June 7, 2004

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

Re: File Reference 1102-100

Dear Ms. Bielstein,

Intel Corporation appreciates the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards Share-Based Payment an amendment of FASB Statements No. 123 and 95 (the "Exposure Draft" or "ED"). A summary of our major comments is as follows:

- We continue to believe that recognizing compensation cost for employee services received in exchange for equity instruments will impair the usefulness of financial statements by reporting a corporate cost when the corporate entity to which the financial report relates has not incurred an economic cost. We have previously provided our detailed rationale for this view to both the FASB and the IASB in prior comment letters. Rather than repeat that rationale in this letter, we refer the Board to our January 31, 2003 response to FASB’s Invitation to Comment on this topic.

- We continue to believe that it is not possible to reliably measure the fair value of a long-lived nontransferable employee stock option at grant date. It is our opinion that the models described in the ED rely on too many estimates about future expectations that are inherently subject to measurer bias and are not objective or verifiable when made and are not revised to reflect actual outcomes.
We believe that the ED as written will be difficult and costly to initially implement and to administer on an ongoing basis. When we consider what will be required to successfully implement the fair value at grant date requirements (using the preferred binomial lattice model) and administer compliance thereafter, it is clear that it will be both difficult and costly. Significant internal effort would be required to design and develop systems that track employee data in ways that would allow us to aggregate individual option awards into homogenous groups that would provide meaningful information about exercise and termination behaviors. Significant internal effort would also be required to develop and continually reassess our subjective expectations about future volatility and what we think its term structure will be over time. Additionally, we will most likely need to retain external valuation experts to assist us in the design of the model and to review our input assumptions. While we don't, at this time, have a basis to quantify the external fees, we have heard other large multi-national companies' estimate that the initial fees could easily exceed $300,000 with annual fees around $100,000. Given the size of our employee base and the breadth of our option plan, we would expect the fees we would pay to exceed that amount. Over and above that, the subjective judgments required to estimate fair value at grant date would expose us to significant legal costs associated with shareholder lawsuits that second guess our subjective estimates with the benefit of hindsight. Finally, we believe that if the proposed Statement is issued in the fourth quarter of 2004, it will require a delay in the effective date to January 1, 2006. As noted above and in our responses to the Issues below, the ED would result in significant effort and complexity. The systems required to measure, track, and appropriately account for stock option related expense (and the tax effects) do not exist at this time and will require significant effort to develop. In addition, there is currently a limited capacity on the part of valuation experts to assist companies in estimating the fair value of share-based payments using the binomial lattice approach.

We believe that all excess tax benefits and tax deficiencies attributable to share-based compensation should be recognized in equity. We do not understand how an excess tax benefit is due to an equity transaction while a tax deficiency apparently is not. Both the excess tax benefit and the tax deficiency result from the same phenomenon; share price changes between the date the option is granted and the date the option is exercised. Either the effect of a share price change subsequent to option grant is an equity item or it is not. We see no conceptual merit for the distinction made in the ED between stock price increases and stock price decreases.

While we strongly object to the recognition of employee stock option related "costs" in the income statement, if the Board nonetheless chooses to require it in a final standard, we recommend that the expense be finally measured at the vesting date using an intrinsic value measurement attribute. As discussed in our response to Issue 3 below, we make this recommendation for both conceptual and pragmatic reasons.
If the Board chooses to require the recognition of employee stock option related "costs" in the income statement in a final standard, we urge the Board to consider a requirement to report such "costs" on a single income statement line item similar to what is required by FAS 142 for goodwill impairment write-offs. Stock option expense would truly be unique and different than other costs included in the income statement; both from the perspective that the stock option related "cost" does not represent a past, present or future cash outflow and due to the subjectivity of the expense measure relative to other costs. A one line item presentation would most transparently display this unique cost for the benefit of financial statement users most interested in assessing the cash generating ability of a particular business operation.

