June 30, 2004

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

Reference No. 1102-100

Dear Ms. Bielstein,

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board's (the "Board") Exposure Draft, Share-Based Payment—an amendment of FASB Statements No. 123 and 95 (the "Proposed Standard"). This comment letter supplements our initial views that were submitted to the Board on June 7, 2004. We commend the Board for issuing this Exposure Draft which we believe will produce both relevant and reliable financial information for the capital markets. Moreover, we also reaffirm our support for the independence of the Board's standard setting process—which is driven by investors' needs for reliable and relevant financial information to make informed investment decisions.

We support the Board's conclusion to require the recognition of compensation cost for the fair value of equity instruments granted to employees in exchange for the services provided by such employees. We also believe that the Proposed Standard would (1) increase the comparability of reported financial information by eliminating alternative reporting methods for employee share-based payments, (2) improve the transparency of financial reporting, and (3) further demonstrate the Board's commitment to issue standards that are grounded in the consistent application of sound principles. We support the issuance of the Proposed Standard, although we believe that certain aspects could be improved to (i) specifically acknowledge and allow for future improvements in modeling techniques and (ii) clarify other aspects that would enhance a preparer's ability to cost-effectively implement the Proposed Standard.
Our significant comments are summarized as follows:

1. We do not object to the modified grant date model. Although we prefer a “pure” grant date model, we are convinced that the unresolved valuation issues inherent in a pure grant date model make the modified grant date model a practical solution.

2. We have continuing concerns regarding valuation models. Nevertheless, because of the relevance of reporting compensation cost for the fair value of share-based payments, we support the Board’s conclusion. We agree that lattice models address certain issues that exist in closed form models, such as Black-Scholes. However, we note that lattice models present their own challenges and thus may not be suitable for every company. For the reasons discussed in the Appendix to this letter, we recommend that the final standard not indicate that the lattice model is preferable over another model, consistent with the approach taken by the International Accounting Standards Board (IASB).

3. We believe that the model for income tax accounting described in the Proposed Standard is inconsistent with certain principles of FASB Statement No. 109, Accounting for Income Taxes. The proposed accounting is also unnecessarily complex. We propose an alternative approach that we believe (i) is simpler to apply, (ii) better reflects the differences between book and income tax accounting for share-based payments, and (iii) is more intuitive to preparers and users of financial statements.

We appreciate the opportunity to express our views in this letter. Our responses to the specific questions contained in the Proposed Standard are included in the attached Appendix. If you have any questions regarding our comments, please contact Dave Kaplan (973-236-7219) or Ray Beier (973-236-7440).

Sincerely,

PricewaterhouseCoopers LLP
Appendix

Recognition of Compensation Cost
Issue 1: The Board has reaffirmed the conclusion that employee services received in exchange for equity instruments give rise to recognizable compensation cost. This Proposed Standard 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 believe that share-based payment (“SBP”) awards are valued by employees, who are motivated to obtain them and appropriately view such awards as part of their compensation. Accordingly, in our opinion, SBP awards granted to employees are compensation. We agree with the Board that companies should recognize in their financial statements compensation cost resulting from the exchange of employee services for SBP awards.

Issue 2: The Board concluded that 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 that pro forma disclosure is not a substitute for recognition of compensation cost in financial statements.

Measurement Attribute and Measurement Date
Issue 3: This Proposed Standard 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. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

We agree with the Board’s conclusion that fair value is the relevant measurement attribute and grant date is the relevant measurement date. Refer to our responses to Issues 4(a) to 4(d) for comments regarding the implementation of the Proposed Standard’s guidance on fair value.

In our February 2003 response letter to the Board’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, Shared-based Payment, we supported a “pure” grant date model as preferable to the modified grant date model of FASB Statement No. 123, Accounting for Stock-Based Compensation (“FAS 123”), subject to the resolution of certain valuation issues. We continue to believe that a “pure” grant date model is conceptually preferable.
Nevertheless, we do not object to the Board’s retention of the modified grant date model in the Proposed Standard. We have become convinced that the unresolved valuation issues inherent in a pure grant date model (such as issues related to the valuation of performance awards) make the modified grant date model a practical solution. We also believe that the modified grant date model better accommodates the recognition of compensation cost for awards that do not vest.

