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Response to the FASB's exposure draft on share-based payment: an amendment of FASB statements No. 123 and No. 95. (Financial Accounting Standards Board) *D. Eric Hirst; Hollis Ashbaugh-Skaife; Eli Bartov; Anne Beatty; Christine Botosan; Paquita Davis-Friday; Patricia M. Fairfield; Patrick Hopkins; Russell Mallett; Robert Uhl; Mohan Venkatachalam.*

INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comment from standard setters on issues related to financial reporting. This paper summarizes the Committee's response to the FASB's March 2004 Exposure Draft, "Share-Based Payment: An Amendment of FASB Statements No. 123 and No. 95" (hereafter, the ED). The comments reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The ED addresses accounting and disclosure requirements for share-based payments made in connection with employee services. The ED maintains that the cost of employee services received in exchange for share-based payments should be recognized as an expense to the extent the services are consumed. Because the value of the services consumed cannot be measured directly, the expense is established based on the fair value of the share-based awards granted (adjusted for forfeitures).

The ED distinguishes awards made by public entities from those made by nonpublic entities and small business issuers. It also distinguishes awards classified as liability awards from equity awards. An award is a liability award if the employee can compel the entity to settle in cash or other assets or if the choice of settlement is the entity's but the substantive terms of the agreement (established by past practice, for example) are such that cash or other asset settlement is anticipated.

The ED establishes the fair value of public entities' awards by reference to observable market prices of similar traded options. If market prices are not available, then fair value is estimated using an option-pricing model. The ED states a preference for, but does not require, the use of a lattice model (e.g., binomial model). In contrast, nonpublic entities must choose whether to establish fair value in a similar manner as public entities or use intrinsic value remeasured at each reporting date through settlement.

Public entities' awards classified as liabilities are effectively accounted for using settlement-date accounting because the liability balance is remeasured to fair value at the end of each reporting period through settlement. Public entities' awards classified as equity instruments are effectively accounted for using grant-date accounting, because fair value is not adjusted post-grant (other than for forfeitures). (1) In contrast, nonpublic entities choosing to remeasure their equity awards to intrinsic value at each reporting date through settlement effectively use settlement-date accounting for both awards classified as equity instruments and liability awards.

Summary of the Committee's Position

In brief, our general position on accounting for share-based payments remains unchanged from the Committee's 1994 response to the FASB on the exposure draft for SFAS No. 123, Accounting for Stock-Based Compensation (AAA FASC 1994) and the Committee's 2003 response to the IASB on the exposure draft for Share-Based Payments (AAA FASC 2004a). In both prior letters and here, the Committee strongly endorses the conclusion that share-based payments should ultimately lead to the recognition of compensation expense. We encourage the FASB to hold firm in its desire to expense this form of compensation and to resist Congressional pressure to weaken the proposed standard. In addition, research described in a later section demonstrates that the fair value of stock options can be reliably measured using option-pricing methodologies. Given the complexity and variety of share-based compensation arrangements, the Committee agrees that the FASB should not specify a single option-pricing model. Finally, we agree that cash-settled options are liability awards that should be remeasured to fair value at the end of each reporting period.

Nonetheless, the Committee has several reservations. First, we have concerns regarding the implementation of grant-date accounting. Second, the proposed disclosure requirements are inadequate. Third, we question the use of intrinsic value through settlement date by nonpublic entities for awards classified as equity instruments. Fourth, the Committee questions the asymmetric treatment of the write-off of deferred tax assets and excess tax benefits. Finally, the Committee disagrees with the requirement that entities adopt the standard prospectively.

Settlement-date accounting overcomes many of the Committee's concerns regarding the implementation of grant-date accounting. However, the Committee does not recommend settlement-date accounting for awards classified as equity instruments because remeasurement is conceptually inconsistent with equity classification, (2) and classifying such awards as liabilities is difficult to defend. Instead the Committee calls for disclosure of: (1) the fair value of stock options outstanding remeasured at the end of each reporting period, (2) a comparison of grant-date fair value to settlement-date intrinsic value for all options settled (i.e., exercised or expired) during the period, and (3) sensitivity analysis of the effect of changes in significant valuation model assumptions on the fair value of awards granted and the associated expense. Many of the implementation advantages of settlement-date accounting may be realized by combining these disclosures with grant-date accounting for awards classified as equity instruments.

