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June 25, 2004

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

Letter of Comment No: 544/  
File Reference: 1102-100

Re: File Reference 1102-100

Dear Ms. Bielstein:

Eli Lilly and Company appreciates the opportunity to comment on the FASB's Proposed SFAS, Share-Based Payments, an amendment of FASB Statements No. 123 and 95 (the "ED").

We have summarized the items we believe to be the most significant in the paragraphs below. In addition to these comments, we have attached a document to respond directly to the issues raised by the Board in the ED.

#### **Measuring Fair Value of Stock Options**

We agree with the conclusion of the Board that the binomial lattice approach to valuing share-based payments is an improvement over closed-form models; however, we still have concerns about the reliability of the model. For example, we do not believe the binomial lattice model adequately adjusts for the lack of transferability inherent in this type of instrument. Further, we do not agree that an adjustment to the expected life of the stock option is sufficient to properly discount the fair value for the lack of transferability, as suggested in the ED. This deficiency in the model could greatly overstate the fair value of options in some cases.

We also believe that models will continue to be evaluated and new models created over time. These models could potentially better represent fair value for employee stock options. However, as the ED reads today, by the Board selecting a "preferred" model, companies will most likely be forced to use this model regardless of the situations referred to above. In light of these items, the final standard should clarify that companies have the flexibility to choose their own method and model and not mandate the use of one model.

The complexity and cost of the binomial lattice model is also a concern. It is expected that implementation will require the help of external consultants accompanied by significant internal effort to gather the information and data needed to populate the model. While the lattice model may offer greater flexibility and incorporate some of the unique characteristics of equity awards granted to employees, we are concerned that companies will be required to expend considerable resources to develop an estimate that still has a high degree of imprecision.

#### **Income Taxes**

We do not support the Board's conclusions related to accounting for the income tax effects of share-based payments. We believe that any subsequent differences between the tax benefit recognized initially and the actual tax benefits realized are the result of an equity transaction and should be recognized in additional paid-in capital. We believe this treatment is consistent with SFAS 109, *Accounting for Income Taxes*. Our understanding is that the Board has also concluded that the exercise of a stock option is an equity transaction. Given this, we do not understand the Board's conclusion that this equity transaction should be handled differently depending upon whether the tax benefit ultimately realized is greater or less than the benefit initially recorded.

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We also do not agree with the Board's decision to move away from the portfolio approach in FASB Statement 123 to an individual employee level to account for the income tax effect of share-based payments. It is inconsistent to compute and track the income tax effect of share-based payments on a different basis than the computation of fair value and compensation expense. The fair value computation of share-based payments is an estimate; therefore, it does not seem logical to attempt to account for income taxes with such precision. We do not understand what is really to be gained, given the added costs and resources necessary, to achieve such precision.

Accounting for the deferred tax impact on an individual employee level is not operational without a considerable amount of effort and resources. For example, we grant employee stock options to over 40,000 employees in more than 90 countries around the world. We do not have the systems necessary to track this information and would therefore be required to build and maintain systems to track the tax impacts at the individual employee level. This task is very difficult for a multinational company that needs to accommodate multiple tax jurisdictions and movement of employees within these jurisdictions. We do not believe there is any significant value added by moving to an individual employee level, especially given the anticipated significant costs.

As noted above, we believe that there is conceptual support for a standard that would both allow for a portfolio approach to accounting for income taxes as well as require that any subsequent differences in realized tax benefits, both higher and lower, be recognized in additional paid-in capital. This methodology would have the added advantage of being significantly less complex from an operational standpoint.

We also believe the Board needs to provide additional guidance as it relates to the accounting for deferred taxes on vested awards. There is currently no guidance specific to those awards that have no compensation expense, and therefore no deferred taxes, in the proposed rules. We believe the appropriate accounting would be to record the tax impact through equity, as no deferred taxes had been previously set up for these awards; however, it is not clear in the ED. We would also assume that the portfolio approach would be "grand-fathered" for those vested awards, even if the individual employee approach were to be adopted in the final standard. We would like further clarification regarding these transitional issues.

#### **Clarification of Paragraph B.184 and C.123**

Our concern is that both paragraph B.184 and C.123 state that certain instruments subject to the ED become subject to Statement 150 when continued employee service is not necessary to retain fair value of the instrument. B.184 specifically mentions a situation when an employee could terminate service and receive or retain the fair value of the instrument for the remaining contractual term of that instrument (e.g., plans that allow retirees to continue to exercise for the remaining contractual term of the option).

