June 21, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1102-100

We are pleased to respond to the Exposure Draft of the Financial Accounting Standards Board’s (FASB’s) Proposed Statement of Financial Accounting Standards, Share-Based Payment, dated March 31, 2004 (the “Exposure Draft”).

We strongly agree with the fundamental conclusion in the Exposure Draft that employee services received in exchange for equity instruments give rise to compensation cost that should be recognized in the employer’s financial statements. While we acknowledge that some have concerns over the ability to appropriately measure the fair value of employee stock options, we believe option-pricing models are capable of reliably measuring those instruments. As stated in our comment letter on the FASB’s Invitation to Comment, 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,’ we support the conclusions in the Exposure Draft because we believe the intrinsic value model in APB Opinion No. 25, Accounting for Stock Issued to Employees, lacks any fundamental principle, making its application difficult and resulting in a need for the FASB and its Emerging Issues Task Force to issue extensive implementation guidance. Unfortunately, the volume of that guidance has only contributed to the difficulty in applying Opinion 25.

We have the following major comments on the Exposure Draft:

• The final standard should provide additional guidance to assist preparers, particularly those at nonpublic companies and public companies with limited trading activity, in estimating expected volatility. Constituents have expressed concerns that the expected volatility used in calculating the fair value of a long-term, non-exchange traded option, bears no correlation to the volatility implied in the pricing of publicly traded options. In light of those concerns, the guidance provided by the Exposure Draft should be significantly enhanced.

• We believe the fair value method should be required for all companies and will not impose a greater burden on nonpublic companies than the allowed alternative method.
We agree with the conclusion in the Exposure Draft that the exercise of a stock option is a capital transaction. For that reason, we disagree with the Exposure Draft’s conclusion that the deferred tax asset be written off to the income tax provision when the tax deduction is less than the expense recognized for financial reporting purposes. Further, we disagree with its conclusion on the accounting for excess tax benefits when a company has a net operating loss carryforward but has concluded a valuation allowance is not required under FASB Statement No. 109, Accounting for Income Taxes. The Exposure Draft reaches the conclusion that the excess tax benefit has not been realized, even though it has increased the net operating loss carryforward. This conclusion is inconsistent with current practice and is difficult to reconcile to the accounting under Statement 109 when a valuation allowance is not required.

We agree with the objectives-based approach to determining required disclosures. However, we encourage the Board to discuss the proposed disclosures with its User Advisory Council so disclosures that are not useful to financial statement users are not perpetuated while others that may be useful might be omitted.

We believe companies should be permitted to adopt the fair value method using a retrospective approach that would result in recognizing as compensation expense the fair value of stock options as determined by applying the provisions of Statement 123 as they existed at the original grant date. However, we do not believe companies should be allowed to apply the measurement provisions of the proposed Statement to those earlier awards.

We believe all nonpublic companies should have a consistent effective date and transition. Even though some nonpublic companies previously have elected to estimate the fair value of stock options granted to employees, we believe they will still require additional time to understand and apply the provisions of the final standard. Accordingly, we believe all nonpublic companies should apply the provisions in the Exposure Draft for awards granted, modified, or settled in fiscal years beginning after December 15, 2005.

Our responses to the specific questions raised in the Exposure Draft, including the comments above, are included in Attachment I. We comment on additional matters in Attachment II.

We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to Joe Graziano at (732) 516-5560, or Jeff Ellis at (312) 602-8991.

Very truly yours,

Grant Thornton LLP
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 strongly agree with the Board's conclusions. We believe there is no conceptual merit to the two primary arguments against recognizing compensation expense for stock options granted to employees — that the cost of stock options granted to employees is already appropriately reflected in the earnings per share calculation and that the award does not require the employer to use assets or incur a liability. Stock options have value, and that value should be reflected as compensation expense over the period that the employee earns the right to those options. Further, companies regularly issue stock options for nonemployee goods and services and in financing transactions and recognize expense based on the estimated fair value of those awards, determined using an option-pricing model. We do not see any merit in accounting for stock options granted to employees for services differently than options granted to nonemployees.

