Dear Ms. Bielstein:

The Financial Accounting Policy Committee ("FAPC") of CFA Institute\(^1\) is pleased to comment on the Financial Accounting Standards Board’s ("FASB") Proposed Statement of Financial Accounting Standards: *Share-Based Payment: An Amendment of FASB Statements No. 123 and 95* (the "Statement"). The FAPC is a standing committee of AIMR charged both with maintaining liaison with standard setters who develop financial accounting standards and regulate financial statement disclosures, and with responding to new regulatory initiatives. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

**General Comments**

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\(^1\) With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, CFA Institute, formerly known as the Association for Investment Management and Research\(^\circledast\) or AIMR\(^\circledast\), is a non-profit professional organization with a global membership of more than 70,000 financial analysts, portfolio managers, and other investment professionals in 121 countries of which more than 57,000 are holders of the Chartered Financial Analyst\(^\circledast\) (CFA\(^\circledast\)) designation. AIMR’s membership also includes 129 Member Societies in 48 countries.
The FAPC strongly supports this proposed Statement. We believe that the proposed accounting principles will improve significantly both the quality and the comparability of reported financial statements. It is the view of the FAPC and a long-held view of CFA Institute that:

- Stock options awarded to executives and other employees are compensation;
- Compensation is a cost of the production of goods and services, including research and development, marketing, administration and other services;
- All costs, including the cost of stock options, should be recorded appropriately as expenses in the income statement; and
- Stock option expense should be measured at fair value.

The proposed Statement, while differing in some respects from our views, nonetheless is consistent with our position in certain principal and fundamental aspects, and represents a substantial improvement in reporting for stock option compensation.

Our position on this issue has not changed for a number of years. The Global Financial Reporting Advocacy Committee (GFRAC) of CFA Institute stated in its 31 October 2000 letter, G4+1 Special Report – Accounting for Share-Based Payments, addressed to the International Accounting Standards Committee and the FASB:

We firmly believe that stock option awards or the granting of similar rights to employees or suppliers are forms of remuneration and, therefore, should be recorded at their fair value in the financial statements.

Share-based payments impact the financial resources of the firm. Whether these resources are held in the form of cash or any other asset form is irrelevant. By granting shares or options to shares, a company (1) foregoes the cash it would have received had it sold these instruments to investors and (2) dilutes its equity base...Under current accounting standards, share-based payments are unrecognized expenses.

Proper accounting of all stock and stock options provides investors, both stockholders and creditors, with the necessary information to properly assess the present and future economic effect that these transactions have on the enterprise’s financial position and, in turn, on their investment in that enterprise...We believe that accounting for these transactions at their fair value provides transparent and consistent financial information which aids in the efficient allocation of capital within the financial markets.

For reasons more fully discussed in the Specific Comments below, the FAPC, consistent with the views of the GFRAC, believes that the compensation expense to be recorded should be estimated
at date of grant, using an option (fair value) pricing model and inputs appropriate for the conditions and constraints of the option grant. We believe that the compensation expense should be remeasured at each reporting date thereafter until the vesting date, with changes in the fair value of the compensation expense reported as incurred. From the vesting date until the exercise or settlement date, any additional changes in fair value reported as financing expense.

We agree that the lattice model provides much greater flexibility for modeling the fair value of specific option grants and employee behavior with regard to the grants. We also believe that a specific model should not be specified at this time, but that the markets should be given appropriate latitude to continue to develop and improve the valuation models for options.

We agree with the conclusion of the FASB that the inputs to the valuation model for stock options should include, among other items, the expected exercise behavior rather than the termination date of the options, and the expected volatility rather than an unadjusted measure of the historical volatility. However, because these two estimates are important drivers of the valuation output of the model, and are subject to substantial manipulation, we believe it is essential that a benchmark measure of the volatility be provided to users in the disclosures in the notes, as well as the historical average exercise or settlement dates.

