



Letter of Comment No: 32
File Reference: 1101-001
Date Received: 11/4/02

November 1, 2002

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

**Proposed Statement of Financial Accounting Standards,
“Accounting for Stock-Based Compensation—Transition and Disclosure”
(File Reference No. 1101-001)**

Dear Ms. Bielstein:

We appreciate the opportunity to provide you with our comments on the Proposed Statement of Financial Accounting Standards, *Accounting for Stock-Based Compensation—Transition and Disclosure*, (the Exposure Draft). We commend the Board for its responsiveness to constituent concerns about the transition requirement of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. We generally support the decisions described in the Exposure Draft, although we do have certain comments for the Board’s consideration.

Transition Alternatives

We agree with the Board’s decision to provide additional transition approaches for the adoption of Statement 123 that would enhance the comparability of the statement of operations for different reporting periods. We also understand that the Board wishes to provide multiple transition alternatives to encourage adoption of Statement 123. However, we do have concerns that the continued use of three transition alternatives will reduce the comparability of the statement of operations among different companies and may create confusion among investors.

We considered recommending that one of the newly proposed transition alternatives be eliminated. We expect that, for a variety of reasons, most companies would prefer not to restate their historical financial statements and, accordingly, we considered recommending that the transition alternatives be limited to prospective approaches. However, we believe that any concerns about the lack of comparability associated with the various transition approaches are mitigated by the pro forma disclosures required by Statement 123 (as proposed to be expanded in the Exposure Draft). Further, we acknowledge that retroactive application of Statement 123 results in the clearest and most comparable financial statements, and do not wish to prohibit companies that wish to adopt Statement 123 retroactively from doing so. Accordingly, we are not opposed to the Board’s decision to provide for two additional transition alternatives for companies adopting Statement 123.



Ms. Suzanne Q. Bielstein

November 1, 2002

Page 2

The Board has proposed not to eliminate the prospective transition approach currently required by Statement 123 (i.e., prospective application only to new awards) even though the information to apply either of the proposed transition approaches will be readily available. We understand that decision was based on the desire not to penalize companies that have made the decision to adopt Statement 123 based on its existing transition provisions, and we agree with this rationale. However, we believe that the Board can still be fair to those companies by permitting the use of the original prospective approach only for companies that adopt the recognition provisions of Statement 123 for employee stock-based compensation by a certain date (say, for fiscal years beginning before July 15, 2003). Such an approach ultimately would limit the transition alternatives to two approaches without unfairly penalizing companies that already have announced their intent to adopt the recognition provisions of Statement 123 for employee stock-based compensation.

Regarding the potential adjustment to additional paid-in capital described in proposed paragraph 52A, we note that the adjustment may be required for unvested awards and “certain variable awards.” However, the Board does not describe what it means by the phrase “certain variable awards.” We believe the proposed guidance refers to an equity award accounted for as a variable award under Opinion 25 that would be accounted for as a fixed award under Statement 123 (e.g., an award that was accounted for as a variable award under Opinion 25 because of a prior repricing). However, that is not clear from the language used in the Exposure Draft and we recommend further clarification of the Board’s intent. Additionally, we recommend that the Board provide examples of the application of the guidance in paragraph 52A to help ensure consistent application.

We also note that the proposed prospective transition may result in unintended consequences. Under Statement 123 companies may recognize compensation cost assuming that all awards subject only to service requirements will vest, and recognize the effect of forfeitures as they occur by reversing any compensation expense previously recognized for those forfeited awards. In applying the FASB’s proposed prospective transition guidance, it appears that a company could recognize income in the form of the “reversal” of expense that previously was only recognized in pro forma disclosures. In some circumstances, those reversals could exceed current period stock compensation expense, resulting in net income from stock options expense. The FASB may wish to consider whether the reversal of compensation expense not previously recognized in the statement of operations should be recognized as an adjustment to additional paid-in capital, with no impact on the statement of operations.

Expanded Disclosures

We are highly concerned about excessive disclosure requirements and the need for investors to sift through the resulting voluminous financial information to obtain information that is relevant to their investment decision. However, in light of the existence of two alternative accounting methods for accounting for stock-based compensation, and the potential for three transition alternatives for companies adopting the recognition provisions of Statement 123 for



Ms. Suzanne Q. Bielstein

November 1, 2002

Page 3

stock-based employee compensation, we agree that the incremental disclosures proposed in the Exposure Draft should be required. While some users have indicated that they believe the statement of operations is more useful if all stock-based compensation is recognized based on estimated fair value, other investors have indicated that they will simply reverse stock compensation expense when analyzing the operating results of a company. We believe the proposed disclosures will serve both groups of investors.