In addition to the conceptual superiority of the fair value method, we believe there is little merit in the argument that the fair value of employee stock options is not reliably measurable. We believe option-pricing models available today are capable of reliably measuring the grant date fair value of employee stock options. Although the need to adjust the inputs to an option-pricing model to give effect to the unique characteristics of employee stock options may create some amount of measurement uncertainty, there are many areas in accounting that are subject to measurement uncertainty. That uncertainty does not relieve a company of its obligation to make reasonable estimates. For example, companies are required to estimate the cost of remediating environmental contamination, providing pension and postretirement benefits to employees, providing warranty coverage on products sold to customers, and settling litigation. Each of these areas is subject to measurement uncertainty, but companies recognize expense prior to the ultimate settlement based on their best estimates. It would not be in the best interests of financial statement users to delay the measurement of those obligations until the amount can be measured with greater precision.

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?
We agree with the Board’s conclusion. While the Board accepted disclosure instead of requiring recognition in Statement 123, it made that decision only when its independence came under attack in Congress. However transparent the disclosure may be, we believe it cannot overcome accounting that is conceptually flawed.

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 both conclusions.

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?

Generally, we believe the Exposure Draft provides sufficient guidance to enable preparers to apply the fair value method. However, as noted in our introductory comments to this letter, we believe the Board should provide additional guidance on how an entity should determine expected volatility. In addition, we believe the Board should expand the list in paragraph B21 of the Exposure Draft of factors, such as those discussed below, that may affect an employee’s exercise behavior.

Guidance on determining expected volatility will be of particular importance to companies with shares that are thinly traded or not traded at all, as well as for companies that have experienced
a fundamental change in the nature of their business. Although stock-based compensation arrangements are not within the scope of the project on fair value measurements, we note that the estimates of fair value using an option-pricing model will generally fall within the “Level 3 Estimates” category of the fair value hierarchy. (We think it would be unusual to find a quoted market price for equity instruments that are similar to employee stock options and, if a similar equity instrument is identified, that the differences between an employee stock option and a similar equity instrument will be objectively determinable.) We believe it would be helpful if the application guidance in the final Statement were organized in a way that is consistent with the Board’s conclusions on the priority of the inputs that should be used in a Level 3 Estimate. Namely, when quoted market prices do not exist for similar equity instruments, or the differences are not objectively determinable, fair value should be measured with valuation techniques that may consider significant market inputs. To the extent market inputs that a third party would use to determine fair value do not exist or are not available without undue cost and effort, the company should use entity-specific inputs as a practical expedient. We believe additional, practical guidance, preferably in the format of the fair value hierarchy, is needed to assist companies in developing appropriate estimates of expected volatility of their stock price, a significant input for estimating the fair value of stock options.

While the proposed standard should not specify a method by which all companies must determine expected volatility, we believe a discussion of market input factors to consider, and methodologies that could be used, would be helpful. For example, companies with LEAPS (long-term equity appreciation securities) may be able to estimate expected volatility by computing the implied volatility in LEAPS with varying maturity dates and projecting that data forward, similar to the way interest rates for specified periods are imputed using a forward yield curve. Other companies with large trading volumes may be able to determine trends in historical volatility by computing volatility for increments within the relevant historical period and projecting the resulting trend in volatilities forward. For a thinly traded or nonpublic company, those market inputs may not be available for estimating expected volatility. In that circumstance, the company could, for example, develop an estimate of volatility by reference to observed volatilities of similar public companies, as discussed below. If such data does not exist or is not available without undue cost and effort, the company could estimate volatility with entity-specific inputs. For example, the company could employ a Monte-Carlo model, using inputs that would normally be used in a valuation of the business. By varying certain sensitive inputs (such as selling price and quantity), a valuation specialist can estimate the company’s volatility.

Paragraph B16 of the Exposure Draft suggests the use of volatilities for “similar” public entities, which is a Level 3 Estimate using market inputs. We believe the final standard should provide guidance on when an entity is similar. To be a valid comparable, the entity should have similar product offerings, serve similar markets, and be at the same stage of development. In addition, the entity should preferably have a similar capital structure, be of similar size, and follow similar accounting policies. To the extent those factors are not similar, adjustments may be required to take into account the impact of the differences on the comparable entity’s volatility. We think it may be difficult for some companies to identify “similar” public entities for purposes of determining expected volatility; as a result, we believe it is important for the FASB to expand the discussion of expected volatility to include a discussion of other methods for...
estimating volatility using entity-specific inputs, such as the entity's historical (and expected) volatility in earnings, cash flows, revenues, or other key measures affecting the company's volatility.