We disagree with the proposed differential reporting for equity-based compensation for non-public and small to medium-sized (“SME”) entities. We believe that best practice requires that the same measurement and recognition standards should apply to all entities reporting identical or similar transactions. Consequently, it is our view that a single consistent and comparable measurement and recognition method should be required for the reporting of equity-based compensation. The proposal that non-public entities and SMEs potentially would be permitted to use the intrinsic value method, measuring the expense at grant date, and remeasuring the expense at each reporting date until settlement, is consistent neither with the core requirements of this proposed Standard, nor with fair value measurement and recognition on a timely basis.

We believe that it is imperative that this standard be made effective for reporting periods beginning after December 15th, 2004. However, in order to expedite the transition, we propose a method for implementing the transition that should ease the process for preparers while assuring users of the financial statements that the standard will be fully implemented in the shortest possible time.

Specific Comments

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.

The FAPC agrees with this conclusion. As we state in our General Comments, we believe that stock options awarded to executives and other employees are compensation for goods and services provided to the entity by the employees. These goods and services should be recorded appropriately as expense in the income statement.

The failure to recognize and record the cost of this compensation results in an understatement of costs, and an overstatement of net income. The fact that the company pays for the compensation with options on its shares is no different from paying with cash or other assets. When an entity issues stock options to employees or other suppliers of goods and services, the company is “in essence using the potential cash it would have received by selling these instruments to investors to pay for the goods and services rendered.”2

The form of the currency used for payment, cash, options, or goods and services, should not matter. Indeed, the fact that employees accept such compensation readily attests to their belief in the economic value underlying the options, and to their acceptance of such instruments in lieu of cash or other forms of payment.

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 this conclusion. The decision to allow the intrinsic value alternative in Statement 123 was based not upon the logic and principles expounded in that Statement (which strongly supported the recognition of the fair value of the options granted, measured at the grant date) nor did the method reflect the views of the FASB Board members at the time. Rather, as the supporting documents for the Statement make clear, the intrinsic value alternative, resulting in nearly all cases in the recognition of zero compensation expense, was adopted as an expedient to overcome certain political challenges.

We would observe that under the intrinsic value method, at least on a theoretical basis, stock option compensation is “expensed.” The difficulty, indeed, the fatal flaw, in the intrinsic value

2 GFRAC Comment Letter, G4+1 Special Report – Accounting for Share-Based Payment, 31 October 2000, p. 2.
method is that when combined with grant date accounting, the two lead not to fair value recognition of the amount of compensation expense awarded to employees, and to the value foregone by shareholders, but rather to the recognition of zero expense. It is untenable to assume that employees are transferring their valuable services to the companies that employ them in exchange for zero compensation.

When opponents of stock option expensing maintain that the compensation should not be expensed, their most fundamental premise is incorrect. The options are expensed, but not at their fair value. Thus, the amount included in the totals of the financial statements, is understated, the net income is overstated, and the financial statements of many companies are materially misleading.

The intrinsic value method converges to the fair value of the options only when the employee exercises or settles the options or when they lapse, resulting in the termination or cancellation of the options, and voiding any further relevance of the remaining time value of the options. However, use of the intrinsic value method, rather than fair value, for reporting periods prior to exercise results in a partial fair value recognition that is not consistent with fair value principles.

We agree with the FASB's basis of determination regarding the issue of disclosure as compared to recognition, cited in paragraph C28:

> Since recognition means depiction of an item in both words and numbers, with the amount included in the totals of the financial statements, disclosure by other means is not recognition. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria. [Emphasis added]

If, as opponents of fair value expensing hold, disclosure is an adequate substitute for recognition in the financial statements, then there would be no need for financial statements. Curiously, those opposed to expensing do not take such a position. They maintain only that the cost of a single item, equity-based compensation for employees, should not be recognized in the financial statements.

Such selective exclusion of a major economic cost, and a principal cost of production, is unsupportable on either theoretical or practical grounds. Indeed, such a proposed exclusion amounts to a demand by a relative few individuals that their desires for the understatement of compensation expense, and consequent overstatement of net income, supersede the needs of

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millions of investors and other users of financial statements for unbiased, reliable, and transparent financial statements.