Our response follows the order of the Issues identified the Exposure Draft

**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 do not agree with the Board's conclusions. We believe that recognizing compensation cost for employee services received in exchange for equity instruments will confuse the users of financial statements by reporting a corporate cost when the corporate entity to which the financial report relates has not incurred an economic cost. We understand that investors and other users of financial statements use those statements as a starting point to assess a particular entity's ability to generate future cash flow. Recognizing an expense relating to an event that does not represent or create a past, present, or future cash outflow would seem to impair the usefulness of financial statements.

That being said, we acknowledge the Board's technical basis for arriving at its conclusion. That is, employee services embody a future economic benefit that gets used up upon receipt. Because employee services embody a momentary future economic benefit, they momentarily meet the FASB's definition of an asset and are immediately used up in the entity's operations; thus, meeting the definition of an expense. We note that it is this ambiguous notion of a "future economic benefit" that underlies the Board's conclusion that employee services received in exchange for equity instruments give rise to recognizable compensation cost. We also note that it is this ambiguous notion of a "future economic benefit" that underlies other controversial / troubling accounting areas relating to, for example, goodwill, deferred tax assets, and the desire by some to inappropriately defer costs on the balance sheet. It would seem to us that the FASB would do more to improve the credibility, understandability and usefulness of financial reporting if it focused not on stock option expensing, but instead on improving its definition of what qualifies for recognition as an asset in the financial statements.
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?

Accounting for stock-based compensation is a complex and difficult issue that has already been debated and concluded on by the FASB. While we do not agree with all of the specific conclusions reached in FAS 123, we believe that it does strike a compromise that accommodates the difficulty and complexity of this issue and provides for sufficient financial reporting as it relates to fixed employee stock option grants. Additionally, we believe that nothing fundamental has changed since the issuance of FAS 123 in 1995 to justify the FASB's reconsideration of the scope or any other aspects of the conclusions reached in FAS 123.

Given our response to Issues 1 & 2, we do not believe the remaining questions are relevant. However, we have answered them in the event that the FASB proceeds with the expensing of share-based payments as proposed in the exposure draft.

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 do not agree with the Board’s view that fair value at grant date measurement is the most relevant measurement attribute and date. From a conceptual standpoint, we do not believe that the option should be finally measured until it is issued (i.e. - when further services are no longer required). From a practical standpoint, in selecting fair value at grant date measurement, the Board has selected the measurement attribute and date that creates the most complexity, requires the greatest degree of subjective judgment and introduces the greatest opportunity for manipulation on the one hand and legal exposure on the other. If it were unambiguously clear 1) that grant date is the only plausible date at which to measure the value of an employee stock option and 2) that a subjectively determined fair value estimate provides superior decision useful information, then the shortcomings of a grant date fair value measurement approach noted above could be accepted. However, it is not generally accepted that grant date is the appropriate measurement date, nor is it generally accepted that a subjectively determined fair value
estimate would provide more useful information than a less complex, but more objectively determinable measurement attribute.

Therefore, we would urge the Board to reconsider its conclusions related to the measurement attribute and date. Should the Board require expense recognition in a final standard, we request that it seriously consider the merits of an intrinsic value measurement attribute with final measurement at the vesting date. From a conceptual standpoint, vesting date measurement is superior to grant date. Transactions should not be finally measured until both parties have fulfilled their obligations under the agreement. In the case of an employee stock option, the employee has only a contingent right to the option until the service obligation is fulfilled at the vesting date. A fair value measure at vesting date, however, would be overly complex and burdensome. Therefore, from a pragmatic standpoint, we urge the board to reconsider the intrinsic value measurement attribute in this context. Intrinsic value measurement relies on observable market data and is much less complex and costly to apply than fair value. While the final measure would not be a theoretical fair value measure as the Board would prefer, we believe that intrinsic value measured at vesting date would provide a more understandable, reliable, and representationally faithful expense measure than fair value measured at grant date. An intrinsic value measured at vesting date approach would provide financial statement users with more meaningful information at a reduced level of complexity and cost as compared to a fair value at grant date measurement approach.