Nonpublic entities' use of intrinsic value through settlement for awards classified as equity instruments is logically inconsistent with an equity classification for such awards. The Committee urges the Board to reconsider this decision and require nonpublic entities to follow substantively similar procedures as public entities. The Committee recommends nonpublic entities use a pricing model with inputs drawn from comparable public companies or other sources if sufficiently reliable internal estimates are not available. If a sufficiently reliable estimate of volatility is not attainable internally or by reference to a comparable public company or other sources, then we recommend a lower bound estimate, computed using a volatility assumption of zero, be allowed. The Committee believes it should be possible to arrive at a reasonable, nonzero, estimate of volatility in the vast majority of cases, and that the use of a zero estimate should be reserved for unusual and rare circumstances.

The ED proposes that post-grant increases in deferred tax assets (i.e., excess tax benefits) be accounted for via an adjustment to paid-in capital, whereas decreases (i.e., write-offs) be recorded by an adjustment to income tax expense. The Committee did not achieve consensus regarding the asymmetric accounting treatment of excess tax benefits versus deferred tax write-offs. Some members of the Committee agree with the ED's proposed accounting, whereas others argue that post-grant increases and decreases in deferred tax assets should be accounted for symmetrically.

Finally, the Committee recommends retrospective adoption of the standard with previously reported pro forma or recognized share-based payment expenses viewed as a reasonable ex ante approximation of the amount of expense that would have been computed under the ED's proposed guidelines.

Next, we elaborate on issues where research addresses the Board's position. We then discuss our five primary reservations with the ED and the final section summarizes our position.

RESEARCH IN SUPPORT OF VARIOUS ISSUES

Recognition of Compensation Cost (Issue 1) (3)

Our general position on accounting for share-based payments remains unchanged from that in AAA FASC (1994, 2004a). In both prior letters and here, the Committee strongly endorses the conclusion that share-based payments should lead to expense recognition.

Opponents arguing against expense recognition cite economic hardship resulting from downward pressure on stock prices and/or increased difficulties raising investment capital, but the Committee takes issue with these arguments. Because any unrecognized share-based compensation expense is disclosed in the footnotes, the move from disclosure to recognition should have minimal effect on firm value provided the information is value-relevant and markets are reasonably efficient with respect to publicly available information--a generally accepted hypothesis.

Opponents also argue that employees may be harmed if firms respond to the recognition provisions of the ED by reducing their reliance on share-based payments. This outcome is possible if managers' use of share-based payments under the existing disclosure regime exceeds an economically viable level. Empirical evidence on the economic consequences of accounting standards suggests that managers sometimes respond to mandatory accounting changes by altering their behavior. For example, Mittelstaedt et al. (1995) document benefit reductions in employer-sponsored retiree health care plans following the approval of SFAS No. 106. These economic consequences of accounting rule changes may arise because managers fail to appreciate fully the economic impact of certain transactions until accounting standards require that the effect be measured and disclosed or recognized.

Recognition versus Disclosure of Compensation Cost (Issue 2)

As Lipe (2001) and AAA FASC (2001a) note, equity analysts since Graham and Dodd (1934) and credit-rating agencies (e.g., Standard & Poor's 2002) assert that they are aware of off-balance-sheet items and that they adjust for them in their analyses. Research shows that market measures of equity risk and the market value of equity are associated with estimated liabilities generated using footnote disclosures of operating lease obligations (Ely 1995; Imhoff et al. 1993, 1995). Other studies demonstrate that footnote disclosures about pensions and post-retirement benefit obligations are associated with security prices (e.g., Barth 1991; Choi et al. 1997).

Despite the considerable research that indicates users consider information provided in financial statement footnotes, the Committee nonetheless agrees with the FASB's conclusion that disclosure is not an adequate substitute for recognition. Evidence suggests that capital market participants respond to disclosure and recognition differently. Hirst and Hopkins (1998) find that professional analysts are more likely to discover earnings management when earnings components are clearly reported in a performance statement than when the components need to be determined through fundamental analysis. Hirst et al. (2004) find that footnote disclosure of the fair value of financial instruments along with piecemeal recognition of fair value gains and losses is not a substitute for full-fair-value income measurement. In their study, buy-side analysts who specialized in financial institutions more fully priced interest rate risk when its impact was more transparently disclosed (i.e., under full-fair-value accounting). Aboody (1996) shows that stock market participants react differently to asset write downs that are recognized in the financial statements by oil and gas firms adopting the full-cost method versus those disclosed by firms using the successful efforts method.

