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Director of Major Projects and Technical Activities
File Reference No. 1101-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Letter of Comment No: 13
File Reference: 1101-001
Date Received: 10/30/02

Dear Mrs. Bielstein:

BDO Seidman, LLP is pleased to offer comments on the Exposure Draft (ED), *Accounting for Stock-Based Compensation—Transition and Disclosure.* A summary of our major comments is as follows:

- For fiscal years beginning after December 15, 2002, there should be only one method of transition to the fair value method.
- Our first choice for the single method of transition is the cumulative effect method of APB Opinion No. 20, *Accounting Changes.*
- The Board should not be so prescriptive on the placement and format of disclosures in notes to annual financial statements, but should consider requiring disclosure on the face of the income statement in certain circumstances.
- The pro forma disclosures should not be required in interim financial reports.
- The Board's current plans regarding accounting for stock-based compensation in light of the IASB project are appropriate and timely.

One Method of Transition

We believe that it is beneficial for users of financial statements to have just one method of transition to the fair value method. Diversity and lack of comparability already exist between employers who have adopted the fair value method and employers who continue to use the intrinsic value method. The Board should not aggravate the lack of comparability by creating three transition methods for an extended period. Instead, we recommend that the Board choose the single method of transition that it believes is best and require that method for voluntary accounting changes for years beginning after December 15, 2002, with early adoption of that transition method permitted. Because

some employers already made the voluntary accounting change expecting to use the prospective transition method specified in FASB Statement No. 123, *Accounting for Stock-Based Compensation*, the Board should permit the prospective method to be used for the remainder of the current fiscal year in fairness to those employers. Under this approach, employers would have a choice between *two* transition methods in the current fiscal year and no choice thereafter, rather than a choice among *three* transition methods for the indefinite future under the ED.

We agree with those who criticize the prospective method in Statement 123, because the ramp-up effect causes the initial years to be unrepresentative of the long-term effect of the fair value method. We also agree with the Board that the practical reasons for using the prospective method in 1994 no longer exist. Therefore, we believe the transition methods that apply the fair value method to post-1994 awards are more useful than the prospective method.

Of the three possible transition methods that the Board discusses in paragraph A6. of the ED, our preference is the cumulative effect of a change in accounting principles under Opinion 20 applied to all awards granted, modified, or settled in fiscal periods beginning after December 15, 1994. We prefer this method because it has been the established standard method of implementing voluntary accounting changes for more than 30 years. We believe it is beneficial to users, preparers, and auditors to use established, familiar, and understood approaches, rather than newly created approaches, whenever possible. The cumulative effect method is not perfect; the APB itself acknowledged the trade-offs in Opinion 20. It has the great virtue, however, of being familiar. The Board's stated reasons in paragraph A7. for rejecting the cumulative effect method are troublesome. The Board is the custodian of its predecessors' literature. We believe it is inappropriate for the Board to denigrate that literature while leaving it in place. If the amount of the cumulative effect adjustment is not meaningful, then how meaningful are the journal entries triggered by new paragraph 52A? If some constituents find it confusing to report the cumulative effect in earnings, and the Board agrees with them, that is a reason to reconsider Opinion 20, not a reason to selectively override it.

The retroactive restatement method of paragraph 52(c) may be impracticable for companies whose financial statements were previously audited by Arthur Andersen LLP. If these companies restate their financial statements, the current auditor, at a minimum, will need to audit the restatement adjustments. Moreover, under the recently issued interpretation of SAS Section AU 508, one could conclude that such a restatement would require a full reaudit of the restated financial statements.

Our final observation on this topic is that settling on a single method of transition for fiscal years beginning after December 15, 2002 is the more important issue. Which of the three methods in paragraph A6. the Board chooses is less important than settling on one.

Disclosures in Annual Financial Statements

We agree with the Board that the disclosures of (1) the accounting method used for stock-based compensation and (2) the method of transition to the fair value method belong in the "Summary of Significant Accounting Policies" or its equivalent, because both are disclosures of accounting policies. However, we believe that the disclosure of pro forma earnings and earnings per share is not a disclosure of an accounting policy, and that preparers should have the freedom to display that information in the note where they believe it is most logical. We tend to believe that the pro forma information fits more logically with the disclosures specified in paragraphs 46 through 48 of Statement 123 than with the "Summary of Significant Accounting Policies," but we think this is a decision that should be made by preparers. Further, we do not believe that the Board should be prescribing a specific tabular form for the disclosures. Each preparer should be allowed to present the disclosures in the manner that it believes it most suitable. It is discouraging to us that at the same time that the Board is initiating a project to explore a more principles-based approach to setting accounting standards, the Board would propose such a prescriptive approach to required disclosures.