We believe paragraph B21 should be expanded to incorporate additional factors that may influence an employee's exercise behavior, such as the employee's level in the company (e.g., management or rank-and-file), his or her salary level, age, marital status, wealth, and family situation (e.g., children approaching college age). However, we recognize the more factors a company considers in estimating employee exercise behavior, the less likely it will be able to aggregate groups of employees for purposes of determining the fair value of their awards.

With respect to the concerns expressed by constituents about the consistency of fair value estimates, we note that APB Opinion No. 20, Accounting Changes, requires disclosure when an entity changes an accounting principle. As discussed in Opinion 20, changes in accounting principle include changes in the methods of applying an accounting principle. Accordingly, a company that changes its method of estimating the fair value of its stock options (including changes in the way it determines the inputs to the option-pricing model) would be required to comply with the disclosures required by Opinion 20. Regarding the concerns expressed about comparability, we note that paragraph 46 requires information about the method by which fair value is estimated such that users of financial statements should be able to make comparisons between companies within the same industry.

Finally, we believe illustrations of how to apply the guidance in paragraphs B13 to B30 should be provided, focusing in particular on how nonpublic and thinly traded public companies should estimate expected volatility.

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 both conclusions. Although we believe that the use of a lattice model is preferable to the use of the Black-Scholes-Merton model, we agree with the decision not to mandate its use. We believe many companies, particularly nonpublic companies and thinly
traded public companies that do not have an extensive history of using stock options as a form of compensation, would not have sufficient data about employee early exercise and post-vesting termination behavior to make the use of a lattice model preferable.

We believe the Board should clarify that a company is not precluded from using a lattice model, even if some of the inputs it uses are in no greater detail than would be used in estimating fair value using the Black-Scholes-Merton model.

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.

We do not believe the Board should specify a particular method of determining expected volatility. However, as discussed in our response to Issue 4(a), we believe the final standard should provide more application guidance on how to determine that input.

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.

We believe determining the fair value of stock options granted to employees using the expected term and requiring the recognition of compensation cost only for those stock options that the employee earns gives appropriate recognition to the unique characteristics of those instruments.

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 agree that the use of the intrinsic value method should be required if the fair value of an equity instrument cannot reasonably be estimated at the grant date. However, we do not agree that a company should be required to continue to remeasure compensation cost based on the intrinsic value method if the condition that precluded a reasonable estimation of fair value at the grant date no longer exists. We note that the principal reason given for this requirement in paragraph C67 of the Exposure Draft is the Board's concern that companies will seek to delay measuring the fair value of an award so as to select a date at which the fair value will be minimized. We disagree with the Board's rationale. First, it assumes that management has the ability to determine when the share price will be at its lowest point, making it advantageous to measure the fair value of any previously-granted stock options. Second, it assumes that the auditor would just accept management's assertion that it could not reasonably estimate the fair value of a stock option. We do not believe either assumption has merit, particularly in the regulatory environment in which we find ourselves today.

We believe the requirement in paragraph 46(c) of the Exposure Draft to disclose the method by which a company has determined the fair value of equity instruments granted during the period also serves as an impediment to the potential abuses over which the Board is concerned. If a company has concluded it cannot reasonably estimate the fair value of an equity instrument granted, it would be required to disclose that fact, as well as the reason fair value is not reasonably estimable. At such time that a company determines that fair value is reasonably estimable, it would be required to disclose the change.

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 accept the Board's conclusion that, except in very limited circumstances, employee stock purchase plans should be treated as compensatory arrangements in the interests of international harmonization. We do not, however, agree with the principle set forth in the Exposure Draft of comparing the terms at which shares are made available to employees with the terms at which shares are offered to all shareholders of the same class of stock. Further, we do not believe the Board has adequately explained its decision to so substantially revise the approach in Statement 123 to determining if an arrangement is noncompensatory. The reasons cited in paragraph C77 were equally applicable when the FASB considered the issue in Statement 123. As noted in paragraphs 232 and 235 to 236 of Statement 123, the FASB initially concluded that employee
stock purchase plans should be treated as compensatory arrangements. However, that Board was swayed by the argument that the discount was an avoided cost of a capital transaction.