Furthermore, substituting footnote disclosure for recognition may have the effect of creating or enhancing opportunities for subsets of users to identify and exploit market inefficiencies. For example, research by Fairfield and Whisenant (2001) reports that analysts from the Center for Financial Research and Analysis successfully identify overvalued firms by analyzing the full set of disclosures provided in firms' SEC filings.

Option-Pricing Methodology and Measurement Reliability (Issue 4(b))

The Committee agrees that the ED ought not specify a particular valuation model and that the fair value of share-based payments can be measured reliably. Several studies examine the reasonableness of the fair value estimates produced by option-pricing methodologies when applied to employee stock options. Marquardt (2002) reports that the Black-Scholes model can be adjusted to provide reasonable estimates of employee stock option (ESO) costs. Bettis et al. (2004) extend Huddart and Lang (1996) and Carpenter (1998) and conclude that within the Black-Scholes model, adjusting the maturity of an American option to reflect the expected time to exercise produces a reasonable estimate of grant-date fair value. Nevertheless, Rubenstein (2004) cautions that, in addition to the risk of early exercise, certain features of employee stock options complicate the application of option-pricing methodologies to ESO valuation. Specifically, because employee stock options have longer times to expiration than traded options, input variables must be forecast for much longer horizons. Second, over long horizons, the valuation of options is much more sensitive to the method used.

Best practices for employee stock option valuation continue to evolve. Although allowing firms the flexibility to choose their own models might impair the consistency and comparability of the information presented, the Committee agrees with the decision to leave valuation model choice up to firms because innovations in financial economics and firms' experience with alternative models hold the possibility of improved reliability as time passes.

The Board's conclusion that the fair value of employee share awards can be measured with sufficient reliability is consistent with research showing market participants find current disclosures "reliable enough" to use. For example, Li (2002) documents a negative association between unexpected stock returns and changes in stock option expense disclosed in Form 10-K filings. Based on this finding, she concludes that SFAS No. 123 footnote disclosures communicate useful information to investors.

Bell et al. (2002) investigate the economic effect of employee stock options on firm value for 85 profitable software firms. They report that stock prices treat ESO expense as an intangible asset (i.e., as a net benefit to the firms). Aboody et al. (2004b) build on the analysis in Bell et al. (2002) and estimate explicitly both stock compensation expense and the beneficial effect of motivating employees with stock-based compensation. Using analysts' forecasts of long-term growth in earnings to capture the benefits, they find that stock prices are negatively associated with SFAS No. 123 compensation expense, as one would expect. Finally, Li (2002) finds that share prices are associated with both outstanding employee stock options (based on a Black-Scholes model) and expected future option expense (on the basis of the current disclosed expense or the current disclosed expense adjusted for expected growth).

PRIMARY RESERVATIONS

Grant-Date Accounting (Issue 3)

The Committee agrees that fair value is the relevant measurement attribute for share-based payments. However, significant implementation concerns arise when the grant date is employed as the relevant measurement date. These implementation issues include opportunities for managers to structure transactions to achieve desired accounting outcomes and opportunities for earnings management due to a lack of estimate true-up. These implementation issues could be mitigated by using the settlement date as the measurement date.

A number of recent academic papers argue for the use of settlement (or vesting) date accounting (e.g., Hull and White 2003; Kaplan and Palepu 2003; Bulow and Shoven 2004; Kirschenheiter et al. 2004; Rubenstein 2004). However, settlement-date accounting for awards classified as equity instruments is not defensible on a conceptual level because it leads to the periodic fair-value remeasurement of an instrument appropriately classified as equity under the existing liability and equity framework.

The Committee has written on the Liability-Equity classification issue previously (AAA FASC 2001b). Although most members of the current Committee agree that employee stock options settled in equity are not liabilities, there is some debate among the members as to whether employee stock options settled in equity are strictly equity from both a solvency and valuation perspective. Existing common shareholders and stock option holders are inherently different;

they do not share the same voting rights and they are characterized by different pay-off functions. The distinction between debt and equity is complex even in the relatively simple context of stock options, and the distinction is important because the classification of instruments has implications not only for the balance sheet, but also the income statement. Accordingly, the Committee supports the FASB's ongoing efforts to reconsider and clarify the definitions of liabilities and equity.