Some believe that compensation cost should be adjusted if SBP awards expire out-of-the-money because no “value” was provided to the employee in that circumstance. However, those who hold that view generally have not proposed that SBP awards that are exercised when the value of the award exceeds the grant-date fair value also increase compensation cost for the additional value received by the employees. This model might be described as a one-sided vesting date or exercise date model. Others propose that because of forfeiture, transferability restrictions, and post-vesting truncation provisions, that SBP awards only have value to an employee and do not have a value that can be determined by the marketplace. After considering these arguments and their implications, we concluded that the Board’s grant date model is conceptually consistent with generally accepted accounting principles and theoretically sound because the grant date is the date a mutually agreed-upon exchange occurs between the employer and employee.

**Fair Value Measurement**

**Issue 4(a):** Do you believe that this Proposed Standard 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?

While we believe that the Proposed Standard, in general, provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency, we have certain specific comments regarding expected volatility which are included in our response to Issue 4(c).

**Issue 4(b):** Do you agree with the Board’s conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board’s conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

We agree with the Board that the relevance of financial statements will be improved by recording compensation cost for the fair value of employee stock options. We continue to have concerns regarding the reliability of fair values determined by the use of option-pricing models, such as lattice or closed form models. Despite our concerns, we support the Board's conclusion to recognize as compensation cost the grant-date fair value of
employee stock options using an option-pricing model over the alternatives of continuing the use of the FAS 123 disclosure model or Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, intrinsic value method. We believe that the Proposed Standard will enhance the transparency of financial statements by providing more relevant and reliable information regarding SBP as compared to the existing alternatives.

We agree with the Board that lattice models address certain issues that exist in closed form models, such as Black-Scholes. However, we note that lattice models also raise potential issues, including complexity and the costs to implement them. Lattice models, as intended to be used by the Proposed Standard, will incorporate more refined assumptions regarding early exercise than are currently incorporated in the Black-Scholes formula and therefore should result in a more accurate estimate of fair value. On that basis, the results of a lattice model can be considered more reliable than the results of the Black-Scholes model. However, there are some advantages provided by the Black-Scholes model. First, after nearly ten years of required disclosures under FAS 123, Black-Scholes has the advantage of being far more familiar to the financial community than the less used lattice models. Second, the assumptions and mathematics for Black-Scholes are easier to develop, monitor, and audit than the same inputs into lattice models.

We believe that the Board should not indicate that one model (a lattice model) is preferable to another model and recommend that the Board adopt the approach in International Financial Reporting Standards 2, *Share-based Payment* ("IFRS 2"). The Board's current deliberations on the Proposed Standard *Fair Value Measurements* summarize its conclusions on the hierarchy of valuation techniques used to measure fair value, but the Board has not indicated a preference for a specific valuation technique within a given level of the hierarchy. The Proposed Standard on *Fair Value Measurements* would provide preparers significant discretion in the selection of a valuation technique within a given level of the hierarchy. We believe that such flexibility regarding the selection of option-pricing models is consistent with the Board's tentative conclusion in the project *Fair Value Measurements* and should be included in its final standard on *Share-Based Payment*. Such flexibility will allow preparers to assess the costs and benefits of all available models given their unique circumstances. Accordingly, we believe that companies should be allowed to choose the option-pricing model that they believe best follows the concepts in the *Fair Value Measurements* project.