Additionally, the Board’s rationale for why it favors grant date measurement is not clear to us. Paragraph C53 of the ED states that the Board chose to retain grant date measurement “...for essentially the same reasons discussed in the basis for conclusion of Statement 123.” The basis for conclusion of Statement 123 essentially describes a split in opinion amongst Board members as to whether grant date or vest date is the most relevant measurement date. It then goes on to conclude that grant date should be used for pragmatic reasons that are completely irrelevant to a proposed statement that would require expense recognition: “...respondents’ overwhelming opposition to vesting date measurement...would make it less likely that entities would voluntarily adopt the fair value based method if it were based on the stock price at the vesting date...therefore, on balance, the Board decided to retain the Exposure Draft’s provision that compensation cost should be measured...at the grant date” (Paragraph 158.)

Finally, we would also note that the Board has decided in its Business Combinations project that the final measure of shares issued as consideration in a business combination should be at the date the shares are issued (as opposed to the date the terms of the transaction are agreed to). We do not understand why equity instruments issued in the context of a business combination would be measured at issue date while equity instruments issued to employees would be measured well before issuance (at grant date). We would further note that the Board is currently deliberating issues in its Liabilities and Equity project that could ultimately have an impact on the measurement date issue in this ED. Rather than proceeding with the issuance of a final standard on share based compensation with the potential of amending one of its most significant aspects within a
year or two, we would encourage the Board to first conclude on the related issue in the Liabilities and Equity project.

**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?

The guidance probably would ensure consistency in the methodology a company uses to gather the historical data for the input assumptions from period to period. However, that does not mean that the necessary subjective judgments will be made in a consistent way from one period to the next or across companies and, therefore, the expense recognized will not be comparable period to period or across companies.

It is our observation that expected option lives and volatilities of long-lived, non-transferable employee stock options are not subject to reasonable estimation. Unlike other accounting estimates, these initial estimates, under a grant date measurement model, are also not subject to revision and refinement as future events unfold and actual option lives and stock volatilities are revealed. Therefore, short of either changing the measurement date and / or the measurement attribute, any additional guidance intended to increase consistency would only be arbitrary.

**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 do not believe that the fair value of employee share options can be measured using any model with sufficient reliability at the grant date. The models used to estimate fair value at grant date rely on too many judgments about future expectations that are inherently subject to measurer bias and are not objective or verifiable.

The Board acknowledges the importance of objectivity and verifiability in paragraph B7 of the ED by stating that: “In estimating fair value, the assumptions made should not represent the biases of a particular party.” Yet, in paragraphs B19 and B25 the Board states that an entity that fails to consider the extent to which future experience is reasonably expected to differ from historical experience would not comply with the measurement requirements of the ED. How could an entity that is required to incorporate expectations about the future, and is prohibited from relying solely on observable data in doing so, not introduce its own bias into the input assumption?

While we agree with the notion that valuation model inputs based solely on historical experience will result in significant measurement error, introducing expectations about the future inherently incorporates measurement bias and does not solve the measurement error problem. Grant date fair value measurement will always result in measurement error because observable historical data is not always relevant and data based on expectations about the future inherently introduces measurement bias and is not reliable.

To illustrate, consider a specific example relating to the “expected term” input into a valuation model. We used an expected life assumption of 6.5 years when we estimated the fair value of our 2000 employee stock option grants using the Black-Scholes valuation model. That assumption was based entirely on observable data (historical exercise experience and the vesting term of the awards). In hindsight, that historical data based assumption did not prove to be relevant. Because of the significant drop in our share price since 2000 (the average exercise price for 2000 grants is $54.68 vs. a current market price of approximately $28.00), the actual life of our 2000 stock option grants will most likely be something very close to the ten year contractual life (if they get exercised at all). The impact of using the 6.5 year expected life versus the ten year contractual life was an approximate $750 million reduction in the measured value of our 2000 grants (which speaks to the counterintuitive outcomes that can result from a fair value at grant
date approach); illustrating the point that historical based inputs are not relevant in a valuation model designed to predict the future.