The Committee supports using the grant date as the measurement date, but for reasons that follow, strongly encourages the Board to require disclosure of additional information to mitigate some of the short-comings of grant-date accounting.

Opportunity for Transaction Structuring

If an entity settles employee stock options in cash, then it classifies the award as a liability and employs settlement-date accounting. However, if the entity repurchases shares on the open market and immediately uses those shares to settle employee stock options, it classifies the award as an equity instrument and employs grant-date accounting. Except for differences in transaction costs, the impact on the entity's cash position and equity is identical and presumably, the economic benefit derived from the employee services is unaffected. Yet, the cumulative amount of compensation expense can be dramatically different. (4) Because settlement method (the mechanism used to distinguish between awards classified as equity and liability awards) can be manipulated by managers, managers have the opportunity to structure share-based payment transactions to achieve desired accounting results.

Existing evidence suggests they do. Kahle (2002) finds that share repurchase decisions and levels are associated with the number of options firms have outstanding. She finds that the stock market views repurchases that appear motivated by the desire to avoid dilution as less positive than repurchases that may be signaling undervaluation or a return of free cash flow to shareholders. Bens et al. (2003) find that repurchase decisions are associated with incentives to manage diluted EPS and to maintain a desired rate of EPS growth. Furthermore, Bens et al. (2002) show that these share repurchases crowd out real investment (i.e., research and development expenditures and capital expenditures). They also find evidence that such behavior is associated with declines in future performance. Thus, evidence exists that Treasury stock transactions are linked to option granting and exercise.

Further, more general evidence of transaction structuring comes from Marquardt and Wiedman (2003). They find that the likelihood of firms issuing contingently convertible bonds (COCOs), which are often excluded from diluted EPS calculations under SFAS No. 128, is significantly associated with the reduction in diluted EPS that would occur if the bonds were traditionally structured convertibles. They also document that firms appear willing to incur additional costs to secure the perceived financial reporting benefits associated with COCOs. One motive for this behavior is the existence of performance-related management compensation contracts. The authors connect their research to an extensive literature that focuses on the interaction between accounting rules and transaction structuring, including Imhoff and Thomas (1988), Comiskey and Mulford (1986), Engel et al. (1999), and Ayers et al. (2002).

Nelson et al. (2002) use auditor survey data to document that managers are more likely to attempt earnings management through transaction structuring when accounting standards are precise and through interpretation and judgment when standards are imprecise. Additionally, auditors are less likely to adjust structured (unstructured) earnings management attempts when standards are precise (imprecise). For example, earnings management "attempts involving leases, consolidations, and determining the appropriateness of the equity vs. cost method tend to be governed by precise standards, and transactions in these areas are amenable to structuring, so they are less likely to be adjusted" by auditors (Nelson et al. 2002, 177).

The opportunity for transaction structuring is an undesirable property of a principles-based accounting standard, which should capture the economic substance of the transaction as opposed to its form. Theoretical work by Dye (2002) predicts that when accounting reports consist of one of two binary classifications and one of these classifications is preferred by preparers, preparers engage in "classifications manipulation" in order to receive the preferred accounting treatment. When this situation occurs, more firms attain the preferred treatment than would otherwise be the case, and accounting standards are consequently less effective in distinguishing between real economic differences in transactions (Marquardt and Wiedman 2003, 8).

Opportunity for Earnings Management

In addition to concerns about transaction structuring, the Committee is concerned with the considerable demand grant-date accounting places on the reliability of management's grant-date parameter estimates (e.g., the expected number of options to be exercised, the expected volatility of share price, the expected dividend yield, the risk-free rate of interest, the term of the option, and, for nontraded companies, the current market price of a share). A unique feature of grant-date accounting is that managers' accounting estimates are not constrained by the "truing up" mechanism common to most accrual accounting estimates. This makes the reported amounts susceptible to unintentional measurement error and provides managers with an opportunity to manipulate financial statement numbers by intentionally biasing their grant-date estimates. (5)

Research and anecdotal evidence show that firms use discretion over accounting policies and/or estimates to achieve reporting goals (e.g., McNichols and Wilson 1988). (6) In general, the evidence is consistent with managers using discretion in accounting estimates to satisfy various objectives including maximizing management bonuses (Healy 1985), smoothing earnings or enhancing future performance via "big bath" accounting (Elliott and Shaw 1988; Strong and Meyer 1987), avoiding debt covenant violations (Sweeney 1994), and meeting management's or analysts' earnings forecasts (Kasznik 1999). In the options arena, Bartov and Mohanram's (2004) evidence suggests that managers manage earnings upward prior to large option exercises by top-level executives in order to increase the cash they receive on exercise and subsequent sale of their stock.