Assuming certain conditions are met (no option features, plan is open to substantially all full time employees meeting limited employment qualifications), Statement 123 permits a discount equal to "the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering." In an equity offering to third parties, a company incurs costs to have the offering underwritten. Under the current accounting model, those costs are treated as a reduction of the proceeds from the offering. In the employee share purchase plan envisioned in Statement 123, as long as the employee discount is equal to that foregone cost, the accounting for the two arrangements is similar (that is, neither transaction affects net income). However, under the proposed Statement, the accounting for the discount would differ based on whether the discount was provided to employees or paid out to underwriters. We do not believe that is an appropriate result. If the proceeds of issuing shares to employees or third parties are the same, we do not believe compensation cost should result from issuing shares to employees prior to such time as the Board decides to require expense recognition of all costs associated with issuing shares. If the Board decides to retain the exception in paragraph 23(b)(2) of Statement 123, we believe it should eliminate the "safe-harbor" provided in the last sentence of paragraph 23(b) and require a company to support the discount based either on the avoided cost of issuing shares to raise a significant amount of capital or the discount that would be reasonable in a recurring offer to shareholders or others.

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 compensation cost should be recognized over the requisite service period.

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 agree with the method specified in the Exposure Draft for recognizing compensation cost on awards with graded vesting.

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 agree with the general framework proposed for accounting for modifications. However, we do not believe an assessment of the probability that an award will (or will not) vest should affect the incremental expense to be recognized as a result of a modification. Rather, we believe an employer should determine the incremental difference in the fair value of the award resulting from the modification and then apply the guidance in paragraph 26 of the Exposure Draft to determine how much, if any, of the adjusted compensation expense should be recognized. We believe that model is similar to how companies are currently accounting for modifications that change the probability of vesting under Statement 123 and is consistent with both the underlying premise in the Exposure Draft that the fair value of an award is not impacted by the probability that the employee will vest and the model adopted by the IASB in IFRS 2. We would propose the following changes to paragraph 35, as revised by the ED:

35. A modification of the terms or conditions of an award that increases its fair value shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater fair value, incurring additional compensation cost for that incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the original award immediately before its terms are modified. Any change in the number of instruments expected to vest at the modification date shall be accounted for in accordance with paragraph 26 of this Statement.

b. Total recognized compensation cost for an award rarely will be less than the fair value of the award at the grant date. Thus, the total compensation cost measured at the date of a modification generally shall be (1) the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus (2) the incremental cost resulting
from the modification. Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 26 of this Statement.

c. A change in compensation cost from the modification of an award measured at intrinsic value in accordance with either paragraph 20A or paragraph 22 of this Statement shall be measured by comparing the intrinsic value of the modified award, if any, and the intrinsic value of the original award, if any, immediately before the modification.

Illustrations 12 (paragraphs B115–B121), 13 (paragraphs B122–B131), and 14 (paragraphs B132–B153) of Appendix B provide guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial instruments from equity to liability or vice versa and modifications of vesting conditions.

The proposed revisions would change the conclusions for the first two outcomes in Illustrations 13(c) and 13(d) of the Exposure Draft. Applying the proposed revisions to those scenarios, there would be no incremental compensation to be recognized as a result of the modification because none of the terms that affect the fair value of an option were changed. Because the modification discussed in Illustration 13(c) results in a change in the assessment of the probability that the employee will vest in the option, Enterprise T would recognize compensation cost of $146,900 in both scenarios in which vesting occurs. Similarly, in Illustration 13(d), Enterprise T would recognize compensation cost of $146,900 in both scenarios in which vesting occurs.

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 proposed in the Exposure Draft. The Board concludes in paragraph C129 that tax deductions in excess of compensation expense recognized for financial reporting purposes is attributable to a capital transaction. We agree with that conclusion. However, we find it difficult to reconcile that conclusion with the accounting if the tax deduction is less than the amount of compensation expense recognized for
financial reporting purposes. Under the modified grant date approach where subsequent changes in the fair value of an award classified in equity are not recognized, the exercise (or vesting, in the case of unvested stock) is a capital transaction regardless of the resulting tax benefit. Adjusting the deferred tax asset through the income tax provision if the deduction for tax purposes is less than the expense recognized for financial reporting purposes introduces a mixed model to the accounting for stock-based compensation because the compensation expense that gives rise to the income tax benefit is not remeasured. Accordingly, we believe the Board should retain the method specified in Statement 123 to account for circumstances where the deduction for tax purposes is less than the amounts reflected as compensation expense in the financial statements, with one modification. Based on the conclusion that the exercise of the option is a capital transaction, we believe the amount of the deferred tax asset written off if the deduction for tax purposes is less than the expense recognized for financial reporting purposes should not be limited to the extent of excess tax benefits previously credited to paid-in capital.