Would the measure of the value of our 2000 employee option grants have been more reliable if we had used the binomial model rather than Black-Scholes? We utilized a binomial software package to gain an understanding of how the valuation outcome would differ between that arrived at using the Black-Scholes model and that arrived at using the binomial model. We considered historical volatility and implied volatility for market traded call options on Intel stock to develop a reasonable range of expected volatility. We also considered a number of reasonable share prices at which we would expect employees to exercise their options. While our analysis was necessarily at a high level, the results indicate that the valuation outcome is highly sensitive to the point within the reasonable volatility and share price ranges selected. For example, the lower end of a reasonable expected volatility range was 31 percent and we assumed that the lower end of a reasonable stock price appreciation range that would cause employees to early exercise was 50 percent. Using those lower end assumptions resulted in a fair value estimate of a 2000 option grant of $24.78 per option. On the high end of the reasonable range, expected volatility was 76 percent and stock price appreciation was 200 percent. Using the higher end assumptions resulted in a fair value estimate of a 2000 option grant of $43.63 per share. That difference translates to an approximate $2.7 billion difference in the expense measure and illustrates that the use of the binomial model along with the focus on expected assumptions rather than historically observable assumptions would not generate a more reliable estimate than the Black-Scholes model. Rather, it would only increase the complexity of the estimate, require a greater number of intuitive assumptions which are not based on observable events and would introduce increased measurer bias into the estimate.

At a recent financial reporting conference, Douglas Carmichael, the PCAOB Chief Auditor expressed an audit concern relating to fair value measurement that should be considered by the Board when it reconsiders its conclusion that the fair value of employee share option can be measured at the grant date with sufficient reliability: “When fair value cannot be measured by reference to matters that are directly observable, and if the measure represents little more than the measurer’s state of mind, neither the measurement nor the measurement method are verifiable. In those circumstances, the independent auditor has a scope limitation and should not express an unqualified opinion on financial statements that are materially affected by such a measurement.”

Regarding the Board’s question on the preference for the binomial lattice model over the Black-Scholes model because it offers greater flexibility, we are skeptical. Greater flexibility requires more subjective judgments on the part of preparers and greatly increases the complexity of the estimation. If it were clear that the increase in the need for subjective judgments ultimately resulted in a more accurate estimate of the value of an employee stock option, the increased effort may well be worth it. However, the ED did not provide any evidence that that is the case. In the absence of such evidence, how can the board say that the binomial model is preferable? Based on what has been offered
as evidence in the ED, it would appear that the complexity of the binomial model will only create an illusion of precision that really is not there.

**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.

Other than requiring the use of an expected volatility of zero (which would at least improve consistency and reliability), we do not think that it is possible to specify any one method for estimating expected volatility that would result in a better estimate of expected volatility over any other method. In deep and liquid option markets, implied volatility is simply another way of quoting the option price and does not truly represent the best estimate of actual price volatility that will ultimately be realized in the future. In non-market situations, such as employee stock option awards, it is truly a guess. Without the confirming aspect of independent market transaction, estimating expected volatility necessarily always will be in the eye of the beholder. Nevertheless, in an environment where corporate officers must certify the accuracy of their financial reports under penalty of jail time if such certification is in error, we would urge the Board to mandate either the use of zero volatility or a specific method of arriving at the expected volatility estimate if it maintains the current fair value at grant date measurement approach.

**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 nontransferability 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.
If the objective of this proposed Statement is as stated in the ED "...to recognize in an entity’s financial statements the cost of employee services received in exchange for valuable equity instruments issued...to employees in share-based payment transactions,” the unique characteristics of employee share options have not been appropriately considered. The measurement guidance in the ED fails to contemplate the unique “market” in which employee share based transactions occur. The rationale underlying the ED’s required valuation techniques and assumptions assumes a market where the option holder can fully hedge the risk associated with holding options & that the option holder’s capital is well diversified. In contrast, the “market” for employee services and employee stock options is comprised of employers and employees. Specifically, employees that cannot hedge their risk and are inherently undiversified (a significant portion of their wealth is tied up in the employer (whether through salary, shares owned, options, or otherwise)). As a result, the employee (the “seller” of employee services & at the same time, the “buyer” of employer equity instruments) would demand a much larger risk premium for the option than an outside investor holding freely tradable options. If one of the “market participants” in the “...employee services received in exchange for valuable equity instruments...” transaction would demand a large risk premium that ought to be incorporated into the measure of the cost of the employee service.

