of systems, particularly for companies with broad-based option plans. Assuming grant levels and valuations remain consistent year-to-year, it is our contention that after the initial ramp up of the graded vesting methodology, period compensation expense would mirror the expense recorded under a ratable approach.

Given (1) our theoretical argument for recognizing compensation charges in a manner that mirrors the "uniform" rendering of employee services, (2) the fact that a lattice valuation model could capture the value of each tranche into a single value, (3) the significant overhaul/development of systems required to support the proposed Statement's attribution and valuation approach, (4) the fact that after the initial ramp

up of the graded vesting approach, period compensation expense would level out (all things held constant), and (5) the expected timing of the final issuance of the proposed Statement (fourth quarter of 2004) and the time required to develop the systems needed to apply the graded vesting model (by January 1, 2005), we recommend that the Board reconsider its position on attribution and valuation of awards with a graded vesting schedule.

If the Board requires the graded vesting model in the final Statement, we request that the following be considered: (1) The modified prospective transition methodology that was proposed in the ED will result in inconsistent amortization of compensation costs between pre-adoption and post-adoption awards with graded vesting. We recommend a change in transition (to permit retroactive application) in order to eliminate this inconsistency; and (2) Given the expected timing of the final issuance of the proposed Statement and the time required to develop the systems needed to apply the graded vesting model, consider this in light of the proposed effective date.

Recommendations: The Board should: (1) allow a straight-line attribution model for awards with graded vesting; (2) allow entities to value an award with a graded vesting schedule as a single award; (3) consider any implications on the proposed effective date if (2) is not accepted; and (4) permit retroactive restatement to allow companies to present financial statements on a consistent basis, year-to-year, if (1) and (2) are not accepted.

## **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 do not support the IFRS 2 method of accounting for tax consequences of instruments awarded to employees. Additionally, we do not support the FASB's requirement that all excess tax benefits should be recorded in additional paid-in capital and all "shortfalls" should be recorded in the income statement; instead we believe all tax "true-ups" should be recorded in additional paid-in capital. Finally, we do not support the ED's requirement to track and true-up tax benefits associated with share-based awards on an individual basis. Each of these points is expanded upon in the following paragraphs.

We concur with the Board's decision that the amount of the temporary difference recognized prior to an award's exercise should be determined based on the fair value of the award (and compensation cost recognized) used for book purposes rather than by reference to the expected future tax deduction (i.e., by remeasurement to current intrinsic value every reporting period). As a result, we do not support the IFRS 2 methodology, which requires reference to an expected future tax deduction. Per IFRS 2, true-up entries to either additional paid-in capital or to the income statement are required every reporting period until settlement (for up to forty periods for an award with a 10 year life) based on intrinsic value. Under the IASB's methodology, companies will be required to track deferred tax asset data on a grant-by-grant, country-by-country, individual-by-individual, and (in certain circumstances, tranche-by-tranche basis), and will be required to perform this true-up process for every award every reporting period until the award's settlement. For a multinational company with a broad-based program and a mobile employee workforce, this will be quite a costly endeavor. Ultimately, by settlement date (i.e., exercise or expiration), the amount of deferred tax asset recognized will be equal under both the IASB and FASB methodologies. As such, there appears to be no cost-benefit rationale for adoption of the IASB's

approach. We acknowledge that in the absence of changes to the ED, the FASB's methodology will still require companies to implement a systematic tracking process to perform true-up calculations at either expiration, exercise, or forfeiture of an individual award. It will not, however, require true-up of every award at every reporting period. As detailed below, we believe that the FASB methodology also fails a cost-benefit analysis. In the absence of any other choice, however, we believe the FASB's approach is more practical than the IFRS 2 requirements.

The FASB's ED on share-based payments provides that excess tax benefits (defined as any realized tax benefit in excess of the previously recognized deferred tax asset) would be recognized as additional paid-in capital. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost would be reported as income tax expense. We do not agree with this method of accounting for income taxes, and believe that any adjustments necessary to account for differences between the tax effect of the compensation cost recognized for financial statement purposes and that of the actual tax deduction realized (both excesses and "shortfalls") should be recorded in additional paid-in capital.