We initially interpreted "subject to" Statement 150 to mean that we must apply Statement 150's mark-to-fair value accounting. After further review and discussion, we now believe this was intended to point to the guidance in Statement 150 and then allow us to make the determination as to whether or not we should follow Statement 150 based on our unique facts and circumstances. We would like to see the Board make this clarification in the final statement, as it is unclear what the Board intended with the language "subject to" Statement 150.

#### **Effective Date**

The ED is extremely complex particularly as it relates to setting assumptions, developing a binomial lattice model, and accounting for the income tax associated with the share-based payments. For most companies, the systems necessary to track information required under the ED are not yet developed and would require significant resources to put in place. Also, developing and refining a binomial model, including setting assumptions, is expected to take a minimum of 8 to 10 weeks for an external consultant (not taking into account the information and data collection the company must have to create the model). This may cause difficulties for the limited number of valuation experts available to perform these calculations, which could add extra time due to workload constraints.

We understand that companies can still adopt the standard using existing valuation methods and convert to the binomial lattice model when the information becomes available. However, this does not change the need for system development as discussed above. Furthermore, this becomes a challenge to explain to the market place. As opposed to having one transition year, there will be multiple transition years, which is confusing and not received well in today's environment. While this may be an option for many companies, it is an unattractive option due to the communication challenges.

Finally, considering the amount of change already introduced to companies with implementation dates in late 2004 and early 2005, it seems unreasonable to try to force this into the same time period. The human resources necessary to implement this standard, in most companies, will be the same as those implementing Sarbanes Oxley – Section 404, SEC accelerated filing dates, and drastic changes to equity programs as a result of this ED. Given the timing of the final standard (expected in Q4 2004), we believe a one-year delay is needed, even if companies continue to use the Black Scholes model. This would allow companies to fully assess the impact of the ED in their current equity programs, redesign their programs and build the systems infrastructure needed to implement the standard. Given the current timing, companies are “rushing” to make changes to their equity programs, without the benefit of seeing a final standard, which would allow them to more thoughtfully analyze and consider their alternatives. A delay would also allow companies the time needed to determine the income impact of the changes and update guidance to the investment community on a more timely basis.

We appreciate the opportunity to express our views and concerns regarding the ED. If you have any questions regarding our response or would like to discuss our comments further, please feel free to call at (317) 276-2024.

Sincerely,

ELI LILLY AND COMPANY

S/Arnold C. Hanish  
Executive Director, Finance and  
Chief Accounting Officer

## **Lilly's Responses to Issues identified by the Board**

### **Recognition of Compensation Cost**

**Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.**

We support the Board's overall conclusion that share-based payments to employees represent compensation cost. However, there are several items that the Board needs to address before issuing this statement. The largest of these concerns continues to be the debate as it relates to the reliability of fair value models. See further discussion of these concerns in the Issues listed below.

**Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?**

Due to the concerns around reliability of the estimates produced by the current valuation models, we could accept a conclusion that pro forma disclosure would be an appropriate substitute in this situation. See further discussion in the Fair Value Measurement Issues listed below.

### **Measurement Attribute and Measurement Date**

**Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?**

We agree with the Board's conclusion that the relevant measurement date is grant date fair value; however, we still have concerns around the reliability of the fair value estimate, as discussed below under Fair Value Measurement Issues. We also believe the Board should clarify the definition of grant date. The ED defines the grant date as the "date at which the employer and employee reach a mutual understanding of the key terms and conditions of a share-based payment arrangement." This definition works for broad-based employee plans with a standard size grant where the approval and communication can happen almost simultaneously. However, it is more common to grant under a management plan, where many grants are customized, and the communication date will likely differ from the measurement date (generally the date all necessary approvals have been obtained) due to the amount of time and effort needed to put together large-scale confidential employee communications. Our management plan is communicated on an individual employee basis and each grant is a function of the individual's level and performance, which as mentioned above requires a significant amount of time and effort to develop. We do not believe the fair value calculation should change based on changes in the market price of the underlying stock during the time between the measurement date and employee communication. Accordingly, we believe the definition should be clarified to recognize that the grant date may be the date in which the award's terms have received appropriate levels of approval, provided the time between this date and the date of communication is a reasonable period of time (i.e. 2 to 3 months).

## Fair Value Measurement

**Issue 4(a):** This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

We do not believe the FASB should dictate one model that should be used. Companies should have the flexibility to use judgment and consider operational complexities of the different models when choosing the model that is best for them rather than being forced into one model. A company's situation, and the external environment, can and will change over time, which requires flexibility in the guidance. We believe the Board should give general guidance and let practice evolve. We understand that this flexibility and significant reliance on management's judgment will lower comparability; however, given the need to develop complex company specific assumptions to compute an estimate for a company's equity instruments, we do not believe it is appropriate to give additional or further restrictive guidance.