Some would say that this line of argument fails to distinguish the economic cost to the company and the economic value to the employee-recipient. Those that hold that view contend that the economic cost of granting an option is the amount the company could have received if it were to sell the option to an outside investor rather than giving it to the employee. That is, the risk aversion of the employee is irrelevant. In fact, the Board appears to hold this view as evidenced by the discussion in paragraph C17 where the Board states its rationale for rejecting the minimum value method by stating “...minimum value does not result in a measure of the amount of cash an entity forgoes by granting share options to employees rather than issuing similar option to third parties, that is, the fair value of the options.” The Board is advocating accounting for a transaction that not only did not occur, but one that likely cannot occur. The unique characteristics of employee stock options means that options issued to third parties would not be similar.

The Board’s view also diverges from the stated objective of this proposed Statement. Remember, it is the entity’s use of the employee service that gives rise to the compensation expense being measured; not the issuance of the option. While that expense is measured by reference to the issued option, the context in which that option is issued must surely be relevant to the overall objective of recognizing “...the cost of employee services received.” One would think that the focus here should be on the transaction that actually occurred (employee services exchanged for share options) rather than a hypothetical transaction that did not occur. Otherwise, measurement error (overstatement) will result.
If the Board retains a fair value at grant date measurement approach in a final standard, we would propose two changes to the ED’s measurement guidance to address the uniqueness of employee share options.

1. We would modify the interest rate assumption used to present value cash flow in the binomial model to use a rate that incorporates an appropriate risk premium consistent with what the employee base would require, rather than the risk free rate.

2. We would introduce a mechanism to properly account for the employee’s inability to transfer (or monetize the time value of the option). In a letter to the FASB dated January 6, 2004, Merck proposed the use of a “put-on-call” approach where the value of a put on the underlying call option is calculated and deducted from option value as a discount representative of the value of the selling privilege embedded in a freely-traded option price. We would support such an approach.

**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?

As stated in our response to Issue 4(b) above, we do not believe that there is any circumstance in which it is possible to reasonably estimate the fair value of an employee stock option at grant date. For that reason, if the Board requires expense recognition in a final standard, we would advocate using an intrinsic value method with remeasurement through vest date (as opposed to exercise date) for all equity based awards.

**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?

The primary purpose of an employee stock purchase plan is not to compensate employees for services rendered, but to encourage employees to become shareholders in an effort to get employees to think like owners. Further, we do not believe that selling shares at a discount should result in a corporate expense as no corporate assets have been used up nor has their value diminished as a result. Therefore, we do not agree with the stated 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 service period is the appropriate basis for attribution.

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?

The guidance provided in paragraphs B37–B49 appears to be 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 understand how the Board arrived at this conclusion. However, if the Board were to think about this issue from the perspective of the option related expense being recognized in income, there is an equally compelling case that graded vesting awards should be attributed to income on a straight line basis. That is, the employee isn’t providing incrementally more service in the early years of the option so why would you expect to see 52 percent (in the case of a four year graded vesting option) of the expense taken in the first year? In addition, the Board’s conclusion introduces a significant amount of complexity that does not appear to be necessary. If one assumes that option terms and grant quantities are consistent over time, the total expense recognized in any given year using this approach will be very similar to the expense recognized from ratable attribution. Meanwhile, the complexity and cost will be much greater using the accelerated approach that would be required by the ED.

If the Board requires the accelerated vesting approach in a final standard, the ED’s prescribed transition guidance will create an artificially high expense in the early years after the effective date as “straight-line” attribution from the pre effective date years would be combined with the accelerated attribution of post effective date grants. We
would recommend that preparers be allowed to recast pre effective date attribution from the “straight-line” approach to the accelerated approach.