We believe that all equity-based compensation awards are essentially transactions comprised of two stages: compensation expense during vesting and an equity transaction at exercise date. This seems consistent with the Board's conclusion in paragraph C129, which states that the total tax deduction pertains to two separate transactions or events:

- a. A transaction in which employees render services as consideration for an award of shares, share options, or other forms of share-based payment. Use of those services in the entity's operations results in compensation cost, which is an income statement item.
- b. A equity transaction, such as the exercise of share options. That equity transaction will be affected by share price changes between the date an award of options is granted and the date the award is exercised or otherwise settled.

Consistent with this view and the intraperiod allocation principle in Statement 109, Accounting for Income Taxes, we believe that the tax accounting treatment should be similarly bifurcated with (1) income statement recognition at the time of grant for the tax effects related to the award's fair value and the recognition of a deferred tax asset, and (2) balance sheet recognition at the time of exercise to true-up the deferred tax asset through additional paid-in capital, regardless of whether the true-up is an excess or "shortfall" as compared to the deferred tax asset. This treatment is similar to the approach required under Statement 109 for the tax consequences of other equity transactions. For example, paragraph 36(c) of Statement 109 requires the tax effect of temporary differences caused by stock issuances to be recorded in equity as an addition to or reduction of the proceeds from the stock issuance.

We support the general principle that all tax effects should be recognized in the income statement and the tax effects of items recognized in equity should be reported in equity alongside the items to which they relate. The measurement date for recording pre-tax compensation expense in the income statement is the grant date, with no adjustment for subsequent changes in the intrinsic value of the award. The tax accounting treatment as described above would match this principle – that is, the tax effect would be recorded in the income statement only based on the fair value of an award at grant date, and any adjustments resulting from differences in the actual tax deduction (generally determined at exercise date) would be recorded in additional paid-in capital. We are troubled by the inequitable result that this proposed Statement would create by recording an adjustment to the income tax provision without a corresponding adjustment to pre-tax income.

In paragraph 44 of the proposed Statement, the Board specifies that the tax deduction received for an individual employee's equity instruments must be trued-up to the amount that had been recorded as a deferred tax asset for those instruments. This represents a significant change in language from that

included in Statement 123. That Statement did not specify that companies would be required to perform true-up calculations on an individual employee basis. The absence of this language in Statement 123 coupled with the fact that the Board allowed "shortfalls" to be recorded against additional paid-in capital to the extent that a company had built-up excesses in equity for prior awards (that had been accounted for under a fair value method), led many companies to apply Statement 123 tax accounting on a portfolio approach. We believe it is conceptually appropriate to perform tax accounting "true-ups" on a portfolio approach and that this approach meets a cost-benefit analysis as compared to the requirements to true-up on an individual basis as required in the proposed Statement.

Under the ED, the valuation of share-based payment awards will be performed on a grant-by-grant basis, not on an individual-by-individual basis. Determining fair values of awards by grant takes into consideration the expected exercise behavior of the group as a whole. Inherently, certain employees in each grant will exercise their awards before optimal exercise dates and others will exercise after optimal exercise dates. Upon determination of the grant's fair value, this amount will be recorded over the employees' requisite service periods with an associated build up of a deferred tax asset (based on the applicable tax rates for the employee group). Given the fact that the deferred tax asset is recorded on a portfolio approach based on a valuation that includes both suboptimal and optimal exercise behavior, it seems conceptually inappropriate to require companies to true-up the actual tax deduction received for each individual employee to a pro-rate portion of a deferred tax asset recorded per books (that already includes a "smoothing" impact for the portfolio). Given that the valuation and grant date tax accounting is performed on a portfolio basis, we believe it is also appropriate to record the related true-up on a portfolio basis. Additionally, any amounts that differ from the cumulative amount recorded for the total grant would be recorded in additional paid-in capital (as noted above).

