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Letter of Comment No: 5542
File Reference: 1102-100

Morgan Stanley

June 30, 2004

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

Re: File Reference No. 1102-100
Proposed Statement of Financial Accounting Standards - Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (the "Exposure Draft")

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to provide comments on the Exposure Draft. Broadly, we agree with the Board that share-based payments provided to employees give rise to recognizable compensation cost and that fair value is the most appropriate and relevant measurement of that cost. Effective in fiscal 2003, Morgan Stanley adopted the fair value provisions of Statement of Financial Accounting Standards No. 123 ("SFAS 123"), *Accounting for Stock-Based Compensation*, and records compensation expense based on the fair value of all stock-based awards.

We, however, have concerns regarding the application of the fair value and recognition provisions as proposed in the Exposure Draft and certain of the proposed changes to SFAS 123. Specifically, our comments relate to the concepts surrounding the use of a lattice model for determining fair value, the attribution of compensation cost, the treatment of forfeitures, the level and usefulness of certain required disclosures and cash flow information, the recognition of income tax effects related to share-based compensation, the prescribed transition provisions and the operationality and costs of certain provisions. Our detailed comments are found below.

Fair Value – Option Pricing Model

We believe that the Board should eliminate its preference for the lattice model over a closed form model and that companies should have the flexibility to choose the valuation technique or model that they believe provides the best fair value estimate of its employee share-based awards based on their company's respective facts and circumstances.

Paragraph 6 of the Exposure Draft states that "a better estimate of the fair value of an employee share option may be obtained by using a lattice model that incorporates employees' expected exercise and expected post-vesting employment termination behavior than by using a closed-form model...with a single weighted-average expected option term as input." In addition, paragraph B18 of the Exposure Draft expresses that the lattice model is a preferable model to a closed-form model for purposes of valuing employee share options.

As the lattice model and the Black-Scholes model (i.e., a closed-form model) are based on the same financial and mathematical theory, we do not believe that one model should be preferable over the other nor are we in agreement with the Board's assertion that a better estimate of fair value may necessarily be derived by the use of a lattice model. We accept that the two models may generate a different estimate of fair value, especially when the assumptions incorporated into the lattice model are expanded to include dynamic post-vesting employment termination behavior and forecasts of option exercise patterns, volatility, risk-free interest rates and dividend yields. The Basis for Conclusions in the Exposure Draft indicates that a lattice model is preferable because of its ability to accommodate employee exercise patterns and adjust for the nontransferability of employee share options therefore allowing for greater flexibility in reflecting the characteristics of each contract. The perceived ability to be more precise about employee exercise behavior and therefore create a better fair value estimate is not apparent to us. The lattice model's fundamental dependence on these more numerous subjective estimates may actually serve to compound estimation error and we are skeptical about a company's wherewithal to accurately predict employee behavior such that a perceptibly more reliable fair value is achieved from such an exercise.

Putting aside the fact that many companies lack information regarding the relationship of employee exercise behavior and share prices or the practicality of accumulating and maintaining this data, we contend that collecting this detailed historical information may not be that relevant or reliable in predicting future exercise patterns. Vesting provisions, stock prices, stock price volatility, tax laws, employee terminations and other variables such as broader market cycles seem to <u>always</u> change over time, especially in cases where employee options have extended terms (e.g., ten year maturities). For example, during the period from 1994 to 2004, the equity markets have experienced significant cyclical shifts and companies have seen dramatically different employee exercise behaviors over this period that could easily not have been anticipated.

In addition, we do not concur with certain premises cited by the Board that the lattice model better reflects an "observable market price."

- Our experience indicates that market valuations used for actual transactions such as over-the-counter options are based on less information than that incorporated in a lattice model, but akin to data used in a Black-Scholes model. For instance, the Exposure Draft infers that a benefit of the lattice model is to be able to vary the volatility of a company's stock price over the life of the award in order to derive a better estimate of fair value. Yet, the majority of market participants who value various types of options, including longer-term convertible bond features with the potential for early exercise given a particular investor's propensity for dividends instead of coupon payments, do not vary the volatility assumption for their calculations unless some distinct event indicates that separate volatilities should be used. Even in these circumstances, however, the Black-Scholes model still would be used in tranches.