The importance of this issue to investors is supported by a survey\(^4\), cited in paragraph C30 of the proposed Statement. The survey was conducted by CFA Institute to determine the views of our global membership, particularly those research analysts and portfolio managers who regularly employ the data found in financial statements in their analyses and valuations of companies. The survey data showed that 83% of those responding believe that stock option compensation should be expensed in the income statement.

### 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?

The FAPC believes that all financial decision-making is based upon fair value measures. Consequently, fair value is the only relevant measure for assets, liabilities, revenues, and expenses, including the expense of employee compensation, whether paid for in cash, other goods and services, or with options on the entity’s own equity.

However, we disagree with the proposal that the compensation to be recorded should be measured solely at date of grant. We believe that the amount of the compensation expense to be recorded should be the fair value of the options, measured at date of grant, and remeasured, or “trued up,” at each reporting date until the vesting date. Following the vesting date, any additional fair value changes occurring until the settlement date would be reported as a financing expense.

Vesting conditions are a feature of essentially all such equity-based compensation plans. The most prominent of the vesting conditions is the requirement that option grantees not only remain with the company but continue to provide services to the company until the vesting date. If they leave before that date, withdrawing their further service to the entity, they forfeit their right to receive the options.

We believe that the economic essence of the vesting requirement of continued employee service is that the options are awarded at the grant date conditional upon the additional service provided by the employee between grant and vesting. At the grant date, an estimate of the compensation... 

\(^4\) "Survey on Accounting for Stock Options," CFA Institute. The survey was conducted in September, 2001.
cost should be made, using a model appropriate for such options. However, fair value principles, as applied to the recognition of the compensation expense, require that the full fair value of the options be remeasured at each reporting date. The final compensation expense measurement would be made at the vesting date, the first date that the employee is entitled to fully realize the value of the compensation. Thus, the fair value at grant date, and all successive changes in fair value, would be recognized in the financial statements as expense.

The period between vesting date and exercise or settlement reflects the company's continuing obligation to provide stock to the employees at their discretion and at a date of their choosing, up and until the maturity date of the options. On date of grant, the company has written a contingent call option, an option on an option. At vesting, the contingency is removed, but the performance obligation, or liability remains. Thus, the fair value accrued during the final vesting to settlement period represents a financing charge.

**Fair Value Measurement**

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

We agree in general with the proposed guidance for the implementation of fair value measurement and recognition. In the absence of observable market prices for such instruments, we agree that an option pricing model should be employed. However, transparency requires disclosures sufficient to explain what model has been used, the assumptions required for the model, and the specific inputs used. Indeed, the disclosures should be sufficient to permit users of the statements to replicate the valuation process, if a Black-Scholes model has been employed, and to provide a comparison figure, or reality check, using Black-Scholes if a lattice model has been used.
As we explain more fully below, we believe that it is essential that a benchmark for both the volatility assumption and the expected exercise behavior be required disclosures. In the absence of such benchmarks, it will not be possible for users of the statements to evaluate the appropriateness of the volatility measure employed in the model.

**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?

Few if any of the numbers in the financial statements are precise, an observation that has been made widely. The issue, then, is ultimately the degree of reliability and transparency of a measure. We believe that the use of an option-pricing model, with market or other verifiable inputs for the required assumptions, and with full disclosure and transparency of both the model and the inputs, provides sufficient reliability and transparency for decision-making.

The selection of an option-pricing or valuation model involves a tradeoff among transparency, simplicity, and accuracy. We agree with the conclusions in the Statement that the flexibility available with lattice models, and the ability of the company to tailor the model to the specific terms of a particular stock option grant and to the company’s experience with specific exercise behavior and the like, render lattice models the preferable alternative. However, such models, involving a number of judgments and decisions, are subject to bias. Disclosures sufficient to permit replication of the calculations, or at a minimum, a comparison valuation, are essential if the valuations are to be interpreted and understood.