In addition, from a cost-benefit perspective, we believe the proposed requirement that tax "true-ups" be performed on an individual employee basis is a particularly burdensome administrative requirement for multinational companies with broad-based programs (i.e., with tens of thousands of optionees). Further, the complexities associated with a mobile workforce, especially expatriates (regardless of the "home" country), result in additional burdens presuming that true-up adjustments of local country tax effects must be tracked on a quarterly basis over the life of each individual's award(s). This becomes even more complex for a company that has to track share-based awards by individual and by tranche (if required to value each graded vesting tranche at a separate value). Although the Board has specified that in the absence of tracking exercises by tranche, a company may employ a FIFO-based approach to exercise, because of the different values assigned to each tranche and the attribution method proposed, this will still require a complex matching back to the tranche. For example, assume an award of 4,000 options with four-year graded vesting is granted to an employee (tax rate of 40%) with the following fair values per option: Tranche 1: \$100 Tranche 2: \$110 Tranche 3: \$120 Tranche 4: \$125

	2005	2006	2007	2008	Total
Tranche 1					
Compensation Expense	100,000				100,000
Deferred Tax Asset	40,000				40,000
Tranche 2	,				
Compensation Expense	55,000	55,000			110,000
Deferred Tax Asset	22,000	22,000			44,000
Tranche 3			· · · · · · · · · · · · · · · · · · ·		
Compensation Expense	40,000	40,000	40,000	ļ	120,000
Deferred Tax Asset	16,000	16,000	16,000		48,000
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Tranche 4			<u> </u>		
Compensation Expense	31,250	31,250	31,250	31,250	125,000
Deferred Tax Asset	12,500	12,500	12,500	12,500	50,000
Totals					
Compensation Expense	226,250	126,250	71,250	31,250	455,000
Deferred Tax Asset	90,500	50,500	28,500	12,500	182,000
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On 1/1/08, the employee exercises 1,400 options, each with an \$80 intrinsic value at exercise. The company employs a FIFO methodology for "true-ups"; as such, it is presumed that 1,000 options were exercised from Tranche 1 and 400 options were exercised from Tranche 2. The total deferred tax asset recorded as of 12/31/07 is \$169,500. However, this example shows that even though the company uses a FIFO methodology for truing-up the tax impacts at exercise, it must still track this data on an individual and tranche-by tranche-basis, because at exercise, the actual deduction received  $\{(1,400 \times $80) \times 40\% = $44,800\}$  must be compared to the deferred tax asset recorded for those 1,400 options  $\{(1,000 \times $100 \times 40\%) + (400 \times $110 \times 40\%) = $57,600\}$ , as opposed to the total amount of the deferred tax asset recorded as of 12/31/07. This example would result in a "shortfall" recorded to the income statement of \$12,800 at exercise.

Alternatively, a model that allows companies to compare actual cumulative tax deductions received to the total portfolio deferred tax asset recorded results in a significantly less complex system of tracking and true-up requirements under either a cliff or graded vesting attribution model. Given both the theoretical and cost-benefit concerns detailed above, we strongly encourage the Board to reconsider this change in language from Statement 123 and allow companies to utilize a portfolio approach for tax "true-ups".

<u>Recommendations:</u> The Board should: (1) not converge the final Statement with the IFRS 2 model; (2) allow entities to record any excess tax benefits and "shortfalls" to additional paid-in capital; and (3) eliminate the requirement to perform "true-ups" on an individual employee basis.

## **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.

We believe that the disclosure objectives set forth in the proposed Statement (paragraph 46 of Appendix A) are appropriate and complete. In our opinion, they are sufficient without additional guidance. Consistent with the principles-based approach, we do not believe additional guidance in the form of the Minimum Required Disclosures (paragraphs B191 – B193) is warranted. Additionally, we believe that a significant purpose of the disclosure requirements under Statement 123 was to accommodate the fact that entities continued to account for stock options under the intrinsic value provisions of APB 25, Accounting for Stock Issued to Employees. While we understand and support the Board's belief that the intent of disclosures is to "explain and elaborate on information recognized in the financial statements" we contend

that the level of disclosure required under the Minimum Required Disclosures is greater than that required under Statement 123 and is burdensome and excessive given the recognition of the associated compensation costs in the financial statements. We would further contend that there are few costs recognized in the financial statements with a comparable level of disclosure requirements. Permitting companies to exclusively utilize the principles-based disclosure objectives would allow entities to achieve flexible but appropriate levels of disclosure, reflective of their specific circumstances, which would ultimately provide the most meaningful value to users of financial statements.