Although we acknowledge that a theoretical breakthrough in option-pricing models is possible, we do not expect such a breakthrough to occur in the near future. We believe that in the near term it is more likely that advances in data mining, computing power, and software will drive improvements in lattice models that will provide more accurate estimates of fair value. For example, such improvements could simplify the use of regression analysis regarding the correlation of stock price and employee exercise behavior as compared to the application of suboptimal exercise factors. We believe that
the Board should actively promote potential improvements in the measurement of SBP awards by explicitly acknowledging the potential for refinements in existing valuation models.

If the Board disagrees with our recommendation and the lattice model is deemed preferable in the final standard, we recommend that the standard clearly indicate the circumstances when the Board believes such a model is preferable and provide guidance on the factors preparers should consider when selecting an option-pricing model.

Issue 4(c): If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Because of the individual facts and circumstances that each company will need to evaluate, we believe that the Board should not require a specific method of estimating volatility. However, we believe it would be useful if the guidance in Appendix B of the Proposed Standard on expected volatility include broad guidance indicating that any adjustments to historical volatility be objective, measurable, and verifiable based on current marketplace information. Moreover, if a company is unable to obtain current, reliable marketplace information to support adjustments to historical volatility, we suggest that the historical volatility be used as the expected volatility.

Issue 4(d): Do you agree that the guidance on how the unique characteristics of employee share options would be considered in estimating their grant date fair value gives appropriate recognition to those characteristics? 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 that the guidance appropriately recognizes the unique characteristics of employee stock options. For the reasons indicated in our response to Issue 3, we support the use of the modified grant date method. We also support the use of expected term in the measurement of fair value under a closed form model and the disclosure of a calculated expected term for a lattice model.

Issue 5: 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? If not, what other alternative do you prefer, and why?

We do not agree. The application of the intrinsic value method for an award whose fair value cannot be reasonably estimated at the grant date represents an exception to the fair value principle included in the Proposed Standard. The proposed guidance would require
companies to remeasure such awards at intrinsic value over the life of an award. FAS 123 required the intrinsic value method for awards for which the fair value initially could not be reasonably estimated, but with use of fair value when circumstances allowed. We support retention of the FAS 123 recognition approach, coupled with incremental disclosure which is described below, because we believe it is more consistent with the fair value principle of the Proposed Standard.

When the fair value of awards cannot be reasonably estimated, we propose that for all such awards issued during the reporting period or outstanding at the end of the reporting period, the following information be disclosed:

- the specific terms of the award and number of shares underlying the option grant
- the reasons why management granted an SBP award whose fair value it was unable to estimate
- the specific facts that must be determined in order to calculate an estimated fair value
- the number of awards whose fair values were estimated during the current reporting period

In this instance, we believe that additional disclosure and the retention of the FAS 123 approach is a better alternative than creating a broader and ongoing exception to the fair value principle of the Proposed Standard.

**Employee Stock Purchase Plans**

Issue 6: For the reasons described in paragraph C75, this Proposed Standard 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. We support the Board’s conclusion that employee stock purchase plans are not compensatory only if employees are entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of shares.

**Attribution of Compensation Cost**

Issue 7: This Proposed Standard would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer’s equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?
We agree that the requisite service period is the appropriate basis for attribution; however, we believe that the application of requisite service period could be simplified. Specifically, we suggest that the Board discontinue the use of service inception date and retain FAS 123’s grant date approach. Prior to the grant date (as defined by the Board in FAS 123), we believe that there has not been an agreement on the exchange of services for equity instruments and therefore there should be no accounting recognition until such an agreement is reached and approved. We believe this approach may reduce potential complexities that may arise when a company grants awards (a) where the terms may not be known and agreed to or (b) that await compensation committee, board, or shareholder approval.

**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 provides 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 that the guidance in the Proposed Standard regarding requisite service period could be clarified to more clearly articulate its practical application and interaction with other concepts proposed by the Board, specifically with market, performance, and service conditions and the required probability assessment of which condition will lead to vesting. The interaction of these three concepts for a specific award will affect the estimate of the award’s fair value, the appropriate attribution period, and the ability to reverse previously recognized compensation cost. We suggest that the Board more clearly explain the proposed guidance in this area. One potential way to improve the guidance would be to include a table that summarizes the various combinations and the results of those combinations in a simple, user-friendly manner.