As we observe in our General Comments, we agree with the conclusion of the FASB that the inputs to the valuation model for stock options should include, among other items, the expected exercise behavior rather than the termination date of the options, and the expected volatility rather than an unadjusted measure of the historical volatility. However, because these two estimates are important drivers of the valuation output of the model, and are subject to substantial manipulation, we believe it is essential that a benchmark measure of the volatility be
provided to users in the disclosures in the notes, as well as the historical average exercise or settlement dates. Our suggestion regarding possible benchmark measures of the volatility are discussed in more detail below.

**Issue 4(c):** Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

The value of an option is directly dependent upon the price of the company's stock, and more importantly, the volatility of that price. Thus, we do not agree that a uniform volatility assumption should be required.

The volatility measure is the single most important driving input to an option pricing model. However, we do not believe that a single method should be prescribed for estimating the expected volatility. The method appropriate to a particular case should take into account the long-term stability of the company's share price, short-term shifts in the volatility, expected changes and ongoing trends, and other similar effects. Having said this, however, we believe strongly that users of the statements need a benchmark, a volatility comparison measure, for evaluating the reasonableness of the company's volatility assumption, and the likelihood of material bias in the resulting compensation and financing expense recorded, based upon that assumption.

Consequently, we believe that at a minimum, the unadjusted historical volatility, measured over a recent period of appropriate length, which is dependent upon the historical behavior of the stock price, and environmental business changes ongoing, should be required to be disclosed. A second choice, widely used in the financial markets where prices of traded options on the company's stock are readily available, is the implied volatility of the at-the-money (ATM) option. Both the historical volatility and the implied volatility of the ATM option have been shown to be useful predictors of the future volatility. While we would agree that these may not be perfect measures for projecting future changes in the option value, we believe that the measure will provide a reasonable benchmark, a reality check, on the appropriateness of the volatility assumption input to the option model.
Another possible choice is a benchmark reflective of the company’s industry or business sector. We would need to have additional disclosures for this benchmark explaining clearly how it was determined and, if the company’s number is not consistent with the benchmark, why this is so.

**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.

These adjustments are helpful. However, we believe that full fair value recognition of the compensation expense requires a “truing up” of the assumptions made, beginning with grant date estimation, and continuing with recognition of changes in the fair value during each reporting period until settlement date. The Statement proposes a “modified prospective” method that will require adjustments for attrition or forfeiture until vesting date, but not for fair value changes. We believe that the expense recognized should reflect the full fair value effects of early or late exercise, forfeiture patterns, and the like, and these effects should be reflected in the financial statements at fair value when incurred.

Although the option holder is entitled to exercise the option at vesting date, the options may be out-of-the-money following that date, in which case the option will not be exercised until and if the option value rises above the strike price. In this case, the employee will have rendered service to the entity, but no payment will be made in the form of stock, unless the price exceeds the exercise price. The expense recognized for compensation should fully reflect this condition as well as the fair value for in-the-money options.

**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 fail to understand this provision. As we have previously stated, we believe that a single measurement and recognition method should be required of all issuers, regardless of industry, size of firm, or any other characteristic. We do not believe that differential accounting methods have a logical or economic basis. Moreover, menus of accounting choices do not promote or enhance transparency, consistency, or comparability.

More fundamentally, we find it puzzling and distressing that entities would issue instruments which they cannot, or say that they cannot, value.

The purpose of financial reporting is to provide information that is useful to those who need it, investors and other users. The desires of preparers to avoid full recognition and disclosure, or the convenience of one class of preparers, should not govern the appropriate recognition method.

If companies issue an instrument, they should expect and be bound to recognize and report the effects of the instrument in the same manner as any other entity. In this case, all companies should be required to measure the fair value of the options at grant date, and remeasure at each reporting date until settlement.

The intrinsic value method is consistent with full fair value measurement only on the date of settlement. As we have made clear, we believe that the only information useful for financial decision-making is fair value information. Consequently, we do not believe that the intrinsic value method is appropriate for any reporting entity.

**Employee Stock Purchase Plans**

**Issue 6:** For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

We agree with this principle and believe that this represents an important improvement in reporting.