<u>Recommendations:</u> The Board should: (1) eliminate the Minimum Required Disclosures; and (2) permit entities to exclusively utilize the principles-based disclosure objectives.

#### **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?

For the same reason given in Statement 148, Accounting for Stock-Based Compensation-Transition and Disclosure, we believe that the Board should allow companies to adopt the proposed Statement under either a modified prospective transition or a "modified retroactive" transition. "Modified retroactive" transition represents the restatement of prior periods' reported net income to the fair value-based method of accounting for awards granted, modified, or settled in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required by Statement 123. As noted in paragraph A14 of Statement 148, the Board affirmed its decision to permit both the retroactive restatement method (which is the "modified retroactive" method described above) and the modified prospective method because (a) both methods address the ramp-up effect that results from the prospective transition and (b) the reported amount of stock-based compensation cost determined under either method will be the same in the period of adoption and all subsequent periods. We contend that if it is practicable for a company to restate prior period financials, even on this "modified retroactive" approach, it will result in greater consistency when evaluating the company's financial statements period-to-period (i.e., for trend analysis). Additionally, prohibiting retroactive restatement, thereby, requiring a portion of compensation cost be recorded in the income statement and a portion be disclosed is inconsistent with one of the Board's main arguments for mandating the fair value recognition of share-based compensation in companies' income statements--that footnote disclosure is not a substitute for accounting recognition. As a result, we fully support permitting entities to restate their prior period financial statements using a "modified retroactive" transition if it is practicable to do so.

Additionally, we believe that entities should be permitted to restate their prior period financial statements under a full retroactive transition. As such, all valuations would be performed on a similar basis (i.e., lattice model) and attribution would be on a similar basis (i.e., grading vesting; to the extent our recommendation on graded vesting is not accepted) period-to-period. From a pure comparability standpoint, we believe this would be the most appropriate accounting treatment. This approach would allow valuation methodologies, tax consequences, and recognition patterns to be consistently applied within a company's financial statements. In the Basis for Conclusions of the proposed Statement, the Board rejected the full retroactive restatement approach because a company might conclude that some aspect of its valuation method used in prior years should be changed, which could call for revised estimates of prior period data (i.e., revised estimates of employees' expected early exercise and post-vesting employment termination behavior would have the benefit of hindsight). We agree with the Board's concern as it relates to hindsight, however, we believe that valuations could be re-performed

using the lattice model with historical data available at grant date. We believe that it is entirely appropriate that companies be allowed to use a valuation methodology that may not have been widely accepted (or understood) at the time the pro forma calculations were prepared. One argument against fair value expensing has consistently been that closed-form models overvalue share-based awards. If a company is going to restate its prior period financial statements (and be subject in future periods to true-up of tax accounting, which is based on the initial valuation), we believe it is appropriate to allow entities to re-value their awards under a preferable (as described by the Board) and more reliable method of valuation than may have been used when preparing their pro forma disclosures.

While we understand that the Board must consider the entire hierarchy of accounting qualities prescribed in FASB Concept Statement No. 2, we believe it is imperative that companies be permitted to apply the final Statement consistently within their financial statements. Per FASB Concept Statement No. 2:

Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

We acknowledge that full retroactive restatement may be impracticable for certain companies and we do not recommend that it be mandated. To the extent a company has the ability and the data available to comply with this transition, however, we believe companies should be permitted to do so, in order to achieve consistency in period-to-period financial statements

Lastly, we request that the Board include transitional disclosure examples to aid companies in their first year of adoption (similar to the type provided in Statement 148). Specifically, please clarify through example disclosure, the language included in paragraph 24, page 8 of the proposed Statement.

<u>Recommendations:</u> The Board should (1) permit entities to adopt the final Statement under the following transition methods: (a) modified prospective; (b) "modified retroactive"; or (c) full retroactive; and (2) provide transitional disclosure examples to aid in the year of adoption.