Additionally, the Proposed Standard uses the terms “vesting” and “exercisability” interchangeably, resulting in difficulty reconciling the stated principles to the detailed guidance. We note that SBP awards may include terms such as:

**Award 1** – fully vested at grant date, 10 year contractual term, becomes exercisable only if a market or performance condition is met, and whose term truncates to 30 days if the employee leaves the company for any reason.

**Award 2** – fully vested at grant date, 10 year contractual term, becomes exercisable only if a market or performance condition is met, and whose term remains 10 years even if the employee leaves the company for any reason.

**Award 3** – unvested at grant date, 10 year contractual term, becomes vested and exercisable only if a market or performance condition is met, and is forfeited if
the employee leaves the company for any reason prior to vesting, with or without term truncation for post-vesting employee termination.

These are just a few of the SBP awards that exist today. Given how the above awards refer to vesting and exercisability, we believe that the Board should consistently use those terms in its examples to illustrate the vesting date concept underlying the definition of requisite service period so that users can appropriately determine the requisite service period.

In addition, it appears that most or all of the Board's consideration of the requisite service period implicitly assumes the truncation of the contractual term in the event of employee termination. In our experience, this is not a universally realistic assumption. We believe that the Proposed Standard needs to be more precise in this regard and that it would be beneficial to also include a discussion and an example regarding how the Board's requisite service model would apply in situations such as Award 2 above.

Issue 9: This Proposed Standard 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 that an award with a graded vesting schedule should follow the attribution model in the Proposed Standard, which is consistent with FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. We believe that an award with a graded vesting schedule constitutes multiple elements that should be accounted for separately because the employee may terminate service and retain portions of the award in which they are vested. The economics of awards with graded vesting schedules are clearly different than awards with cliff vesting. We believe that permitting only one attribution model for these awards promotes greater consistency among reporting companies. We recognize that preparers may incur certain one-time costs in order to implement this provision of the Proposed Standard. However, we believe that the benefits of consistently accounting for SBP awards with graded-vesting outweigh the implementation costs because the proposed attribution model does not require significant ongoing administrative costs or management judgment, but rather requires only one-time changes to administrative systems.
Modifications and Settlements

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

We believe that the underlying concepts regarding modifications could be improved and that the guidance provided in the Proposed Standard may not be sufficient to enable constituents to clearly understand and consistently apply the Board's principles. Under the Proposed Standard the accounting for modifications of market, performance, and service conditions is based upon an analysis of the “probability” that the vesting conditions will be met. We believe that the examples in Appendix B of the Proposed Standard are too simplistic and do not provide adequate implementation guidance. For example, the illustrated examples of “probable-to-probable” or “improbable-to-improbable” modifications result in either no compensation or no additional compensation to be recognized. Given that the ultimate resolution of these modifications may not be consistent with expectations at the modification date, it is unclear to us how subsequent changes in probability assessments (either of the original or modified conditions) should be treated. While we can speculate as to the Board’s conclusion in those circumstances, additional guidance should be provided to ensure the appropriate application of the Board’s principles.

The examples in Appendix B assume that (a) no other changes are concurrently made to the award, such as to service, vesting, exercise price, or term and (b) no modifications are made to the vesting condition itself, such as changing from an EBITDA target to a customer satisfaction target. We believe that the guidance on accounting for modifications would be enhanced by illustrative the accounting for these more realistic circumstances.

The determination of “probable” is an obvious linchpin in the proposed model. It will become a key judgment to be made in practice. We observe that the Proposed Standard uses the term “expected to vest” to describe proposed modifications in Appendix B illustrations, whereas the discussion in paragraphs C101-C103 uses the term “probable” of vesting. To avoid any confusion, we recommend that the Board use consistent terminology in the two appendices.
**Income Taxes**

Issue 11: This Proposed Standard 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 2, *Share-based Payment* (IFRS 2). Do you agree with the method of accounting for income taxes established by this Proposed Standard? If not, what method (including the method established in IFRS 2) do you prefer, and why?