The Board has proposed that the new pro forma disclosures described in proposed paragraph 45(c) be included in the note to the financial statements that includes the summary of significant accounting policies. While we agree that this note may be a logical location for the proposed disclosures, we do not believe that it is appropriate for the Board to go so far as to mandate the location for the disclosures. Many companies, particularly those that operate in a large number of segments, disclose a significant number of accounting policies. We are concerned that an excessively long accounting policy note would reduce the benefit of that note; namely, a brief summary of the significant accounting policies that may be important to investors. While we believe companies must disclose their accounting policy for employee stock-based compensation in the accounting policy note, we believe it would be reasonable for companies with lengthy accounting policy notes to provide the proposed pro forma disclosures in the note that includes the other detailed disclosures required by Statement 123. If the Board is concerned about the prominence of this disclosure, it could mandate a cross-reference from the accounting policy note to the note that includes the proposed pro forma disclosures.

We understand that the Board considered requiring disclosure of the amount of stock-based compensation expense included in each line item in the statement of operations. Given our concerns about disclosure overload, it should be no surprise that we are opposed to such a disclosure requirement. We believe that there is no compelling reason to disclose this type of information, particularly given the fact that this level of disclosure generally is not required for other types of non-cash transactions. Stock option use has expanded beyond only senior executives and, therefore, SG&A expense is not the sole line item in the statement of operations that could be impacted by stock option expense. Tracking the ultimate disposition of compensation cost, for example, in the cost of sales line for companies using the retail LIFO inventory costing method, could be cost prohibitive and any perceived benefits of this information likely would not exceed the cost of obtaining the information.

New Disclosures Required in Interim Financial Statements

We do not believe that information included in the notes to the annual financial statements should be repeated in the notes to interim financial statements unless there has been a significant change in the information being provided (this view generally is consistent with the guidance in Article 10 of SEC Regulation S-X). However, we understand that investors' scrutiny of stock-based employee compensation practices and accounting has increased significantly of late, and that some users of financial statements believe that disclosure of stock-based compensation expense is important to their investment decisions. Further, the

Ms. Suzanne Q. Bielstein

November 1, 2002

Page 4

proposed pro forma disclosures will enhance the comparability of reported financial information given that there are two acceptable methods for accounting for stock-based employee compensation, and three proposed methods to adopt the fair value method described in Statement 123. Accordingly, we agree with the Board's decision to require in interim financial statements the pro forma earnings information required in annual financial statements by Statement 123. We do not believe that the incremental cost of preparing these interim disclosures will be significant.

Accounting for Income Tax Effects

The Board has proposed adding language to paragraph 44 of Statement 123 to clarify that only excess tax deductions (recognized in additional paid-in capital) resulting from awards accounted for under Statement 123 are available to offset any write-offs of deferred tax assets if the actual income tax deduction realized is less than recognized compensation expense for an award. We note that this limitation is consistent with paragraph 44 of Statement 123. However, we believe that clarification of this requirement would be beneficial. In particular, we note the clarification in the last sentence of paragraph A14 of the Exposure Draft that under either of the prospective transition approaches there will be no excess tax benefits accumulated in additional paid-in capital available for the write-off of deferred tax assets resulting from stock-based awards recognized at fair value. Without that clarification, some may have concluded that application of the new proposed prospective method (in which additional paid-in capital is adjusted as if unvested awards and "certain variable award" had been accounted for under the fair value method) may have resulted in amounts in additional paid-in capital that are available for write-offs of deferred tax assets relating to awards accounted for using the fair value method. The Board may wish to consider including the last sentence of paragraph A14 in the standard itself, rather than (or in addition to) in the basis for conclusions, to make this point as clear as possible.

Transition

We agree with the essentially immediate effectiveness of the new transition alternatives, subject to our previous comments about limiting the availability of the current prospective transition approach. We also agree with the proposed transition for the new disclosure requirements proposed in the Exposure Draft if a final Statement is issued by the end of 2002. However, we recommend that the Board clarify the application of the transition guidance to interim financial statements. For example, an SEC registrant with a fiscal year ended June 30 would be required to provide pro forma disclosures in its Form 10-Q that include financial statements for the quarter ended March 31, 2003 and the nine-month period ended March 31, 2003 (an interim period that begins April 1, 2001, *before* the December 15, 2002 transition trigger). We assume that the pro forma disclosures are required for both the three-month and nine-month interim periods, but believe this should be clarified in the final standard.

Statement 123 Implementation Issues

Ms. Suzanne Q. Bielstein

November 1, 2002

Page 5

Until recently, very few companies have adopted the fair value recognition provisions of Statement 123 for stock-based employee compensation. As a result, there have been few implementation issues raised with respect to the application of Statement 123. Notwithstanding the pro forma disclosures made to date, as more companies adopt Statement 123 for stock-based employee compensation, implementation issues inevitably will arise. While we do not expect those issues to be as numerous or as complex as the issues that have arisen under APB Opinion No. 25, *Accounting for Stock Issue to Employees*, we urge the FASB to monitor constituents' efforts to implement Statement 123 and identify and resolve the resulting implementation issues in a timely manner.

* * * * *

We appreciate the Board's consideration of our views, and are available to discuss any aspect of our letter with Board members or the FASB staff.

Very truly yours,

Ernst & Young LLP