The ED fails to address one presentation issue that we believe is more significant than which note includes the pro form disclosures, that is, whether there are circumstances in which pro forma disclosures should be presented on the face of the income statement. Under Opinion 20, the pro forma disclosures are required on the face of the income statement, because the income statements for periods before and after the change in accounting apply different principles. The same situation will exist for preparers who choose the paragraph 52(b) transition method. Consistent with our comments in the preceding section about using familiar and established standards, we believe it would be appropriate to require the pro forma disclosures on the face of the income statement whenever both pre- and post- accounting change years are presented.

Disclosures in Interim Financial Reports

We do not believe the pro forma earnings and earnings per share information should be required disclosure in interim financial reports. Does the Board believe that the pro forma effect of the fair value method for stock-based compensation is one of the most important pieces of information in interim financial reports, so important that it should be singled out as one of ten requirements in paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*? We don't. Of all the disclosures that are currently required in annual financial statements but not in interim financial reports, this one would not have been on our "short list" of disclosures to add to interim financial reports. Particularly because the compensation cost of stock-based awards is recognized ratably over the vesting period, the relationship between reported earnings and pro forma earnings tends to be relatively consistent from period to period. If the relationship changes significantly

from the most recent annual financial statements, the preparer should consider disclosing that fact in management's discussion and analysis of operations for the quarter.

The Board's Plans in Relation to the IASB Project

We believe the Board's plan to (1) issue an Invitation to Comment summarizing the IASB's proposal and comparing it to current U.S. accounting standards and (2) consider whether to propose any changes to U.S. standards is appropriate and timely. We believe the confluence of a number of events and conditions may make the next few years a good time to reconsider U.S. standards in this area:

- The IASB appears committed to complete its project, and many segments of the financial community have expressed the desire to achieve greater international harmonization of accounting standards.
- The user and corporate governance communities now seem interested in accounting for stock-based compensation; ten years ago they were largely silent in the debate preceding the issuance of Statement 123.
- The preparer community seems more receptive to a dialogue on this topic than it was ten years ago.
- The financial community and employees both seem to have developed a better understanding of the advantages and disadvantages of fixed stock options with an exercise price equal to the market price on the date of grant. Until recently that particular instrument, which is uniquely favored with zero compensation cost under the intrinsic value method, was widely viewed as a panacea for aligning the interests of employees and shareholders.

As a result, we encourage the Board to implement its plan.

Accumulated Opinion 25 Balances

Paragraph 2.b. of the ED, which would add a new paragraph 52A to Statement 123, is confusing. Suppose an employer granted an option on January 1, 1996, with zero intrinsic value, fair value of $100, and ten-year vesting. Also assume that the employer elects to restate all five years presented in its 2002 annual report (that is, the selected five year data for 1998 through 2002, and the 2000, 2001, and 2002 income statements) to reflect stock-based compensation on the fair value method. In each of those five years, the employer will record $10 of compensation cost and a $4 deferred tax benefit (assuming a 40% tax rate). If the employer had always applied the fair value method, it also would have recorded $10 of compensation cost and a $4 deferred tax benefit in 1996 and 1997, for a cumulative total of $20 of compensation cost and an $8 deferred tax benefit. We think paragraph 2.b. requires the employer to record (as of January 1, 1998) the $8 deferred tax asset that would have existed at December 31, 1997 and an $8 increase to additional paid-in capital, but not to record the $12 reduction to retained

earnings nor the remaining $12 increase to additional paid-in capital (representing compensation cost of $20 net of tax benefit of $8) that would have been recorded in a full retroactive application of the fair value method. If we have understood the paragraph correctly, we think the Board could clarify it by making two changes:

- Replace the first sentence of paragraph 2.b. with: "An entity that elects the transition method in paragraph 52(b) or 52(c) shall adjust the carrying amounts of assets or liabilities arising from stock-based compensation as of the beginning of the first period for which stock-based employee compensation cost is accounted for in accordance with the fair value method." The focus of the existing sentence on additional paid-in capital is confusing, because additional paid-in capital is the "plug" for adjusting the compensation liabilities and deferred tax accounts.
- Delete "additional paid-in capital" from subparagraph b. We don't think the Board intends for employers to record the additional paid-in capital determined under Statement 123. The additional paid-in capital is offset in subparagraph c., but we think it would be clearer to eliminate the term in subparagraph b.

Whether our understanding is correct or not, we think a numeric illustration in the final Statement would be helpful.

Paragraph 2.b. would be unnecessary if the Board adopts our suggestion to use the cumulative effect transition method of Opinion 20.

Other Disclosures

The Board invited respondents to address whether other disclosures about stock-based compensation would be useful, for example, the classification of that compensation in the income statement. We have not identified any other disclosures about stock-based compensation that we believe would be sufficiently useful to require of all preparers. In addition, we believe it would be inappropriate to require disclosure of the classification of this particular cost in the income statement. Preparers do not disclose the classification of a multitude of costs, including cash compensation, pensions, or postemployment or postretirement benefits. We do not see a purpose for requiring disclosure of the classification of this particular component of compensation cost.

We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,

s/ BDO Seidman, LLP