- Key distinctions, as noted by the Board, between the Black-Scholes model and the lattice model are that the Black-Scholes model assumes one can freely trade the option contract and that the option is held to its expiration date compared to transferability restrictions and different exercise patterns that can be incorporated into a lattice model. However, as reflected above, we do not believe that the additional subjectivity involved in incorporating these features will necessarily incrementally provide a better fair value estimate and that early exercise behavior can still be incorporated into the valuation model by use of an expected term for the option.

We also believe that the use of a Black-Scholes model achieves greater transparency and comparability in financial reporting as the key assumptions used in the model are disclosed. This allows a company's fair value calculations to be compared against that of another company. Therefore, if a financial statement user interjects a different parameter into the model because one believes that a different assumption was more appropriate, a different result can be calculated and extrapolated. Disclosure of the key assumptions used in a company's Black-Scholes valuations enables a financial statement user to assess the company's assumptions and even perform certain sensitivity analyses on the company's financial statement information. With a lattice model that contains a large number of different parameters, such extrapolation and recalculation could not practically be accomplished as many investors will not readily be able to understand the underpinnings of a company's fair valuation.

Overall, we do not support the Board's preference for the lattice model over a closed form model as we do not agree that a lattice model will necessarily yield a better fair value estimate due to the subjectivity in predicting future employee exercise behavior. In addition, we do not find precedent within other accounting literature for expressing such a strong preference for use of a specific financial valuation technique in estimating fair value. Therefore, we propose that the Board eliminate any bias toward a specific model and that the final standard should allow companies to choose the valuation technique or model that they believe provides the best fair value estimate of its employee share-based awards.

Compensation Cost – Recognition

The definition of "requisite service period" in Appendix E of the Exposure Draft, states that "[a]n award that requires future service for vesting cannot define a prior period as the requisite service period" and the Exposure Draft requires that compensation cost be recognized over the requisite service period, which is presumed to be the vesting period if the share-based award contains only a service condition. However, we believe that share-based compensation should be recognized as an expense in the period that the company clearly identifies as the period in which the services were rendered for a given share-based grant and is consistent with the Company's overall philosophy for managing and rewarding its personnel. Paragraph 30 of SFAS 123 provided that "compensation cost...be recognized over the period(s) in which the related employee services are rendered....If an award is for past services, the related compensation cost shall be recognized in the period in which it is granted." We believe this provision should be retained and clarified to allow for full recognition of the compensation cost of a share-based award in the period of grant.

In many cases the vesting period requirement is solely a retention tool to obtain future services from a valuable employee and does not ensure that the company will obtain commensurate service value from the employee in future periods. For example, an employee may continue to remain employed and provide an average level of service receiving their base cash salary compensation; however, the employee's service performance may not necessarily be exceptional enough to warrant continued grants of share-based compensation. If, on the other hand, the employee performs at certain service levels in following years, he/she may receive additional, new share-based awards. We believe the company received the real value of the employee's service from the employee's contribution to company's performance in the period for which the awards are specifically granted. In certain industries and established companies where compensation levels (both a mix of cash and share-based awards) are highly dependent upon an individual's revenue generation and the company's overall revenues in a given year, notwithstanding the use of vesting provisions as a retention tool, this provides for a better matching of revenues and expenses. The above approach to compensation can be quite different from that of a broad-based plan in which a large number of employees participate in share-based awards at relatively the same levels (i.e., relatively similar number of share-based awards are granted to each employee regardless of current year revenue contributions). In addition, immediate expense recognition for the full amount of share-based awards provides for greater comparability of financial reporting among companies as it eliminates the inconsistency attributed to different vesting periods.