**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?
Please see our response to Issue 3, above. We believe that compensation cost should be recognized over the requisite service period, but disagree with the sole grant date measurement of compensation cost. It is our view that the cost, as reflected in the fair value changes, should be remeasured at each reporting date until vesting date. Following the vesting date, any additional fair value changes would be recognized as financing expense.

We also believe that the terms of the arrangements be clearly reflected in the financial statements. Different arrangements should not be recognized as if they were similar in their provisions.

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 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 strongly support this proposal. We agree with the FASB that awards with a graded vesting schedule are, in substance, separate awards, and should be accounted for separately. We believe that the resulting recognition reflects the economic substance of the grants.

Graded vesting schedules raise an important issue. We would expect that the fair values for a one-year option would differ markedly from those for a three-year option. Moreover, the assumptions made for such inputs to the option pricing model as forfeiture and expected exercise behavior, would also differ. These differing assumptions would require additional disclosures to achieve needed levels of transparency. That is, investors should be able to rely on the financial statements to differentiate clearly between awards, including those with graded vesting schedules. However, we would expect the additional computational burden to be minimal: they will all be valued using computer-based valuation models.

Any tax effects for graded vesting schedules would also need to be considered carefully. That is, there could be tracking issues resulting from the graded vesting schedules and the provision that the deferred tax asset should be “frozen” at grant date. We would recommend careful consideration of this issue.
**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 principles for accounting for modifications and settlements. The principles, in essence, require that any such changes be accompanied by immediate full fair value recognition of the effects of the changes in the financial statements. We believe that such recognition is 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?

Consistent with our long-standing position, we believe that the entire tax benefit received should flow through the income statement. The treatment of temporary differences aside, we believe that the tax expense should ultimately reflect amounts actually paid to the government. Taking the excess tax benefit to equity gives the appearance that the company is paying much more in taxes than it actually is.

Following this logic, we also support the IASB methodology of only recognizing a tax benefit to the extent of intrinsic value, which is more nearly reflective of the actual tax liability. To do otherwise, gives the appearance that the company is paying less in taxes than it actually is or may. However, we recognize that the purpose of a valuation allowance is to ensure that the benefits recognized are realizable.

**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.

As we have stated repeatedly above, we believe that full and complete disclosure of model(s) used, assumptions, and market-related inputs, and similar items are essential to transparency and understanding of the expense recognized and its reliability. We would add to the disclosures proposed information on historical average option exercise behavior as well as either historical volatility measures or ATM option implied volatility for those companies with traded options on their own stock. These are essential if users of the statements are to properly evaluate the reasonableness and reliability of the expense recognized.

See our comments on Issue 13. If the FASB does not require retroactive recognition, then it is essential that the disclosures required under Statement 123 continue until the new Standard is fully implemented, presumably a period of three years.

We recommend strongly that the proposed disclosures be modified to require that the fair value of options on the date of exercise or settlement be provided. This represents the fair value of the compensation actually received by the employee and the benefit foregone by the shareholders.

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?

Consistent with our long-standing positions on transition methods, the FAPC believes that retrospective application of the Standard is the only appropriate transition method. For example, the FAPC stated in its comment letter dated 31 October 2002 on the FASB’s Exposure Draft, Accounting for Stock-Based Compensation—Transition and Disclosure, an Amendment of FASB Statement No. 123:
The FAPC believes that the FASB should permit only a single transition method, retroactive restatement, for those companies choosing to adopt the preferred accounting method, fair value recognition.

The FASB observes in paragraph C159:

If retrospective application with restatement was practicable, the Board believes it would be the best transition method for this Statement because retrospective application would provide the maximum amount of comparability between periods and thus enhance the usefulness of comparative financial statements. However, the Board concluded that retrospective application of the change in accounting principle to adopt this Statement would be impracticable because it could require an entity to make estimates as of a prior period. Although the guidance in this Statement on estimating the fair value of an award at the grant date is similar to the guidance in Statement 123 that public entities have been following for either recognition or pro forma disclosure purposes, this Statement clarifies and elaborates on Statement 123’s guidance. As a result, an entity might conclude that some aspects of its estimation method used in prior years should be changed, which could call for estimates of, for example, employees’ expected early exercise and post-vesting employment termination behavior as of earlier periods...