**Tax Accounting Model**

The Board's underlying logic related to the accounting for income taxes for employee stock options has persuaded us to change our view regarding this subject. While we agree with the Board that the income tax accounting method established by FAS 123 should not be carried forward, we believe that the proposed model for accounting for income taxes is inconsistent with certain principles of FASB Statements No. 95, *Statement of Cash Flows* (“FAS 95”) and No. 109, *Accounting for Income Taxes* (“FAS 109”) and may be impractical because of its complexities.

In general, we support the Proposed Standard's approach whereby a deferred tax asset is recognized based upon the compensation expense recorded for financial reporting purposes and is then not adjusted until the award is settled. However, we recommend an accounting model under which all adjustments necessary to account for differences between the tax effect of the compensation cost recognized for financial reporting purposes and the tax benefit of the actual deduction realized upon settlement of an award (both "windfalls" and "shortfalls") are recorded as part of income tax expense in the income statement. We believe that the use of the two different methods to measure compensation expense (the grant date fair value method for financial reporting and the intrinsic value method at exercise for tax reporting) does not change the underlying fact that SBP awards are compensation for book and tax purposes.

We believe that our proposed model is consistent with the broad principles of FAS 109 and is analogous to the treatment of other "permanent" differences. For example, the tax law measures statutory depletion in a different manner than is done for financial reporting purposes. The tax benefit for statutory depletion is recorded in the period in which the additional depletion is deductible on the tax return. The income tax accounting issues for statutory depletion are very similar to the income tax accounting issues for employee stock options. We believe that these transactions should be accounted for consistently. Additionally, we believe that our proposed model better reflects the different measurement bases between book and income tax accounting for a SBP award and, accordingly, would be more intuitive to preparers and users of financial statements.

Some may argue that recording windfall benefits as part of income tax expense will inappropriately allow a company to record income as the result of the exercise of a stock option.
option. However, for a company with substantial windfall option deductions, we believe that reducing current income tax expense, potentially to zero, will more accurately reflect the tax profile of the company because the exercise of stock options have generated a tax deduction such that the company pays less tax or is not a taxpayer for that year. We believe that this presentation would be more transparent to users of financial statements than recording windfalls into equity (and recording an “as if” income tax provision), which would not reflect the actual current income tax profile of the company. We also believe that this approach is more consistent with the principles of FAS 109 that address statutory depletion and the treatment of tax-deductible dividends.

We also believe our proposed accounting model is simpler to apply. For example, we believe that the model included in the Proposed Standard would lead to a significant number of implementation issues due to the need for “backwards tracing” in connection with the settlement of option awards and is an exception to the general principle regarding intra-period tax allocation under FAS 109. Our approach would eliminate the need for an additional exception to FAS 109 (introduced in footnote 29 to paragraph B67 of the Proposed Standard) in situations where windfall benefits are lodged within net operating loss carryforwards. Our model is also more consistent with FAS 95 because it retains the principle that all tax activity be recorded through the operating section of the statement of cash flows and avoids reporting imputed, but not actual, cash flows.

Finally, there are a number of incremental effects of stock option deductions on a company’s tax provision. For example, in many instances, stock option deductions enter into the calculation of the company’s research credits, calculated on a multi-year basis. In addition, certain taxpayers are required to include a fixed percentage of their annual stock option deduction in cost-sharing pools for transfer pricing purposes. We believe there is uncertainty as to how and whether these incremental effects should be included in the amount of the windfall benefit ultimately recorded in stockholders equity. Our proposed model would eliminate this potential complication, be easier to apply in practice, and result in more consistent reporting.