Alternatively, companies should be allowed to record the full estimated fair value of the share-based awards as compensation expense in the grant period as an accounting policy decision that is fully disclosed. This would allow a company that truly believes that its share-based awards are associated with employee and company performance in the grant period to reflect how it manages its business in its financial statements.

Treatment of Forfeitures

We do not believe that anticipated forfeitures should be included in initially estimating the compensation cost to be recognized for share-based awards granted to employees. Rather, SFAS 123's current approach that allows for recognizing forfeitures in earnings as they subsequently occur should continue to be an acceptable approach. This is consistent with our views noted above regarding the attribution of compensation cost in that we do not believe that estimates of forfeitures should be included in the immediate expense recognition of the full fair value amount of share-based awards. The exchange transaction that occurred between the employer and the employee in the grant period is represented by the full fair value of the share-based award absent estimated forfeitures; and any subsequent forfeiture activity is not related to services already rendered by the employee for the compensation provided by the employer.

In addition, the proposed accounting to address the impact of employee forfeitures will increase the overall cost of the final standard due to the need for the development of significant systems and procedures to monitor, record-keep and forecast such activity on an ongoing basis. We do not see the cost-benefit from both an initial estimation of share-based awards that are expected to vest and then subsequently tracking such estimates on an ongoing basis. Further, we do not believe this approach results in any incremental meaningful financial information compared to the current approach of recognizing forfeitures in earnings as they occur. For example, the random and idiosyncratic nature of employee forfeiture behavior makes predictions of this behavior suspect at best. Consequently, we recommend that the Board seek to simplify the provisions for recognizing the effects of forfeitures on compensation cost.

Disclosure and Cash Flow Information

While we support providing disclosure information to assist users of the financial statements in understanding the nature of share-based payment transactions and the effect of such transactions on financial statements, we question why a standard that eliminates an option to disclose the recognition and measurement of share-based award expense in lieu of recording it within the financial statements would somehow require increased disclosure. Specifically, we do not see the value or purpose for the following disclosures:

- intrinsic value [par. B191 c. (2)],
- detail (in addition to the total number and amounts) on vested and nonvested awards prescribed by par. B191 d. (1) & (2), and
- description of significant modifications per par. B191 g. (2) as the additional compensation expense that arises from the modification will have to be recorded in the financial statements in the period of the modification.

The proposed disclosures constitute a significant expansion in the level of required disclosures from that of current guidance. Recognizing the desire of many financial statement users to forecast a company's future compensation costs, we still do not see the meaningfulness in the above disclosures in achieving that goal. Such disclosures should not be required if credible delineation of their efficacy is not provided.

In addition, we do not believe that the Board's proposal to require excess tax benefits, as defined by the Exposure Draft, to be reported as financing cash inflows rather than as a reduction of operating cash flows results in meaningful information and disagree with this proposal. Reflecting non-cash amounts in the statement of cash flows seems contradictory and we do not understand why the impact of excess tax benefits from share-based awards should be bifurcated and reported separately when no other payment of taxes requires a similar bifurcation for reporting cash flow effects. Further, we believe implementation and operational challenges will result when considering other tax accounting items like valuation allowances, net operating loss carry-forwards, tax payment and option exercise timing differences.

Income Tax Effects

We believe that the tax effects of changes in the share prices of share-based payment awards between the date an award is granted and the date the award is exercised, or otherwise settled, should be treated consistently and believe that a share-based payment award is attributable to both an initial compensation transaction and a subsequent equity transaction. However, the Board has proposed asymmetrical treatments for the related tax effects of upward changes versus downward changes in the share price between the award's grant date and the awards exercise (or other settlement) date. Under the Board's proposal, the related tax effects of upward changes in the share price are attributed to an equity transaction whereas the related tax effects of downward changes in the share price appear to be attributed to a compensation transaction (thereby reducing the net income of a company). We question why the tax effects related to downward changes in the share price are not also considered to be attributed to an equity transaction as the effect is solely driven by market changes in the share price and not by any related compensation cost attributed to the company. While the Board has objected to SFAS 123's portfolio approach, in arriving at the tax deduction claimed by a company, the impact of upward changes in the share price of exercised awards is netted against the impact of downward changes in the share price of exercised award by another employee. The computation of the tax deduction actually claimed by an entity is consistent with SFAS 123's portfolio view of the income tax effects of share-based awards.

