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Letter of Comment No: 3077
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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Exposure Draft: Proposed FASB Statement, *Share-Based Payment: an amendment of FASB Statements No. 123 and 95* (File Reference No. 1102-100)

Dear Ms. Bielstein

We continue to support the Board's efforts to require companies to recognize all forms of compensation cost in their financial statements. We agree with the Board's premise that share-based payment arrangements are a form of employee compensation that, like other forms of compensation (including salary, cash bonus, pension and other postretirement benefits), should be recognized in the financial statements in the period in which the employer benefits from an employee's service. As the Board concluded in paragraph 9 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, "disclosure . . . is not a substitute for recognition in the financial statements for items that meet recognition criteria."

We also agree with the Board's conclusions that share-based payment arrangements meet the criteria for recognition, and that the grant-date fair value is the measure that most appropriately captures the substance of the arrangement between the employer and the employees. Further, we agree with the Board's conclusion that the fair value measure should be recognized as employees render service during the *requisite service period*.

We recognize that questions exist about a company's ability to reliably value employee stock options given their lack of marketability, long life, and lack of transferability. However, we observe that financial statements reflect at fair value many other items and transactions for which there is not a readily observable market value (e.g., derivative instruments and certain intangible assets acquired in a business combination) or for which the measurement requires the use of significant assumptions (e.g., pension and post-

retirement benefit obligations). We believe that existing valuation models permit companies to value option grants. Furthermore, as has been the case in other situations in which fair value measurements are required (e.g., derivative instruments), we believe it is highly likely that there will be additional developments and refinements in the models over time to enhance reliability and ease of use.

Nonetheless, we expect that a significant number of implementation issues are likely to emerge as companies begin adopting these provisions and auditors begin auditing the related financial statement information. As such, we believe that it would be prudent for the Board to form an implementation group in advance of the effective date of the standard to begin to address known implementation issues.

The body of this letter focuses on key issues identified in the Notice for Recipients in the Exposure Draft. The appendix to this letter provides our response on all those issues.

Graded Vesting Attribution Model

The Exposure Draft would require companies whose share-based payment awards contain graded vesting provisions to treat each vesting tranche as a separate award and to amortize the compensation cost for each tranche over its vesting period. The measurement objective is to value the *arrangement* between the employer and the employee. Because the value of the employee's services is not reliably measurable, the Exposure Draft would require the employer to look to the value of the instruments to determine the value of the arrangement. We agree with the Board's conclusion that an arrangement with graded vesting is different from an arrangement with cliff vesting and that the two arrangements have different grant-date fair values. However, in each case, the *arrangement* contains a requisite service period during which the employee provides service to the employer. We believe that the pattern of service provided by the employee is the same whether the arrangement contains graded or cliff vesting provisions. As a result, we believe that the same attribution method should be used for both arrangements.

For an arrangement with four-year graded vesting in which options vest each month, the attribution approach proposed in the Exposure Draft would result in recognizing approximately 65 percent of the total compensation cost of the arrangement in the first year. Whereas, for an arrangement with cliff vesting over four years, only 25 percent of the total compensation cost is recognized in the first year. Arguably, neither party to the graded-vesting arrangement (the employer nor the employee) believes that the employee has provided nearly two-thirds of the total service in the first year of the arrangement. Since the pattern of service is the same in both graded and cliff vesting arrangements, we believe the attribution method likewise should be the same.

Modifications

We agree with the proposed model for modification accounting for *service-based* and *service- and market-based* awards. However, we are concerned that the proposed accounting for modifications of *performance-based* awards relies heavily on management's judgment about whether the original performance condition would have been met, without a subsequent *true up*. Under the proposal, there is a different accounting for a modification of a performance-based award, if immediately prior to the modification, management's assessment is that the original award was probable of vesting (Type I and Type II awards illustrated in paragraphs B124-B127) versus if management's assessment is that the original award was not probable of vesting (Type III and Type IV awards illustrated in paragraphs B128-B131). The Exposure Draft does not require a true up to reflect whether the award ultimately met or failed to meet the performance condition. We believe that this is inconsistent with other provisions of the Exposure Draft which require compensation cost to be adjusted to reflect the awards that vest based on a performance condition. Additionally, as the Board notes in paragraph C107, this treatment would differ from the requirements of IFRS 2, *Share-based Payment*, resulting in a lack of convergence.

Other Issues

Liability-Equity Classification

While the Exposure Draft provides guidance on classifying awards as liability or equity, it is not always clear whether certain awards are classified as liabilities or equity. For example, we believe that when a nonpublic company grants options to employees which also contain a fair value put feature, the award would be equivalent to a cash-settled SAR and be liability-classified. We also believe that this classification would not be affected by whether or not the put is immediately exercisable. However, we understand that some believe that the "mature-immature" share distinction is relevant in classifying the award. We recognize that, while paragraph 7 (Appendix A) of the Exposure Draft requires that we consider the entirety of the arrangement between the employer and the employee, the Board's ongoing deliberations on liabilities and equity can result in arrangements that are substantively similar receiving different classification. For example, we believe that if, rather than granting a fair-value put on the option, the option's underlying was a puttable common stock, such an award would be equity-classified.

