Karen Salmansohn

From: Sent: To: Subject: Director -Wednest Karen St FW: FILI Stock-ba Letter of Comment No: 257 File Reference: 1102-001 Date Received: 2-37)3

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----Original Message----

From: Martinson, Chad [mailto:chad.j.martinson@medtronic.com]

Sent: Tuesday, February 04, 2003 11:46 AM

To: Director - FASB

Cc: Ellis, Gary; Heggestad, Mark; Hoekstra, Douglas

Subject: FILE REF. #1102-001 - Comment Letter on Comparison of

Accounting Standards for Stock-based Compensation between Certain U.S.

GAAP and the IASB's Proposed IFRS

-Members of the FASB-

Attached is a letter from Gary Ellis, Vice President, Corporate Controller, and Treasurer, summarizing the significant comments from Medtronic's financial management team regarding the differences between certain U.S. accounting standards on stock-based compensation and the International Accounting Standards Board's proposed IFRS on share-based payments. Mr. Ellis would be happy to discuss any questions the Board may have regarding these comments. He can be reached at 763-505-2770.

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We appreciate your invitation to comment.

Regards,

Chad Martinson Manager of External Reporting Ph. 763-505-2768 Fax 763-505-2808

February 3, 2003

MP&T Director Financial Accounting Standards Board (FASB) (of the Financial Accounting Foundation) 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference 1102-001

Re: Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and its Related Interpretations, and IASB Proposed IFRS, Share-based Payment

Members of the FASB:

Medtronic is a world-leading medical technology company, providing lifelong solutions for people with chronic disease. We were founded in 1949 and today serve physicians, clinicians and patients in more than 120 countries. Our current net sales and earnings are annualizing at over \$7 billion and \$1 billion respectively. Our market capitalization is approximately \$55 billion.

We appreciate the opportunity to comment on the differences between U.S. accounting standards on stock-based compensation, principally FASB Statement No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), and its related interpretations, and the International Financial Reporting Standard, Share-based Payment (Proposed IFRS). We understand the invitation to comment specifically stated the Board is not seeking comments regarding whether stock-based awards should be measured at fair value and whether fair value can be reliably measured. While we will honor your request to exclude comments on these issues, it is important for us to state that we have concerns regarding whether the existing option pricing models can reliably measure fair value. Among our specific concerns regarding option pricing models is whether the calculated fair value is properly risk adjusted to reflect the illiquid state of non-traded stock-based awards. We understand that the Board has attempted to risk adjust the fair value of awards by requiring, for awards granted to employees, that companies use the expected term of the award instead of the contractual term. While this adjustment to the model is a step in the right direction, we have concerns whether it is accurate as it is a significant approximation and excludes other restrictions such as black out dates. All of our following comments are made in light of our continued concern regarding whether option pricing models provide a reliable measure of fair value.

Our comments are organized according to the categories set forth in your invitation to comment; scope, recognition, measurement, disclosure, and transition.

Scope

Employee Stock Purchase Plans (ESPPs)

We agree with the Board's conclusion in SFAS No. 123 that a small percentage discount in a broad-based plan offered to employees is an inducement that is analogous to a discount routinely offered to stockholders and others or to avoided stock issuance costs. By allowing a discount, more employees will be motivated to either become shareholders or to increase their holdings in the company. As this discount encourages more employees to purchase company stock, non-employee shareholders benefit as equity is issued at the effective market price and company management is provided with a tool to improve employee retention.

With the goal of keeping shares issued under an ESPP cost neutral to non-employee shareholders while providing a tool to increase employee retention, we encourage the Board to consider increasing the discount that qualifies as automatic compliance with the governing Standard. While the existing 5% discount may have been reasonable at the time SFAS No. 123 was issued (1995), the changes in the capital markets over the last three years have significantly, and likely permanently, increased the cost of issuing public equity. While the 15% discount from market used for purposes of applying Section 423 of the Internal Revenue Code and APB No. 25 may exceed the true cost of issuing public equity for certain entities, we believe minimum discount of 10% more accurately reflects a routine discount and is in the best interest of non-employee shareholders.

Recognition

Service Based Awards

SFAS No. 123 allows companies to elect to recognize expense for stock-based compensation, with graded vesting, by either of the following methods:

- 1.) as if each vesting group represents a separate award, or
- 2.) as if each vesting group represents a single award.

If separate companies granted equity awards with identical terms and identical assumptions were made in determining fair value, the companies could report materially different compensation expense related to the equity awards in each of the reporting periods over the life of the awards. By providing companies with this these alternatives, financial statements become less comparable between companies.

While we understand the theory behind treating each vesting group as a separate award (option 1 above), we believe that from a practical perspective, and to improve comparability between companies, all stock-based compensation related to awards with graded vesting should be recognized assuming the stock-based award is a single award. We believe this is the convention most companies are currently using, is based on theory of similar merits to treating the awards separately, and reduces the complexity of expense recognition. We also recognize this approach is consistent with the IASB's position as set forth in the IFRS.

Measurement

Forfeitures

SFAS No. 123 permits an entity the choice between the following two methods of accounting for the effect of forfeitures on the quantity of equity instruments granted:

- 1.) At grant date, an entity can estimate the amount of equity instruments expected to be forfeited and true up that estimate based on actual forfeitures, or
- 2.) It is also acceptable for an entity to not estimate expected forfeitures but to recognize forfeitures as they occur.