Recoverability of Deferred Tax Assets

As noted above, we generally agree with the Board’s approach whereby a deferred tax asset is recognized based upon the compensation expense recorded for financial reporting purposes and is then not adjusted until the award is settled. However, we believe that the Board should allow for the potential impairment of deferred tax assets related to SBP in circumstances where it is clear that a future tax deduction will never be realized. We are troubled that the Proposed Standard would require a company to leave an asset on its balance sheet when it is clearly impaired. As currently drafted, the Proposed Standard would prohibit a company from recording a valuation allowance against deferred tax assets unless management of the company concluded that the company would not have sufficient future taxable income to support the recoverability of such deferred tax assets. We believe that this will result in recording deferred tax assets that in some circumstances will clearly not be realized. For example, a company has issued options
and recorded the related deferred tax assets as the options vest. The options are significantly underwater as of the balance sheet date and expire within the next 12 months.

Under our proposed approach, if a company were to conclude that it is "remote," as that term is used in FASB Statement No. 5, *Accounting for Contingencies*, that the underlying stock will increase in value such that employees would exercise their options, the company would be required to write off the related deferred tax asset. Our approach is designed to be consistent with the impairment model of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, so that once the deferred tax assets were written off, they could not be reestablished. This approach envisions disclosure of such writeoffs. Should the unlikely occur and the stock price recover such that settlement of the award results in a tax benefit, disclosure of that benefit would be required as well. We believe that this approach better reflects the value to be obtained from deferred tax assets by providing a mechanism for companies to write off deferred tax assets related to SBP awards that will clearly never result in a future tax deduction.

*Accounting for Taxes in Interim Periods*
We are unclear whether the incremental tax effects of shortfalls are to be estimated for purposes of computing a company’s annual effective tax rate for use in interim periods. Based upon our interpretation of the Proposed Standard, it appears that the Board expects a company to recognize the shortfall discretely in the period in which the shortfall occurs. However, based on APB Opinion No. 28, *Interim Financial Reporting* and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, we believe that a company would need to estimate the impact of options shortfalls expected to occur in subsequent fiscal quarters when measuring its estimated annual effective tax rate in earlier quarters. We recommend that the Board clarify the guidance on whether a company should estimate the annual impact of shortfalls (as well as the effect of windfalls tax benefits if the Board accepts our view) for purposes of the interim period effective tax rates, or alternatively that such effects should be recognized on a discrete basis.

*Tax Accounting at Transition*
The Proposed Standard would prohibit the recording of deferred tax assets for awards that were vested or partially vested at the effective date of the final standard. As a result, a company would never have any tax shortfalls to account for in future periods related to such awards and there could only be potential windfalls that, under the Proposed Standard, would be recorded in equity. Absent requiring restatement of prior periods, which would entail recording the deferred tax assets for vested and partially vested awards at the effective date, we do not envision another practical alternative. Thus, we support the Board’s conclusion, but with one modification. Consistent with our other comments regarding income tax accounting, we believe that windfalls that will be required to be recorded upon exercise of vested options should be recorded to income tax.
expense in the income statement. For the reasons indicated above, we believe that our approach is more consistent with the principles of FAS 109 and simpler to apply in practice.

**Tax Accounting for Nonemployee Transactions**

We recognize that the Proposed Standard does not address the measurement attribute and measurement method for nonemployee transactions. Even so, we believe that as an interim step, the Board should consider applying the accounting model for income taxes in the Proposed Standard, modified by our recommendations, to transactions with nonemployees as well. Currently, guidance on this subject does not exist. We believe that some constituents will look to the Proposed Standard when addressing the tax accounting for nonemployee awards. To promote consistency, we recommend that the Board affirmatively indicate that the model for income tax accounting for employee awards is also applicable to nonemployee awards. This represents an improvement over the existing lack of guidance. We also observe that the Board has already addressed one issue regarding the accounting for nonemployees, namely the reporting of the cash flow effects.