However, if the Board rejects the approach suggested above, we prefer the method prescribed in the Exposure Draft to the method adopted by the IASB. While the method in IFRS 2 has the benefit of not delaying the write-off of a deferred tax asset until the date the employee exercises the option or the option expires, we prefer the method prescribed in the Exposure Draft because it avoids additional calculations that would need to be made during interim periods to determine the intrinsic value of the award and does not introduce volatility into the income tax provision. The requirement to determine the intrinsic value of the award at the end of each reporting period for purposes of determining the income tax benefit would be a significant incremental burden for private companies, which would be required to obtain annual valuations (at a minimum), and small public companies, many of which do not have significant resources in the accounting function.

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 the disclosure objectives are appropriate. However, based on the application guidance provided in paragraphs B191 to B193, it appears either the objectives listed in paragraph 46 are not complete, are not adequately explained, or the application guidance goes beyond the objectives. For example, paragraph B191(b) requires disclosure of a reconciliation of equity award activity during the most recent year for which an income statement is provided. It is not clear what objective in paragraph 46 this disclosure is intended to fulfill.
We do not understand the objective that is being met by disclosing the intrinsic value of options exercised or shares vested during the year. Is this intended to be representative of the "transfer of value" from existing shareholders to employees? If so, shouldn't the amount disclosed take into account the tax benefit, if any, realized by the employer? It would seem appropriate to reduce the intrinsic value of the awards exercised or vested by the income tax benefit as shareholders have benefited (or will benefit) from the deduction arising from exercise. It would also seem that the amount disclosed should be reduced by the grant date fair value, since that component of the "value transfer" has already been recognized in the financial statements. Otherwise, shareholders may receive a misleading picture of the impact of the stock-based compensation arrangement.

Paragraph B191(f)(2) requires disclosure of the expected term used in estimating the fair value of options granted during each period for which an income statement is provided. We believe this disclosure should only be required for companies that use an option-pricing model in which the expected term is an input. When a company uses the preferable lattice model, the expected term is not an input that is used to determine the fair value of an option. Requiring a company that uses the lattice model to expend additional time computing a number that has no relevance to the estimation of the fair value that will be recognized as compensation cost seems to penalize those companies that adopt the preferable method. In addition to the disclosure not being relevant to how an option's fair value was determined, we are not sure how a company would compute the expected term to comply with the disclosure requirement. Since a company may incorporate multiple assumptions about volatility over short periods of time, what single input would they use in the Black-Scholes-Merton model to solve for the expected term? Further, a closed-form model cannot incorporate certain assumptions that can be incorporated into a lattice model, such as assumed early exercise when the stock price reaches a multiple of the exercise price. How should that assumption be incorporated into the Black-Scholes-Merton model to take into account the impact of that assumption on the fair value of the stock option? If the Board decides to proceed with this disclosure requirement, we believe it should provide guidance to assist preparers in how to compute the expected life when they use a lattice model and should explain why that number is relevant to users when it does not enter directly into the computation of grant date fair value.

Finally, we believe the Board should consult with its User Advisory Council to determine if all of the disclosures illustrated in paragraphs B191 to B193 will still be relevant to financial statement users after companies begin to recognize compensation cost for the fair value of stock options.
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 that the use of the modified prospective method is preferable to the prospective method as it will promote comparability between reported results of companies with similar arrangements. We do not believe prospective adoption of the proposed Statement should be permitted, particularly since FASB Statement No. 148, Accounting for Stock-Based Compensation—Transition and Disclosure, was clear in limiting the period of time available for companies to adopt the fair value method using that approach. However, grandfathering the accounting by companies that adopted in recent years using the prospective approach would make comparisons between companies with similar arrangements difficult as compensation expense for a company that waited to adopt the fair value method will include the fair value of prior year unvested grants, while compensation expense for a company that adopted the fair value method in 2003 would not. While we sympathize with companies that adopted the fair value method under the assumption that their method of transition would not be affected by any subsequent standard-setting, we believe comparability is of paramount importance.