We are not convinced by these arguments. The vast majority of companies using stock option awards as a form of compensation currently use the intrinsic value method for reporting stock option expense, resulting in nearly all cases in the recognition of zero expense. Consequently, we fail to understand how retroactive recognition of a measure of the fair value of the option expense, the number that companies have been reporting in their notes for a decade, and that the FASB agrees is quite similar to the current proposed method, would be a worse number for comparison purposes than zero.

It is normal and expected that fair value estimation will result in changes in the estimation process over time as events and other circumstances change. These changes are a proper subject for disclosure in the notes to the financial statements.

We believe strongly that it is imperative for investors and other users of financial statements that a final standard be issued by September 30th, with an effective date for fiscal years beginning after December 15th, 2004. The Board has previously permitted preparers, choosing the modified prospective method, to use the calculations under SFAS 123, as compared to the requirements under the new standard. Although we advocate the retrospective method, in the interests of moving the adoption of the new standard forward as expeditiously as possible, we would be prepared to accept the SFAS 123 method for grants made in 2004 and earlier periods. We would also agree that 2005 grants could be recognized under SFAS 123 for interim periods through June 30th, 2005. This additional time would permit companies to make any needed adjustments to systems for measuring the costs of options under the new standard. These costs
could then be restated at mid-year for the first two quarters. We believe that these changes are consistent with SFAS 3 regarding accounting changes and interim financial statements.

Questions 14 and 15 will be considered jointly.

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?

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?

Small Business Issuers

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

We fail to understand the provisions in Issues 14-15. As we have previously stated, we believe that a single measurement and recognition method should be required of all issuers, regardless of industry, size of firm, or any other characteristic. We do not believe that differential accounting methods have a logical or economic basis.
The purpose of financial reporting is to provide information that is useful to those who need it, investors and other users. The desires of preparers to avoid full recognition and disclosure, or the convenience of one class of preparers, should not govern the appropriate recognition method.

If companies issue an instrument, they should expect and be bound to recognize and report the effects of the instrument in the same manner as any other entity. In this case, all companies should be required to measure the fair value of the options at grant date, and remeasure at each reporting date until settlement. If they believe they cannot estimate the volatility, they should be expected to use the volatility of other companies in the industry, or those of a similar size in a related industry.

A proliferation of methods, all of which will be recognized as “GAAP”, serves no investor or other user well. Indeed, not only consistency and comparability, but transparency as well, will be sacrificed to the convenience of preparers. To allow this provision to go forward ill-serves the needs of investors and other users for whom the statements are prepared.

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. We believe that all of the tax effects of stock option compensation should be reported as operating cash flows, consistent with other tax reporting.

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?

No. Although we are strongly supportive of convergence to a single global standard, we do not believe that best practices should be laid aside in the interests of convergence. Indeed, our view is that all extant standards should be conformed to the single best practice, whatever that may
be. We recognize that some issues may be more challenging as a result of differing regulatory or legal structures in force in the differing jurisdictions. However, we believe that the criterion above should stand until such differences can be resolved.

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 so, given our current understanding of the provisions.

Concluding Remarks

The Financial Accounting Policy Committee appreciates the opportunity to express its views on the FASB’s Proposed Statement of Financial Accounting Standards: *Share-Based Payment: An Amendment of FASB Statements No. 123 and 95*. We strongly support the basic provisions of this proposed Statement and believe that it will result in significant improvements to the transparency, reliability, comparability, and consistency of financial statements.

If the Board or staff have questions or seek amplification of our views, please contact Rebecca McEnally at 1-434-951-5319 or at rebecca.mcenally@aimr.org. We would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

/s/ Jane Adams
Jane Adams
Chair, Financial Accounting Policy Committee Institute

/s/ Rebecca Todd McEnally
Rebecca McEnally, Ph.D., CFA
Vice-President, Advocacy, CFA

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