**Disclosures**

**Issue 12:** Do you believe that the disclosure objectives set forth in this Proposed Standard 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, we believe the disclosures should be required for each year an income statement or balance sheet is required (consistent with FAS 123), not only for the most recent fiscal year as currently called for in the Proposed Standard. We believe that such information is important to users and is used to identify trends.

We also believe that the proposed disclosure of the intrinsic value of outstanding awards should be supplemented to include a numerical reconciliation of the number of awards that are "in-the-money" and "out-of-the-money" at the end of each year. We believe that this additional disclosure will provide users with information regarding the number of outstanding options that may be exercised given the end of the year stock price and would prevent potential misunderstandings of how many awards are generating the disclosed intrinsic value.

Lastly, refer to our responses to Issues 5 and 11 regarding SBP awards whose fair value cannot be reasonably estimated and income taxes, respectively.
Transition

Issue 13: Do you agree with the transition provisions (i.e., modified prospective method of transition for public companies and no retrospective application) of this Proposed Standard? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this Proposed Standard? If so, why?

We agree with the Board’s transition proposal to use the modified prospective method for public companies and the prospective method for nonpublic companies. We also believe that both public and nonpublic companies should be allowed to restate previously issued financial statements if they so choose, by recording the amounts that they previously disclosed in accordance with the requirements of FAS 123, as is currently permitted by FASB Statement No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* (“FAS 148”). This would also entail allowing nonpublic companies the ability to restate using the minimum value method under the provisions of FAS 123 and FAS 148. Additionally, if a nonpublic company elects to restate, we believe that it should be required to use the modified prospective method to recognize the unvested portion of any awards outstanding at the effective date of the Proposed Standard.

Nonpublic Entities

Issue 14(a): This Proposed Standard 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 support standards that consistently apply accounting methods to similar transactions and that limit the number of allowable alternatives. We believe that nonpublic companies, similar to public companies, should be required to adopt a fair value approach in order to provide greater consistency across all entities and because exceptions to the fair value principle of the Proposed Standard should be kept to a minimum. Accordingly, we believe that the intrinsic value method should not be allowed as an alternative method. Eliminating the intrinsic value method alternative from the final standard will also promote greater convergence with IFRS 2, which requires nonpublic companies to adopt a fair value approach. We acknowledge that additional effort will be required of nonpublic entities to obtain fair value information, particularly as it relates to measures of expected volatility and the fair value of the underlying stock on the grant date, but we believe that the benefits of consistent and more relevant financial reporting outweigh the costs of those additional efforts. If the Board accepts our recommendation in Issue 4(b) regarding the use of closed form models, the burden on nonpublic companies will be reduced.
Issue 14(b): The Board decided to permit nonpublic companies to elect to use either the fair-value-based method or the intrinsic value method of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition. Moreover, the Board decided to extend the effective date of this Proposed Standard for nonpublic companies. Do you believe these decisions are appropriate? If not, why not? Should other modifications of this Proposed Standard’s provisions be made for those entities?

We believe that the decisions related to nonpublic entities are generally appropriate. However, we disagree with the Board’s conclusion regarding a nonpublic company’s ability to use the intrinsic value method (see our response to Issue 14(a)). We agree with the Board’s conclusions on the use of the prospective method of transition, although we believe that if a nonpublic company wishes to restate previously issued financial statements, it should be allowed (see our response to Issue 13). We agree with the Board’s effective date for the Proposed Standard for nonpublic companies.

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 believe that accounting standards should consistently apply methods to similar transactions and that limit the number of allowable alternatives. We have concerns regarding the use of the intrinsic method of accounting for nonpublic companies (see our response to Issue 14(a)). Consistent with that view, we certainly would not make such a distinction for different classes of public companies. We do not support any alternative treatment for small business issuers as defined by the Securities Acts of 1933 and 1934.

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this Proposed Standard would amend FAS 95 to require that excess tax benefits, as defined by this Proposed Standard, 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?