**Issue 4(b):** Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

We agree with the conclusion of the Board that the binomial lattice approach to valuing share-based payments is an improvement over closed-form models; however, we still have concerns about the reliability of the model. For example, we do not believe the binomial lattice model adequately adjusts for the lack of transferability inherent in this type of instrument. Further, we do not agree that an adjustment to the expected life of the stock option is sufficient to properly discount the fair value for the lack of transferability, as suggested in the ED. This deficiency in the model could greatly overstate the fair value of options in some cases.

We also believe that models will continue to be evaluated and new models created over time. These models could potentially better represent fair value for employee stock options. However, as the ED reads today, by the Board selecting a "preferred" model, companies will most likely be forced to use this model regardless of the situations

referred to above. In light of these items, the final standard should be clear to allow companies the flexibility to choose their own method and model and not mandate the use of one model.

The complexity and cost of the binomial lattice model is also a concern. It is expected that implementation will require the help of external consultants accompanied by significant internal effort to gather the information and data needed to populate the model. While the lattice model may offer greater flexibility and incorporate some of the unique characteristics of equity awards granted to employees, we are concerned that companies will be required to expend considerable resources to develop an estimate that still has a high degree of imprecision.

**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.

The factors given in the ED to be used to estimate expected volatility provide sufficient guidance that allow for management to apply judgment based on the company's unique circumstances. We do not believe the Board should require a specific method of estimating expected volatility and, further, we do not believe the final standard should prohibit use of the historical volatility. If other information is unavailable or not applicable, historical volatility could conceivably be the best indicator of future 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 agree that forfeitures should be taken into account since it is not appropriate to record compensation cost for amounts that will not be "earned". However, an adjustment should be made for the lack of transferability inherent in this type of option in order to properly reflect its value, as described above. We disagree that the adjustment to the life of the stock options is sufficient to properly discount the fair value for the nontransferability. For this reason, and others, we continue to stress the need for flexibility with regard to the fair value model used to value share options.

While we agree that it is appropriate to recognize expense for only those share options that vest, we do not agree with the Board's conclusion to remove the alternative for companies to record actual forfeitures as they occur. This alternative was available under SFAS No. 123 and should continue be allowable for cost-benefit reasons. For companies with a low forfeiture rate, it is unlikely that the actual rate would differ significantly from the estimated rate; therefore, we believe the Board should allow this alternative.

**Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?**

We believe this is not a conceptual answer, but a punitive answer. If it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, then disclosure should be provided to inform the reader the reason the company is unable to establish fair value. At the point it can be reasonably estimated, compensation expense should be recognized using fair value. We believe the approach under SFAS 123 is appropriate and should remain in the final standard.

#### **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 agree with that principle.

#### **Attribution of Compensation Cost**

**Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?**

We agree that the requisite service period is the appropriate basis for attribution, which is generally the vesting period for the award.

**Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?**

We believe the guidance on estimating the requisite service period is sufficient.

**Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?**

We believe the accounting guidance given in SFAS 123 is appropriate for a graded vesting schedule alternative as long as, at any given point in time, the cumulative compensation cost is equal to or greater than the vested portion of the options. An employee's services are provided evenly over the vesting period, whether graded or cliff vesting, which would support straight-line attribution. The proposal in the ED seems to give too much weight to the form of the award rather than the true substance.

## Modifications and Settlements

**Issue 10:** This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

We believe the principles are appropriate.

## Income Taxes

**Issue 11:** This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board’s rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

We do not support the Board’s conclusions related to accounting for the income tax effects of share-based payments. We believe that any subsequent differences between the tax benefit recognized initially and the actual tax benefits realized are the result of an equity transaction and should be recognized in additional paid-in capital. We believe this treatment is consistent with SFAS 109, *Accounting for Income Taxes*. Our understanding is that the Board has also concluded that the exercise of a stock option is an equity transaction. Given this, we do not understand the Board’s conclusion that this equity transaction should be handled differently depending upon whether the tax benefit ultimately realized is greater or less than the benefit initially recorded.

We also do not agree with the Board’s decision to move away from the portfolio approach in FASB Statement 123 to an individual employee level to account for the income tax effect of share-based payments. It is inconsistent to compute and track the income tax effect of share-based payments on a different basis than the computation of fair value and compensation expense. The fair value computation of share-based payments is an estimate; therefore, it does not seem logical to attempt to account for income taxes with such precision. We do not understand what is really to be gained, given the added costs and resources necessary, to achieve such precision.