Evidence described previously suggests ESO data reported in the footnotes are "reliable enough" to be associated with security prices. Nonetheless, other research demonstrates that grant-date estimates of the fair value of employee stock options are highly sensitive to the parameter estimates employed. Applying methods acceptable under SFAS No. 123 to the options of six firms, Coller and Higgs (1997) obtain widely different estimates of compensation expense depending on alternative measures of stock return volatility and dividend yield. (7) In a study of the option exercise behavior of over 50,000 employees at eight firms, Huddart and Lang (1996) find that employees tend to exercise options earlier than they would if they held ordinary options, leading to significant losses compared with the Black-Scholes value of the option. (8) Huddart and Lang (1996) also find that employee stock option exercise patterns are difficult to predict and vary over time, which implies that grant-date estimation of expected option life is susceptible to unintentional measurement error.

Aboody et al. (2004a) document evidence of estimate manipulation in the options arena. They show that firms granting more options, and firms with higher levels of CEO compensation, reduce stock compensation expense by assuming shorter option lives. (9) Related work by Aboody and Kasznik (2000) finds that CEOs manage the timing of voluntary disclosures around option grant dates in a manner consistent with efforts to manipulate the exercise price. In particular, bad news is disclosed early (leading to reduced exercise prices) and good news is delayed (avoiding an increase in exercise prices). Bartov et al. (2004) find that managers strategically incorporate the use of forward-looking information in deriving expected volatility to yield lower volatility estimates and smaller option expenses. A working paper by Hodder et al. (2004) compares input estimates (and resulting option values) to a series of benchmark input estimates (and resulting benchmark option values). They find that, on average, discretion over input values leads to considerable understating of ESO fair values. Nonetheless, nearly 50 percent of their sample firms use discretion in a fashion that increases the ex post accuracy of the fair value estimates and signals subsequent changes in future operating risk. Thus, although allowing managers discretion over input assumptions appears to result in considerable self-serving behavior, evidence exists that many managers use discretion to enhance estimation accuracy.

Providing managers with the opportunity to manage reported employee stock compensation expense is an undesirable property of the ED. Managers' ability to permanently impact reported income and equity by managing employee stock compensation expense could be curtailed under settlement-date accounting for all share-based payments, regardless of settlement method. However, settlement-date accounting is logically inconsistent with the equity classification afforded to share-based payments settled in equity. Classifying these awards as liability awards overcomes this problem but is not consistent with existing or proposed definitions of liabilities.

Proposed Solution--Additional Disclosures

In light of this, the Committee recommends that grant-date accounting be applied to share-based awards classified as equity instruments. To mitigate the shortcomings of grant-date accounting, and allow users to assess the quality of earnings, the Committee recommends the Board require entities to disclose:

* a comparison of grant-date fair value to settlement-date intrinsic value for all options settled (i.e., exercised or expired) during the period; and

* sensitivity analysis of the effects of changes in significant valuation model assumptions on the fair value of options granted and stock option expense.

These disclosures (and others we discuss in the following section) could provide users with information useful in assessing the quality of earnings by documenting the difference between management's estimates and subsequent realizations. Hirst et al. (2003) provide evidence that individual investors consider reconciliations of prior estimates when they assess earnings quality and estimate security prices. Moreover, considerable research has established the usefulness of reconciliations of property and casualty insurers' claim loss reserve development disclosures (e.g., Petroni 1992; Petroni et al. 2000). Given the complexity of share-based award measurement and the long periods over which estimates and actual realizations take place, disclosures similar to those by U.S. property and casualty insurance companies could help users evaluate the quality of a firm's reporting, thereby reducing the likelihood managers will manipulate stock compensation expense. (10)

Disclosure Requirements (Issue 12)

The ED establishes four specific disclosure objectives whose purpose is to explain and elaborate on the information recognized in the financial statements. As in IFRS No. 2 (IASB 2004), the ED describes the minimum disclosures needed to achieve each objective. The disclosure requirements in the ED are almost identical to those in IFRS No. 2. However, the Committee reiterates its concern that the required disclosures are inadequate to meet the needs of users. In addition to the disclosures proposed to deal with grant-date accounting shortcomings, the Committee recommends the following required disclosures, which will make the ED even more comparable to IFRS No. 2:

* the weighted average share price at the date of exercise for options exercised during the period;

* the range of exercise prices and weighted average remaining contractual life of share options outstanding at the end of the period; and

* the weighted average share price and the exercise price in addition to the option-pricing model inputs already explicitly stated.