Additionally, the Exposure Draft provides that an award does not become liability-classified when it meets all other criteria for equity classification but contains a net settlement feature to meet the minimum tax withholding provisions. We understand that a plan that provides for net settlement for amounts beyond the minimum tax withholding causes the entire award to be liability-classified. Because there could be alternative interpretations (e.g., only the incremental withholding amount is liability-classified), we believe the Board's intention should be clarified.

Fair Value Issues

1. Awards with Performance and Service Vesting Provisions

We believe that there may be different interpretations on how to determine grant-date fair value for awards that vest based on either one or more performance conditions or a service condition (e.g., TARSAPs). We note that the Board discussed two views during its February 18, 2004 meeting. One view called for determining grant-date fair value for *all* possible outcomes with a true up of compensation cost to the ultimate outcome. The alternative view would require separate grant-date fair value calculations for *certain* vesting acceleration outcomes. Excluded from the grant-date fair value calculations would be possible outcomes whose likelihood of occurrence at the grant date were deemed to be remote. Examples of those events include acceleration based on an IPO or change of control. Paragraph B82 of the Exposure Draft supports our understanding that the Board chose the first alternative. However, the examples in paragraphs B83-B84 appear to support the second alternative. We believe that the final Statement should clarify the Board's intentions for measuring compensation on awards with performance conditions that can accelerate vesting.

2. Use of Black-Scholes-Merton Model

We agree with the Board's conclusions that a lattice model is preferable to a closed-form model for purposes of measuring the grant-date fair value of a share-option award because a lattice model can incorporate factors that a closed-form model cannot (suboptimal exercise, post-vesting termination, and market conditions). We note that the Exposure Draft permits the use of the Black-Scholes-Merton model to value share-option grants when a company does not have sufficient data needed to populate a lattice model. We are not certain whether the Exposure Draft permits companies to continue to use the Black-Scholes-Merton model indefinitely or whether companies would be required to undertake a reasonable effort to obtain the information needed to apply a lattice model within a reasonable period of time. We believe that the Board should clarify its intentions on this point.

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If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Paul Munter at (212) 909-5567.

Sincerely,

KPMG LLP

Appendix – Response to Issues Identified in the Exposure Draft

Issue	<i>a) KPMG's Views</i>
1. Compensation cost should be recognized in the financial statements	Agree – we believe the amounts are reliably measurable and that the employer should recognize all forms of compensation in the financial statements
2. Pro forma disclosures not appropriate substitute for recognition	Agree – this conclusion is consistent with CON 5
3. Compensation cost should be recognized based on grant-date fair value	Agree – this is the most relevant measure and is reliably determinable
4a. The Exposure Draft provides sufficient guidance so that fair value measurement objective can be consistently applied	Agree – we believe that sufficient guidance is provided and that further developments in the marketplace are likely to result in wider availability of valuation tools that can be consistently applied
4b. Grant-date fair value can be reliably measured	Agree – we believe that existing models provide a reliable measure of fair value
4c. The Board should not mandate a specific method of estimating expected volatility	Agree – the Exposure Draft provides guidance about estimating expected volatility including historical volatility, implied volatility and other means. Since situations will differ from one company to another, we believe that a single approach is unlikely to be appropriate in all circumstances
4d. The approach in the Exposure Draft to measuring and recognizing compensation appropriately captures the economics of equity-based compensation	Agree

5. Intrinsic value method should be used if the company cannot determine fair value	Agree
6. Employee stock purchase plan is compensatory unless employee can buy shares at terms no more favorable than other shareholders	Agree
7. Compensation cost would be recognized over requisite service period	Agree
8. Guidance on determining requisite service period is sufficient	Agree – we believe the Exposure Draft provides sufficient guidance
9. Graded vesting awards should be treated as separate vesting tranches for attribution purposes	Disagree – the effect of graded vesting should be captured in measurement of the grant date fair value, not in attribution
10. Accounting for modifications	Agree – we agree with the Board’s general conclusion on modifications. However, further clarification is needed in situations involving modifications of awards with performance conditions
11. Accounting for income taxes	Agree
12. Disclosures	Agree
13. Transition	Agree
14a. Nonpublic companies may make a policy election to measure compensation cost using intrinsic value	Agree – we believe that the election is appropriate for nonpublic companies
14b. Measurement, transition effective date considerations	Agree
15. Small business considerations— Exposure Draft proposes that all public companies whether SB filers or non-SB filers, should use the same approach to recognition and measurement	We believe that there is no theoretical basis to support a different accounting model for public companies that are SB filers from the model used by other public companies
16. Presentation of cash flow information	Agree

<p>17. Differences between Exposure Draft and IFRS 2</p>	<p>We support the Board's ongoing efforts to improve U.S. generally accepted accounting principles and to converge U.S. GAAP with international accounting standards. We recognize that certain differences will arise in accounting for share-based payments; however, we believe the two Boards should strive for full convergence once this standard is final. As part of that process, we believe that the accounting for modifications in the final standard should be converged to the accounting for modifications in IFRS 2</p>
<p>18. Results of applying the Exposure Draft are understandable</p>	<p>With the exception of the points raised in the body of our letter, we believe that applying this standard will make the financial statements more understandable because information related to equity-based compensation will be captured in the financial statements resulting in more transparent presentation of the information</p>