We do not, however, agree with the reasons given in the Exposure Draft for prohibiting retrospective recognition of compensation cost determined under the fair value method as it existed on the grant date. The Board concludes in paragraph C159 that retrospective application would not be appropriate because “it could require an entity to make estimates as of a prior period.” We agree it would not be appropriate to reconsider assumptions made in determining the grant date fair value of compensation arrangements in prior years in the absence of a conclusion that the assumptions used were in error. To avoid that result and to accommodate companies that would like to present compensation cost under the fair value method for all periods presented, the Board could require the compensation expense in those prior periods be based on the grant date fair value determined under the original provisions of Statement 123. That transition method would be consistent with the requirement in paragraph 21 of the ED that, under the modified prospective method, a company would recognize compensation expense in the year of adoption for any unvested award (or portion of an award) granted in prior years based on the grant date fair value determined under the original provisions of Statement 123. That paragraph precludes a company from reconsidering assumptions made during those prior periods about inputs such as employee exercise behavior (expected life) and expected volatility, in the absence of concluding those assumptions were in error. Since the Board is accepting the use of the grant date fair value determined under the original provisions of Statement 123 for purposes of applying the modified prospective method, it seems to us the same treatment could logically be extended to those companies that would like to adopt the fair value method retrospectively.
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 believe the fair value method is preferable and its use should be required. We do not believe use of the fair value method will impose a significant burden on nonpublic companies. A nonpublic company that elects to use the intrinsic value method will be required to determine the fair value of its underlying shares at each reporting date (which could be quarterly if interim financial statements are issued) until the options are exercised or otherwise settled, which would impose a significant incremental cost on a company that elects to follow the intrinsic value model. However, a nonpublic company that elects the fair value method would be required to estimate the fair value of a stock option only at the grant date, absent any modifications during the term of the option. Considering that estimating volatility is probably the only significant incremental cost that a nonpublic company would incur if the fair value method is used as opposed to the intrinsic value method, we do not believe the use an intrinsic value method provides a nonpublic company a significant, tangible benefit.

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 agree with the Board's decisions on effective date and transition.

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. We believe fair value is the appropriate measure for all entities that grant equity instruments for goods or services.

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 agree with that conclusion.

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?

As discussed in our response to Issue 10, we prefer the accounting treatment for modifications in IFRS 2.

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?

We believe the proposed Statement, taken as a whole, achieves the Board's objective. However, we noted a number of instances where the ED makes excessive use of jargon. For example:

- Paragraph B14, in discussing the use of a lattice model, states that "the expected values used are to be determined for a particular node ... of the lattice and not over multiple periods...." We believe most preparers have limited exposure to lattice models, so a basic explanation of lattice models would be helpful.

- Paragraph B25(a), in discussing factors to consider in estimating expected volatility, states "[t]he term structure of the volatility of the share price over the most recent period ...." We
are not sure all accountants will understand what the "term structure of the volatility"
means. An illustration of the concept would be helpful.

• Paragraph B48 discusses estimating the service period for an award with a market
condition. We believe an illustration would be helpful in placing the discussion in the
proper context.

We recommend that the Board request preparers from a wide range of companies (large and
small, public and nonpublic) to provide a final read in the interests of ensuring the standard is
understandable as those are the parties who will be most impacted if it is not.
Other Comments

In addition to our comments on specific questions raised in the Exposure Draft, we have the following additional comments:

Service inception date

We do not agree with the requirement to begin recognizing compensation cost for an award when all necessary authorizations have not been obtained and obtaining those authorizations is not perfunctory. Prior to the time all necessary authorizations have been obtained, the employee is not entitled to anything, even though he or she is providing services to the employer. In contrast, we agree that a company should begin recognizing compensation cost on an award for which all necessary authorizations have been obtained, even though certain of its terms are not determined (for example, the exercise price), because the employee is earning the rights to the award by providing services. We believe the latter circumstance is significantly different from the former so as to require different accounting.