#### 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 understand the Board's conclusion that cash retained as a result of the tax deductibility of increases in the value of equity instruments (excesses) issued to parties under share-based payment arrangements that are not included in compensation cost recognizable for book purposes should be classified as cash inflows from financing activities. We believe, however, this is inconsistent with the decision reached in EITF 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option, and inconsistent with the treatment of the operating cash flow impacts of other investing or financing transactions, as prescribed by Statement 95. For example, although proceeds from issuing either short- or long-term borrowings are financing transactions (and appropriately displayed as a cash inflows from financing activities in the statement of cash flows),

the associated interest expense and tax benefits derived from that expense deduction, are reported as cash inflows from operating activities.

<u>Recommendation:</u> The Board should not amend Statement 95 for the specific treatment of taxes related to share-based awards.

# 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?

As detailed in our response to Issue 11, we strongly disagree with IFRS 2's method of accounting for the income tax impacts of share-based awards. Additionally, we reviewed the provisions of the ED that describe the differences between the IASE's treatment of Type III medifications and the modifications that result in conversion of equity awards to liability awards and we agree with the treatment prescribed by the FASB's ED.

Recommendation: The Board should not converge with the IASB on any of these matters.

### **OTHER**

# Share-Based Awards Exchanged in a Business Combination

Paragraph 36 of the proposed Statement provides that options and/or share-based payments exchanged in a business combination are considered modifications. The ED further states that all other aspects of accounting for such share-based arrangements are being reconsidered as part of the Board's Business Combinations II project. It is unclear as to how this limited guidance will impact the accounting for business combinations, specifically the impact that such payments will have on the purchase price. We believe that options and/or share-based awards exchanged in a business combination should be measured at fair value and included as a component of the purchase price of the acquired entity unless future service is required in order for an employee to vest in such awards. The fair value of the newly exchanged unvested awards should be recorded as deferred compensation (equity) and recognized in the statement of earnings over the remaining service period.

<u>Recommendation:</u> Given the potential lag in effective dates between the two standards, (i.e., the current proposed effective date of the Business Combinations II project of 1/1/06 versus the effective date of the proposed Statement of 1/1/05) we encourage the Board to provide the above recommended additional guidance as it relates to accounting for exchanges of options or share-based awards in a business combination.

## Implementation and Effective Date

Based on the FASB's most recent Technical Plan, the final Statement on share-based payments is scheduled for issuance in the 4<sup>th</sup> quarter of 2004. The proposed Statement is effective for fiscal years beginning after December 15, 2004, or January 1, 2005 for calendar year companies. In the Basis for Conclusions of the proposed Statement, the Board states that a short time period between issuance and

effective date is warranted because public companies have been recognizing the pro forma effects of share-based payments in the financial statements for years, and although the fair value-based method in the proposed Statement differs in various respects from the one in Statement 123, those differences are not sufficient to require an extended transition period.

We contend that many of the changes proposed in the ED will require major systems modifications and implementation lead time. Specifically, the following proposals are significantly different from the accounting treatment afforded by Statement 123: (1) the accounting for income taxes (with the true-up on an individual versus portfolio basis); (2) the required attribution and valuation of awards with graded vesting; (3) the valuation method to be used (the Board's support of the lattice model as the preferable method of valuation; while not mandated, companies will likely want to adopt under the preferable method); (4) the accounting for forfeitures (prohibition of allowing companies to book as they occur). Given the possibility that the Board may change aspects of the ED prior to issuance of a final Statement (in response, perhaps, to the comment letter process and Roundtables), especially those that currently require significant systems changes and resources, companies may be very hesitant to make investments in such systems and resources until the final Statement is issued. The current timing of the final Statement (i.e., fourth quarter 2004), may make it very difficult for such companies to prepare for a January 1, 2005 implementation.

Recommendation: If the aspects of the ED that require significant work and investment to implement (specifically (1), (2), and (4) above) are not changed to be less burdensome, we request that the Board consider the effective date of this proposed Statement in light of the significant systems modifications and lead time required.

We are available to meet with you in person or telephonically to discuss these issues further. You may reach me at 914-499-5260 or David Colistra at 914-766-0850.

Sincerely,

Richard Carroll