Accounting for the deferred tax impact on an individual employee level is not operational without a considerable amount of effort and resources. For example, we grant employee stock options to over 40,000 employees in more than 90 countries around the world. We do not have the systems necessary to track this information and would therefore be required to build and maintain systems to track the tax impacts at the individual employee level. This task is very difficult for a multinational company that needs to accommodate multiple tax jurisdictions and movement of employees within these jurisdictions. We do not believe there is any significant value added by moving to an individual employee level, especially given the anticipated significant costs.

As noted above, we believe that there is conceptual support for a standard that would both allow for a portfolio approach to accounting for income taxes as well as require that any subsequent differences in realized tax benefits, both higher and lower, be recognized in additional paid-in capital. This methodology would have the added advantage of being significantly less complex from an operational standpoint.

We also believe the Board needs to provide additional guidance as it relates to the accounting for deferred taxes on vested awards. There is currently no guidance specific to those awards that have no compensation expense, and therefore no deferred taxes, in the proposed rules. We believe the appropriate accounting would be to record the tax impact through equity, as no deferred taxes had been previously set up for these awards; however, it is not clear in



the ED. We would also assume that the portfolio approach would be “grand-fathered” for those vested awards, even if the individual employee approach were to be adopted in the final standard. We would like further clarification regarding these transitional issues.

## **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 do not believe the disclosure objectives are appropriate. We feel the amount of disclosure is disproportionate relative to the amount of compensation cost recognized. For many companies, while stock option compensation expense will not be insignificant, it will pale in comparison to many other components of operating expenses. To require such significant disclosure for any item that is a small part of total operating expenses seems inappropriate. We are specifically opposed to the specific cash flow impacts, as the impact is not significant and the transaction does not have a negative effect on liquidity, expense to be recognized for nonvested awards (and the weighted average years in which it will be recognized), and company’s policy for issuing and repurchasing shares as a result of exercise activity.

## **Transition**

**Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board’s rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?**

We agree with the modified prospective method of transition. We would not be opposed to allowing companies to retrospectively adopt the proposed Statement, as long as it was a choice and not a mandate. Additionally, we believe the Board should provide additional guidance on the following transitional questions:

- How to account for the true up of deferred tax assets for pre-adoption awards?
- How to account for forfeitures of pre-adoption awards that occur post-adoption?
- How to account for modifications of pre-adoption awards that occur post-adoption?

## **Nonpublic Entities**

**Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board’s conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?**

We do not agree with the Board’s conclusion to allow different accounting for nonpublic and small business issuers. We believe all companies in compliance with U.S. GAAP should be subject to the same accounting guidance.

**Issue 14(b):** Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

We believe compensation cost using the fair value methodology should be recognized once a company is reasonably able to estimate the fair value of the equity instrument. Until that point, the company should provide disclosure regarding the situation and any factors preventing them from calculating fair value. Until fair value can be determined, companies should base compensation on intrinsic value.

#### **Small Business Issuers**

**Issue 15:** Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

We do not agree with the Board's conclusion to allow different accounting for nonpublic and small business issuers. We believe all companies in compliance with U.S. GAAP should be subject to the same accounting guidance.

#### **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 believe the amounts should be recorded through operating cash flow consistent with all other reductions to the income taxes payable under SFAS 95. It is not appropriate, or consistent, to break-out this tax benefit on the cash flow statement as other similar benefits are running through operating cash flow and it does not have a negative effect on liquidity. In addition, this approach, along with the income tax accounting, would require the individual tracking of option expense versus the portfolio approach (as discussed in Issue 11). This issue was essentially addressed in SFAS 95 and we see no compelling reason to make an exception to the established rule for this one situation.

#### **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?**

We do not believe the Board should consider adopting the accounting treatment prescribed in IFRS 2 for the interest of achieving convergence. If, after considering the comments received on the ED, the Board ultimately concludes that the accounting treatment prescribed by IFRS 2 is a better answer, then it may be appropriate. However, we do not support adopting guidance from IFRS 2 solely for the interest of convergence.

#### **Understandability of This Proposed Statement**

**Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?**

Due to the difficulty and judgment required in estimating fair value of equity instruments that are not "on the market", this proposed Statement will most likely require the use of outside experts and models to understand and implement. Also, it is highly unlikely that many financial statement users will study the standard with reasonable diligence, to fully understand the standard. Therefore, the users' lack of knowledge will negatively affect the usefulness of the information provided by this standard and their ability to appropriately compare the operating results of different companies.