No. We encourage the Board to consider our proposed model for income tax accounting and reporting the cash flows effects of SBP awards (see our response to Issue 11). Under our proposal, the cash flow aspects of tax-related items related to SBP awards would be
treated consistently within the income statement and would be easier to apply in practice. Our proposal would also require all of the income tax effects of SBP awards to be reported within the operating section of the statement of cash flows, consistent with the general principles of FAS 95. We observe that the guidance provided in the Proposed Standard is the first time that the Board would require the use of “imputed” cash flows within the statement of cash flows. We believe that reporting the imputed cash flow effects of SBP awards within the financing section of the statement of cash flows would not result in an improvement to financial reporting.

Differences between This Proposed Standard and IFRS 2

Issue 17: Certain accounting treatments for SBP transactions with employees in this Proposed Standard differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. 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 Standard, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

Although complete convergence would be ideal, the accounting treatment for income taxes should be resolved by identifying and implementing the highest quality accounting model. We believe that our proposed model to account for the income tax effects of SBP awards is a viable, practical, and more transparent alternative to what is contained in either the Proposed Standard or IFRS 2. We recognize that our proposal does not completely converge with IFRS 2, but we believe that it would bring the two standards closer because under both standards the tax treatment at settlement would be recognized in the income statement.

We believe that public and nonpublic companies should follow the same principle (as in IFRS 2) to report SBP awards at their grant date fair values. We would eliminate the current alternative in the Proposed Standard available to nonpublic companies to value such awards using intrinsic value.

As indicated in our response to Issue 4(b), we recommend that the final standard not favor one option-pricing model over another, consistent with the guidance in IFRS 2.

We believe that the other differences referred to in the Proposed Standard are minor and, as agreed to by both boards last October, should be addressed as part of a separate convergence project to minimize or eliminate any remaining differences upon issuance of the final standard or phase two of the Board’s project regarding nonemployees.
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 Standard, taken as a whole, achieves that objective?

Yes, provided that the Proposed Standard reflects the recommendations described in our responses. However, we also recommend that the Board consider issuing the Proposed Standard as a separate document instead of an amendment to FAS 123, which we believe would improve the readability and understandability of the final standard.

Other Comments:

Interaction of FAS 150 and the Proposed Standard

We agree with the Board that any instrument that meets the definition of a liability under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (FAS 150), as amended, should similarly be classified as a liability for purposes of applying the guidance in the Proposed Standard. However, there are a significant number of repurchase provisions that exist with SBP awards and given the language in paragraph 25 of Appendix A and elsewhere in the Proposed Standard, it is unclear whether the Board anticipates that all put features held by an employee would require liability classification. We believe that it would be useful for the Board to consider different repurchase provisions in the context of FAS 150 and the Proposed Standard to ensure that clear guidance is provided. We also observe that the measurement guidance in FAS 150 and the Proposed Standard differ. As a result, it is unclear how such measurement differences should be considered when awards migrate from the Proposed Standard to FAS 150 and vice versa. We believe that the Board should consider providing additional guidance to clarify those situations.

Effective Date

We are concerned about the proposed timing for the release of the final standard and the proposed effective date for calendar year-end public companies. We believe that the Board should select an effective date that reflects not only the need to issue standards in a timely manner, but also allows preparers and their auditors sufficient time to ensure that new standards are implemented with high quality. Under the proposed timing for the release of the final standard, preparers will have only a limited time to address the valuation issues arising from using a lattice model (pending further deliberations by the Board), as well as to develop the systems to record compensation cost and to individually track the tax effects of option awards. We recommend that the Board provide companies at least six months from the issuance date of the final standard to analyze their data and...
alter their processes in order to achieve a quality implementation of the standard. We recognize that six months is arbitrary, but believe that it is a reasonable compromise by allowing a sufficient amount of time to implement a final standard with high quality. We realize that this may create a convergence issue, but we believe that a high quality implementation of the Proposed Standard will provide the capital markets with better information than if the Board issues a final standard which provides insufficient time for preparers to address implementation issues and change processes.