We note that the Board's proposed treatment of the tax effects of option exercises could result in volatile changes in the effective income tax rate of an entity from quarter to quarter and year to year. This volatility, attributed to changes in the company's share price, is not necessarily reflective of the operating results of the company. As a result, the information presented to shareholders regarding the income tax impact of share-based employee compensation will be less transparent, relevant and comparable than that presented in accordance with SFAS 123.

Overall, we recommend that the related tax effects of both upward and downward changes in the share price of exercised share-based awards be accounted for as equity transactions; however at a minimum, the related tax effects should be treated consistently, either as adjustments to paid-in capital or as increases and decreases to the net income of an entity (i.e., directly in the income tax provision).

The discussion surrounding the changes to the treatment of the income tax effects from share-based awards should be in the context of a broader discussion of the appropriate representation of the effect of income taxes in a company's financial statements. We are aware of various discussions by the User Advisory Council and the Financial Accounting Standards Advisory Committee as to the need to revisit income tax accounting under US GAAP. In addition, the Board has acknowledged the need to address the accounting for income taxes as part of its desire for convergence with International Accounting Standards. To the extent that accounting for income taxes is being considered as part of the Board's agenda, we believe that any changes to current income tax accounting are best dealt with in a more comprehensive manner as part of a broader project rather than through this Exposure Draft. We also note that the provisions related to the effect of share-based awards on income taxes are acknowledged by the Board to lack convergence with recent decisions made by the International Accounting Standards Board. We question, given that international convergence is one of the Board's stated objectives, why this particular change to SFAS 123 is warranted when measured against that objective.

Transition Provisions

We are concerned that the Exposure Draft does not carry-forward the transition guidance issued quite recently by the Board in Statement of Financial Accounting Standards No. 148 ("SFAS

148"), *Accounting for Stock-Based Compensation – Transition and Disclosure.* While we acknowledge the recent Board decisions regarding accounting changes in its Short-Term Convergence project, this sets a troubling precedent in so quickly changing the provisions in such recently issued authoritative literature. The Exposure Draft's fundamental premise to prescribe the expensing of share-based payments is a carry-forward of the basic premise in SFAS 123. Therefore, the guidance contained within SFAS 148 should still be relevant. We understand that SFAS 148 did not permit the use of the prospective method of transition for changes to the fair value based method made in fiscal years beginning after December 15, 2003. Thus, on the surface it may seem that the Exposure Draft is not prescribing transition guidance much different than SFAS 148. However, the Exposure Draft would force companies that utilized, as allowed by SFAS 148, the prospective method for their awards to follow a different transition method for many of those same awards, especially ones with longer vesting periods. We recommend that companies that recently adopted the fair value provisions for stock-based compensation under the provisions of SFAS 148 be allowed to retain such adoption provisions.

Operationality and Costs

We understand that the Board conducted a field visit program and understand the extent to which the Board consulted with experts in determining that this Exposure Draft will sufficiently improve financial reporting to justify the costs it will impose. However, we do not agree that certain aspects of the Board's proposal are appropriately justifiable from a cost-benefit perspective.

In addition to our concerns raised earlier about the cost of monitoring forfeitures, we are suspect that truly better estimates will be derived from the use of a lattice model versus other methods like the Black-Scholes model for determining share-based payment fair value amounts. Therefore, the benefit resulting from the burden of tracking, collating, organizing and analyzing the type of data necessary to develop the appropriate parameters for input into a lattice model is not apparent to us.

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We would be pleased to discuss our comments with the Board or the Staff. Please contact Karen Dealey at (212) 537-2452, David Prinzivalli (212) 537-2377 or myself at (212) 537 2620 with questions or comments.

Sincerely,

/s/ David S. Moser
Managing Director,
Principal Accounting Officer