Definition of "employee"

We do not agree with the conclusion in paragraph B51 that a director of a subsidiary should not be treated as an employee for purposes of applying grant date measurement if the parent or another member of the consolidated group elected the director. Under current practice, no distinction is made in accounting for options granted to directors based on whether they were elected by a controlling shareholder or were elected by shareholders not controlled directly or indirectly by the controlling shareholder. Even though a controlling shareholder may have the unilateral ability to elect a director, the director has a fiduciary responsibility to protect the interests of all shareholders. Since the director elected by a controlling shareholder has the same obligations as a director elected by a majority of shareholders, none of whom individually is a controlling shareholder, we do not understand the reason for a different accounting treatment for equity-based compensation arrangements.

Definition of grant date

We do not agree with the modification to the definition of "grant date" to provide that a grant date only occurs on the date that an employee "begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares." We are not aware of any abuses that have resulted from concluding a grant date has occurred, even though, for example, the terms of the grant stipulate that the exercise price will be equal to the market price on a specified date in the future. It appears that the Board has created a new definition ("service inception date") that would not have been required if the original definition of grant date was retained.

We do not believe eliminating the requirement that an employee be exposed to changes in the stock price would fundamentally change the conclusion in the example in paragraph B45. In that example, both parties understand the terms of the award. However, because the exercise
price is not estimable, Enterprise T would follow the intrinsic value method of accounting until it is able to reasonably estimate the fair value of each tranche of the award (which would be at the end of each year when the exercise price is determined).

In addition, we disagree with the conclusion to the example in paragraph B43 of the Exposure Draft. In that example, we believe the grant date occurs on December 31, 20X4, even though the performance targets will not be set until the beginning of each annual period. Although that term of the award is not known, we believe the parties have a mutual understanding, that being the fact that the compensation committee will set the targets at the beginning of each year. We view the setting of the targets annually as only impacting the probability that the employee will earn the award under the terms set at the grant date. As the probability that a performance award will be earned does not affect the determination of its fair value, we do not believe a delay in setting the performance conditions under which an award will be earned should cause a delay in measuring the fair value of the grant.

Interaction of ED and FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity

We believe the final standard should clarify the interaction of the recognition and measurement provisions of the Exposure Draft and the classification provisions of Statement 150. Paragraph 39A of the proposed Statement requires an employer to apply the provisions in paragraphs 8 through 14 of Statement 150 to determine the classification of an award. Paragraph 40A requires the employer to follow the recognition and measurement provisions of the Exposure Draft for purposes of determining the amount and timing of compensation expense to be recognized until such time as the employee could terminate and have the right to exercise the award for its remaining contractual term. Since most compensation arrangements are generally structured so that the period of time in which an employee can exercise a stock option truncates upon termination, most employee compensation arrangements would not be subject to the recognition and measurement provisions of Statement 150 until the employee exercises an option or vests in an unvested share.

We are not sure what impact that conclusion will have on one type of stock option arrangement that is relatively common. Many employers grant options on shares that incorporate put features allowing the employee to require the employer to repurchase the shares at some time after the stock option is exercised. Example 2 of FSP FAS 150-1, “Issuer’s Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,” concludes that an option to acquire a share of stock that may be put to the issuer should be classified as a liability. Assuming that guidance is applicable, a stock option granted to an employee on shares that incorporate a put feature would presumably be classified as a liability. Consistent with the guidance on accounting for liability arrangements in paragraph 25A of the Exposure Draft, we assume the employer would then adjust the liability to fair value each period. Therefore, even though the award is not subject to the recognition and measurement provisions of Statement 150, the end result is the same, with the exception of the impact of vesting provisions on the recognition of
If our assumption as to the appropriate accounting is correct, we believe it would be helpful to include an illustration of the accounting in the final standard.

**Book value option plans**

Appendix G of the Exposure Draft indicates that the guidance in EITF Issue No. 87-23, “Book Value Stock Purchase Plans,” will be nullified on issuance of the final standard. Because of the unique characteristics of those arrangements (that is, the requirement that the employer repurchase shares held by the employee based on a measure other than fair value), we believe it would be helpful for the FASB to provide an illustration of how companies should account for those arrangements under the fair value method. Would they be recognized as equity instruments, with the formula purchase price substituted for the stock price as an input to an option-pricing model for purposes of determining compensation cost? Or should they be recognized as liability awards (for reasons similar to those discussed in the preceding paragraph) and either adjusted to the formula repurchase price or remeasured each period, like cash-settled stock appreciation rights, with the formula purchase price substituted for the fair value of the underlying shares? Many nonpublic companies sponsor formula stock purchase and stock option arrangements, so we believe it is imperative that the FASB specifically address the accounting.