**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 modification principles discussed in paragraphs C96–C115 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 agree with the method of accounting for income taxes established by the ED. We fail to understand how an excess tax benefit is due to an equity transaction while a tax deficiency apparently is not. Both the excess tax benefit and the tax deficiency result from the same phenomenon; share price changes between the date the option is granted and the date the option is exercised. Either the effect of a share price change subsequent to option grant is an equity item or it is not. We see no conceptual merit for the distinction made in the ED between stock price increases and stock price decreases.

We note that the FASB’s original tentative conclusion on this issue was that all excess tax benefits and deficiencies would be charged to equity (a conclusion that we would support). We further note that the FASB subsequently revised its conclusion for what appears to be a compromise between the FASB and the IASB. We are troubled by a FASB accounting conclusion that can only be rationalized as a compromise for the sake of convergence with the IASB. While we support the ideal of international convergence, we do not do so at the expense of quality U.S. accounting standards.

What is even more troubling are the practical difficulties that result from this compromised conclusion. To properly comply with the tax accounting requirements contained in the ED, we would have to set up and track option related deferred tax assets at an individual employee level. This simply will not be operational without a very
significant amount of effort and resources to build and maintain systems capable of tracking the tax impacts at the individual employee grant level. We would need to determine the initial tax benefit for each tranche of every stock option award at the individual employee level (that would be for 80,000 employees) and then we would need to be able to capture each individual employee’s exercise to reference back to the tax benefit related to that particular employee for that particular grant (and the specific tranche) for purposes of determining the deferred tax asset impact vs. the equity impact vs. the p&l impact.

Finally, the financial reporting that results from this conclusion will surely confuse the users of financial statements. On the one hand, the ED does not allow for the true-up of option related expense for the ultimate benefit realized by the employee upon exercise. On the other hand, the ED requires the true-up of the tax effects...but only if it results in incremental expense. The reported results will be counter-intuitive. For example, we granted options in 2000 at an average strike price of 54.68$ (our stock currently trades at approximately $28.00). Those 2000 grants will most likely get exercised at an intrinsic value much less than that implied by the expense recognition that would be required by this ED, if they get exercised at all. It is counter-intuitive enough that over $3.5 Billion of expense would be recognized related to these options, but on top of that to record a potentially incremental $1.5 Billion of tax expense because the options expire worthless will have all financial statement users scratching their heads.

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 this proposed statement are appropriate and complete.

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 believe that, in addition to the modified prospective method, entities should be allowed to use the retrospective method. While retrospective restatement can be burdensome, it would result in greater decision-useful information for financial statement users as it would display a comparative period over period trend.

**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?

See our response to Issue 5.

**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 these decisions are appropriate.

**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?

No.

**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 do not agree with the Board’s conclusion. We question the justification for treating excess tax benefits any different from operating cash flow impacts of other investing / financing transactions like interest expense on outstanding debt. We also question the rationale for “grossing up” the cash flow statement to reflect items that do not reflect actual cash flows. Excess tax benefits simply result in a reduction of taxes that would otherwise have been paid.

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 that the Board should consider adopting the accounting treatment in IFRS 2 solely for the purpose of achieving 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?

Given the complexity of the measurement requirements in this proposed Statement, it would require more than a reasonable level of willingness and diligence to be understood by a large portion of financial statement users. Further, it is unlikely that most preparers of financial statements will be able to implement the proposed Statement without the use of costly outside experts and it will require significant internal resources. Ultimately, the users and preparers lack of understanding of the risks associated with the proposed accounting in the ED (e.g. – the significant assumptions required to measure the fair value of an employee stock option) could risk the credibility and comparability of corporate financial statements.
Thank you for the opportunity to comment on this Exposure Draft. We urge the FASB to consider these comments as it redeliberates share-based payment issues and proceeds to the issuance of a final standard. Please do not hesitate to contact either me (408 765 1444), or John Hertz, Accounting Policy Controller (503 696 7476), with any questions on our comments. Additionally, as indicated in a previous email request, we request the opportunity to participate in the Board’s public roundtable discussion of this issue on June 24 in Palo Alto, California.

Sincerely,

/s/ Andy D. Bryant

Andy D. Bryant
Executive Vice President
Chief Financial and
Enterprise Services Officer