In addition to these disclosures, the Committee recommends required disclosures that are needed for use in security valuation. Using a free cash flow valuation model, Soffer and Soffer (2003) provide a well-developed discussion of the theoretical importance of estimating both future grants of employee stock options and the fair value of existing employee stock options (all net of taxes to the firm) in arriving at the value of common equity. The residual income valuation model (see Penman [2001] for a detailed discussion and references) also requires both of those inputs to value existing equity. (11)

The ED requires disclosure of neither of these important inputs. Although disclosure of future share-based payments does not fall under the purview of the current financial reporting model, disclosure of the fair value of existing employee stock options does and information on past stock compensation expense could be useful to users in forming expectations of future costs. Moreover, because employee stock options often differ from traded options in important respects, reliable estimates of the fair value of employee stock options outstanding may not be available to users from any other source. Given the importance of this information in valuation, the Committee recommends that the ED be amended to add the fair value of outstanding options to the list of required disclosures.

Remeasurement to Intrinsic Value for Equity Settled Options Issued by Nonpublic Companies (Issues 5, 14a, and 15)

In a previous letter (AAA FASC 2003), the Committee described the characteristics we believe principles-based standards should possess. In supporting such standards, we emphasized that they should: (1) use the economic substance, rather than the form, of a transaction to guide financial reporting, (2) provide a description of the economics of the transaction and any assumptions made in reporting the transaction, and (3) if needed, provide implementation guidance in the form of examples, rather than rules.

The Committee views share-based payments made by nonpublic entities and small business issuers as substantially equivalent to share-based payments made by public entities. Accordingly, the Committee does not support the proposal to permit nonpublic and public entities to elect different methods of accounting for share-based payments. The use of different methods will reduce comparability across entities and may impair consistency as companies change status.

The Committee recommends that as with public entities, nonpublic and small business entities should be required to use an option-pricing model to estimate the fair value of employee stock options, if the fair value of the award cannot be established by reference to observable market prices of similar traded options. If sufficiently reliable internal input estimates for use in the option-pricing model are not available, then the inputs should be drawn from comparable public companies or other sources. In the rare and unusual case that a sufficiently reliable estimate of volatility is not attainable internally, by reference to a comparable public company, or through other sources, the Committee recommends that, for reasons of practicality, nonpublic entities be permitted to use a lower bound estimate of fair value, computed using a volatility assumption of zero.

Treatment of Income Taxes (Issue 11)

The ED proposes to account for excess tax benefits by increasing paid-in capital, but to account for write-offs of deferred tax assets by increasing tax expense. The Committee did not achieve consensus regarding the appropriateness of asymmetric accounting for post-grant increases and decreases in deferred tax assets.

Those opposed are concerned that for equity awards, recording the write-off of deferred tax assets through income tax expense results in a mismatch between pre-tax accounting income and income tax expense. This occurs because the post-grant reduction in the fair value of options outstanding that gives rise to the deferred tax write-off is not itself recognized in net income. Further, these members question the conceptual basis for treating excess tax benefits as if they arise from transactions with equity holders, while treating write-offs of deferred tax assets as if they arise from transactions with employees.

The Committee could not agree on a solution to the problem of accounting for post-grant changes in deferred tax assets arising from equity awards, however. This is because even though the ED's proposed approach to account for deferred tax write-offs arising from these awards reflects inappropriate intraperiod tax allocation, it complies with clean surplus.

In contrast, the ED's proposed accounting for excess tax benefits arising from equity awards reflects appropriate intraperiod tax allocation, but creates dirty surplus. As long as the share-based payment instrument is classified as equity while the related deferred tax benefit is classified as an asset, this trade-off is unavoidable. This issue could be resolved by classifying the deferred tax asset as a contra equity account, but because the Committee questions the conceptual basis for doing so, we could not identify a solution to the problem.