**Required use of lattice model**

Paragraph B11 of the Exposure Draft indicates that the lattice model is preferable to a closed-form model, such as the Black-Scholes-Merton model, for computing the fair value of employee stock options. Although that paragraph indicates that the use of a lattice model is not required, paragraph B10 states, in part, that a “valuation model that is more fully able to capture and better reflects those characteristics is preferable and should be used if it is practicable to do so.”

Paragraph B11 provides two circumstances in which the use of the lattice model would not be required — if the employer lacks the historical data on employee exercise behavior used to estimate expected option exercises over the life of the option or if compensation cost is not a significant element of the employer’s financial statements and the employer has concluded the effects of applying a closed-form model will not differ materially from the results obtained using a lattice model (which presumably requires the employer to determine fair value using a lattice model in order to conclude that the results do not differ materially from those resulting from the use of a closed-form model). We are not sure if those are the only two circumstances where the use of a lattice model would not be required; however, based on the wording of the examples included in paragraph B11, we assume that is the case. If our assumption is incorrect, it would be helpful if the Board would clarify its views on when it would be appropriate for an employer to elect to use a closed-form model.

**Short-term inducements**

We did not understand the rationale behind the conclusion in paragraph 35A that only short-term inducements accepted by employees should be accounted for as a modification of the
terms of the award. To us, it seems the terms of the award have been modified and modification accounting should be applied to all awards subject to the inducement, regardless of whether the employee accepts the inducement. Since the inducement results in conveying value to the employee, it should be recognized in the financial statements using the most appropriate valuation methodology. Further, the conclusion that the employer should only account for short-term inducements that are accepted seems contrary to the Board's view that compensation cost should be recognized for all awards that vest, whether or not the employee exercises those awards. We believe the Board should explain why a short-term inducement that is not accepted should be accounted for differently than one that is accepted and should provide guidance on when an inducement should be considered "short-term" for purposes of applying the guidance.

**Accounting for exchanges of stock options in a business combination**

We believe the Board should provide guidance on how the requirement in paragraph 36 of the Exposure Draft to treat stock options exchanged in a business combination as a modification of the award should be applied. We understand the Board is addressing this topic in its Purchase Method Procedures project. However, we note that a final standard is not expected until the second quarter of 2005. As the proposed Statement will be effective prior to the completion of the Purchase Method Procedures project, we believe guidance will be necessary in the interim.

**Accounting for income taxes**

Footnote 29 to paragraph B67 of the Exposure Draft states:

> A share option exercise may result in a tax deduction prior to the actual realization benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction shall not be recognized until that deduction reduces taxes payable.

We disagree with the conclusion that a tax benefit is not realized simply because the deduction resulted in an increase in the net operating loss carryforward unless the company has determined it is more likely than not that some portion or all of the deferred tax asset will not be realized. If that circumstance does not exist, the compensation deduction results in an increase in the deferred tax asset. Unless the Board is proposing a valuation allowance be recognized, the increase in the deferred tax asset resulting from the compensation deduction will result in a benefit for financial reporting purposes that should be recognized as an increase to paid-in capital.

**Disclosures**

In addition to the disclosures required by paragraph 46 of the Exposure Draft, we believe the following disclosures should be required:

- How a company defines its employee groups for purposes of estimating the expected term and, if it does not separately define employee groups, why.
• A comparison of expected lives to historical experience of employee post-vesting exercise and termination behavior.

• A comparison of historical volatility and expected volatility and the process by which management determined expected volatility.

• The number of options outstanding at year-end that are exercisable, segregated by those with exercise prices that are in-the-money, those that are at-the-money, and those that are out-of-the-money as a means of providing information to shareholders as to the potential dilutive effect of outstanding options.

Further, we believe disclosures about stock options and awards granted to executive officers (as defined in Regulation C, Rule 405) and board members in relation to total stock options and awards granted to all employees for a period may provide information that is relevant to users of financial statements.