We note that the Board agreed to the second method for cost-benefit considerations.

While we agree that either of the alternatives can be justified, by providing companies with the choice for expense recognition, two companies issuing identical equity awards and using identical valuation assumptions would report potentially materially different earnings in each of the reporting periods over the life of the awards. By providing companies with this election, the goal of ensuring comparability of financial reports between companies suffers. Accordingly, we do not believe companies should be allowed to choose among alternatives related to accounting for forfeitures.

Furthermore, we agree with the IASB's position in the IFRS that the grant date fair value of equity instrument should take into account the possibility of forfeiture, with no subsequent adjustments recorded. This approach is consistent with the grant date assumptions regarding volatility as no adjustments are recorded to adjust compensation expense to what the expense would have been had the actual volatility factor been used to measure that award. Again, we have concerns whether option pricing models can provide a reliable measure of fair value for stock-based awards, but if option pricing models are to be used, it should be assumed that forfeitures, like other important variables, can be estimated at the measurement date.

Taxes

SFAS No. 123 requires that (a) when realized tax benefits from equity awards exceed the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference is directly credited to additional paid-in capital, and (b) when realized tax benefits from equity awards are less than the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference (that is, the excess deferred tax asset) is written off to the income statement to the extent it cannot offset excess tax benefits previously recorded in additional paid-in capital from other equity awards.

As the tax benefits from the equity awards are as much a true benefit to the company as other items recorded in a company's statement of earnings, we agree with the IASB's position that the benefit should be recognized in the statement of earnings. However, we also agree with the Board's concern regarding the additional volatility this will create in the statement of operations. In fact, we believe that the impact of this volatility could be both frequent and significant.

Under the assumption that the tax benefit from equity awards should be recognized in the statement of earnings, and that the equity awards are generally issued under plans that normally exceed one year and frequently cover a period of approximately ten years, we propose that companies recognize the tax benefit from equity awards, not as they occur, but on a systematic and gradual basis. The systematic and gradual basis would be applied using supportable estimates and assumptions. This approach is consistent with the first fundamental basis for existing U.S. GAAP accounting rules for pensions (as set forth in Appendix A of SFAS No. 87). This approach will result in companies reporting the appropriate long-term net earnings and will eliminate the significant negative consequences of introducing a material non-operating component to company financial statements (again, similar to pension accounting).

Nonpublic Entities

SFAS No. 123 allows a nonpublic entity the choice of measuring the value of equity instruments granted to employees at the fair value or the minimum value, which does not take into account expected volatility. Allowing companies to exclude this variable from the fair value measure on the basis it requires an estimate is contrary to the application of fair value accounting. In order to value a non-traded equity instrument using an option-pricing model, a company is forced to make a series of assumptions and estimates. If stock-based compensation is to be valued using an option pricing model, all relevant variables should be estimated to the best of management's ability at the measurement date. We agree with the IASB's position as set forth in the IFRS that it is feasible to estimate expected volatility of the stock of non-public entities by using other estimation methods.

Performance Based Awards

We agree with the IASB's position in the IFRS to separate actual performance outcomes of performance incentives from the service condition. This effectively attributes compensation to the award as if the award is a service award and is consistent with our view that the possibility of forfeiture affects the value of the equity instruments granted, and therefore should be taken into account when measuring fair value.

Disclosure

We agree with disclosing the relevant assumptions used to determine the expense related to stock-based compensation. We do not agree, however, with the proposed disclosure requirements in the IFRS that would require a comparison of actual experience to the original assumptions for the following reason. As the comparison would not result in an adjustment to compensation expense under the IFRS rules, the comparison appears to primarily serve as a reasonableness test. Disclosure of reasonableness tests of assumptions and estimates used to prepare the financial statements is not necessary and not consistent with disclosure rules for other transactions. The responsibility to prepare financial statements using the most accurate assumptions and estimates, based on the information available at that time, should continue to be the responsibility of management. The responsibility to perform sufficiently detailed reasonableness tests of the quality of assumptions and estimates used by management should continue to reside with the independent auditors.

Even if adjustments are made to compensation expense for the differences between the original assumptions and actual experience, we do not agree that disclosure of the comparison is meaningful or warranted. We liken this scenario to current disclosure requirements for defined benefit pension plans. While disclosure is made of gains or losses related to changes in actuarial assumptions, the disclosure requirements do not require a lengthy disclosure of changes by individual assumption. Furthermore, we can rightfully assume that in most cases, assumptions made in prior periods that proved to be less than accurate would result in a change to the assumptions used (and disclosed) in subsequent periods.

Transition

While we understand the Board's reasons for providing companies with transition alternatives, we believe that the negative impact on comparability of financial statements of allowing companies to choose from alternatives out-weighs the benefits. Accordingly, we believe all companies should follow one method for transition.

With respect to which method of transition should be used, we believe companies should apply fair value accounting prospectively (including granted, but unvested options). This approach is consistent with the IFRS.

* * *

Again, we appreciate the opportunity to comment. We would be happy to discuss any questions the Board may have regarding this letter. Any such questions should be directed to Robert L. Ryan, Senior Vice President and Chief Financial Officer, at 763-505-3111 or to me at 763-505-2770.

Sincerely,

/s/ Gary L. Ellis

Gary L. Ellis Vice President, Corporate Controller and Treasurer