Prospective Adoption (Issue 13)

In our response to the FASB Exposure Draft, "Accounting Changes and Error Corrections," (AAA FASC 2004b) the Committee supports retrospective application as the standard transition method for mandatory adoption of a new accounting standard. Retrospective application results in more consistent and comparable financial information. The Committee is disappointed that the ED does not require retrospective application, and we are concerned that the decision to require prospective application in this case sets a dangerous precedent.

The Committee recommends retrospective adoption of the standard with previously reported pro forma or recognized share-based payment expenses viewed as a reasonable ex ante approximation of the amount of expense that would have been computed under the ED's proposed guidelines. Because entities were required to provide pro forma data under SFAS No. 123, we do not believe that retrospective application is prohibitively costly.

SUMMARY AND CONCLUSION

The Committee strongly endorses the conclusion that share-based payments lead to compensation expense. Research demonstrates that the fair value of stock options can be reliably measured using option-pricing methodologies. The Committee agrees that the FASB should not specify a single option-pricing methodology, and we agree that cash-settled options are liability awards that should be remeasured at fair value at the end of each reporting period.

One of the Committee's concerns with the ED centers on implementation issues that could reduce the usefulness of the information produced by grant-date accounting. To mitigate these concerns and ensure that critical information needed for valuation purposes is accessible, the Committee calls for enhanced disclosure requirements including:

1) the fair value of stock options outstanding remeasured at the end of each reporting period,

2) a comparison of grant-date fair value to settlement-date intrinsic value for all options settled during the period, and

3) sensitivity analysis of the effect of changes in significant valuation model assumptions.

The Committee urges the Board to reconsider its conclusions with respect to nonpublic entities and to require them to follow substantively similar procedures as public entities.

Some members of the Committee question the asymmetric treatment of the write-off of deferred tax assets and excess tax benefits. Others agree with the ED's proposed accounting. Those members expressing concerns recommend that both sides of the adjustment to deferred tax assets be accounted for symmetrically.

Finally, the Committee urges the Board to require retrospective adoption of the standard with previously reported pro forma or recognized share-based payment expenses viewed as a reasonable ex ante approximation of the amount of expense that would have been computed under the ED's proposed guidelines.

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(1) For purposes of this commentary, we use "grant-date accounting" to refer to any expense attribution pattern in which the cumulative expense charged to income over the life of the award is the fair value of awards granted (net of forfeitures). We use "settlement-date accounting" to refer to any expense attribution pattern in which the cumulative expense charged to income over the life of the award is the intrinsic value of the award at settlement.

(2) That is, changes in equity result from transactions involving, and measurements of, assets and liabilities. Equity itself is not remeasured.

(3) The reference to specific issues corresponds to the issues raised by the Board in the ED.

(4) The Committee does not believe that a history of treasury stock transactions should be used to classify an equity-settled stock option as a liability, and similarly the Committee struggles with using a history of cash settlement to justify liability classification for stock options that may be settled in cash or equity at the entity's option.

(5) One estimate is trued up: the forfeiture rate is trued up through to the vesting date.

(6) McNichols and Wilson (1988) show empirically that firms manage their earnings by overproviding for bad debts when income is extreme. For a relatively recent review of the earnings management literature see Fields et al. (2001).

(7) Their volatility estimates included volatility of daily returns computed over 60 days, volatility of monthly returns computed over 60 months, and Black-Scholes imputed volatility from traded options. Their dividend yield estimates included Value Line's estimate of "expected annualized dividend yield," a Wall Street Journal estimate computed as the last quarterly dividend X 4/stock price, the sum of the last four quarterly dividends/year-end stock price, and the sum of the last four quarterly dividends each scaled by stock price on the relevant declaration dates.

(8) Carpenter (1998) provides insights into how modified models can be used successfully; however, her evidence is limited to executive stock options. Huddart and Lang (1996) document differences in exercise patterns across employee groups.

(9) Davis-Friday, Miller, and Mittelstaedt (2004) provide evidence that firms use the discretion available in reporting pension expense (income) to choose assumptions that lead to higher (lower) pension expense (income).

(10) Davis-Friday, Liu, and Mittelstaedt (2004) investigate the factors that make disclosures more or less reliable. They provide evidence that the reliability and usefulness of post-retirement benefit disclosures provided to comply with SAB No. 74 could have been enhanced if more supporting details had been disclosed.

(11) This thinking also seems to be gaining acceptance in practice (see, for example, Clement and Cohen 2002).

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