Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
Tel 425 882 8080
Fax 425 936 7329
http://www.microsoft.com/

CL 79

March 7, 2003

Kimberley Crook, Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH,
United Kingdom

Dear Ms. Crook:

Microsoft appreciates the opportunity to respond to IASB Exposure Draft (ED) 2, "Share-based Payment". Microsoft believes there is an economic rationale to expensing stock options, but we have concerns regarding the appropriate valuation of those options. Nevertheless, there are strong arguments on both sides of this debate and it is critical that standard setters perform an objective, in-depth analysis of the comment letters received. However, once that analysis is performed, standard setters need to decide on this issue and then all constituents in the standard setting process need to move on. We believe FASB Chairman Bob Herz put it best at the AICPA 2002 National Conference on Current SEC Developments when he indicated that, "As important as the subject is, I hope you will agree that there already has been enough emotional, political, and economic capital spent on it". Given the current crisis in confidence in the accounting profession, it is imperative that all involved in the financial reporting process strive individually and collectively to create a new environment of integrity and accountability.

As indicated in the IASB's Framework for the Preparation and Presentation of Financial Statements, comparability, along with understandability, relevance, and reliability are the four principal qualitative characteristics of financial statements. Microsoft is aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options at grant date and believes it is incumbent on the IASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Given this comparability issue, Microsoft believes that the accounting standard should mandate an option-pricing model for valuation purposes that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

Microsoft believes that expected volatility should be excluded from the calculation of the fair value of an employee stock option. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. But as noted in paragraph BC174 of the Basis for Conclusions, "Estimating the inputs required by an option pricing model, such as expected volatility, over long periods can be difficult, giving rise to the possibility of significant estimation error". Even with the use of expected life, the possibility of estimation error could be significant. For instance, the weighted average expected life of Microsoft's options granted in fiscal 2002 was seven years. Furthermore, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life to take account of the effect of non-transferability. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account when valuing employee stock options, such as the effect of blackout periods.

Microsoft is opposed to the IASB's units-of-service attribution approach. If an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instruments, we fail to see why compensation expense should be recorded. In addition, it is important that the IASB recognize the complexity inherent in the units-of-service method, as an increase in the complexity of accounting standards negatively impacts the quality and transparency of financial accounting and reporting. For instance, we observe that it takes ten pages (noting the actual standard is only sixteen pages) to provide four examples with somewhat straight forward fact patterns for the IASB to try and explain the units-of-service method in the ED.

We are also opposed to the ED's requirement that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement. When realized tax benefits from equity awards differ from the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference should be directly recorded to additional paid-in capital. We believe this is consistent with intraperiod tax allocation.

Our responses to the questions raised in the ED are included in Attachment A. If you have any questions, please contact me at (425) 703-6094.

Sincerely,

Bob Laux
Director, External Reporting

Attachment A

Question 1

Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS.

Is the proposed scope appropriate? If not, which transactions should be excluded and why?

Response: The proposed scope is appropriate.

Question 2

Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed.

Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

Response: Microsoft believes there is an economic rationale to expensing stock options, but we have concerns regarding the appropriate valuation of those options.

Question 3

For an equity-settled share-based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7). There are no exemptions to the requirement to measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities.

Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

Response: For consistency purposes, Microsoft believes that entities should measure the goods or services received by reference to the fair value of the equity instruments granted. With respect to the issue of no exemptions to the requirement to measure share-based payment transactions at fair value, Microsoft believes that expected volatility should be excluded from the calculation of the fair value of an employee stock option. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life in the ED to take account of the effect of non-transferability. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account when valuing employee stock options, such as the effect of blackout periods.

In addition, while not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty unlisted entities would encounter in estimating expected volatility and disagree with the comments in paragraph BC139 of the ED's Basis for Conclusions which indicates that the volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We do not agree that results from a mixed attribute accounting model including historical costs and fair value measurements can serve as a proxy for estimating share price volatility.

Question 4
If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

Response: Microsoft believes that the grant date is the appropriate date to measure fair value, as this is the date both parties come to a mutual agreement on the terms of the arrangement.

Question 5
If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

Response: We agree that the fair value of the equity instruments granted should be measured at grant date.

Question 6
For equity-settled transactions with parties other than employees, the draft IFRS proposes a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity instruments granted (paragraphs 9 and 10).

Do you agree that the fair value of the goods or services received is usually more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

Response: For consistency purposes, we believes that for equity-settled transactions with parties other than employees, fair value should be determined based on the equity instruments granted.

Question 7
For equity-settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12).

Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this is not so?

Response: Yes, the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received.

Question 8
Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest.

Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

Response: Yes, it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period.

Question 9
If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

Response: Microsoft is opposed to the IASB's units-of-service approach and believes that compensation expense should be attributed over the service period on a straight-line basis as long as the compensation expense recognized at any date equals the total compensation cost related to vested equity instruments at that date.

Question 10

In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognized the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognizing a transfer within equity, i.e. a transfer from one component of equity to another.

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

Response: No, if an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instrument, we fail to see why compensation expense should be recorded.

Question 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk-free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends.

Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

Response: As indicated in the IASB's Framework for the Preparation and Presentation of Financial Statements, comparability, along with understandability, relevance, and reliability are the four principal qualitative characteristics of financial statements. Microsoft is aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options at grant date and believes it is incumbent on the IASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Given this comparability issue, Microsoft believes that the accounting standard should mandate an option-pricing model for valuation purposes. However, we believe that expected volatility should be excluded from the calculation of the fair value of an employee stock option. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. But as noted in paragraph BC174 of the Basis for Conclusions, "Estimating the inputs required by an option pricing model, such as expected volatility, over long periods can be difficult, giving rise to the possibility of significant estimation error". Even with the use of expected life, the possibility of estimation error could be significant. For instance, the weighted average expected life of Microsoft's options granted in fiscal 2002 was seven years. Furthermore, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life to take account of the effect of non-transferability. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account when valuing employee stock options, such as the effect of blackout periods.

Question 12

If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22).

Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

Response: Microsoft agrees that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability.

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

Response: No, Microsoft believes equity instruments subject to vesting conditions are granted but not issued because they represent a conditional obligation to issue equity instruments in exchange for valuable consideration at a later date. Therefore, vesting conditions should not be taken into account when estimating the fair value of options granted, but rather, are taken into account based on the number of options issued.

Question 14
For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25).

Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

Response: The proposed requirement is appropriate.

Question 15
The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21- 25).

Are there other common features of employee share options for which the IFRS should specify requirements?

Response: As previously mentioned, given comparability issues, Microsoft believes that the accounting standard should mandate an option-pricing model for valuation purposes that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

Question 16
The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies.

Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

Response: See our response to the previous question.

Question 17
If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognize additional amounts for services received during the remainder of the vesting period, i.e. additional to the amounts recognized in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the remainder of the vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?

Response: We agree that the incremental value granted should be taken into account when measuring the services received.

Question 18
If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognize the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/or a grant of replacement options, and for the repurchase of vested equity instruments.

Are the proposed requirements appropriate? If not, please explain why not and provide details of your suggested alternative approach.

Response: The settlement of an unvested equity instrument should be deemed a vesting acceleration event and any unrecognized compensation cost at the date of settlement should be immediately expensed.

Question 19

For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognized in the income statement.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

Response: For cash-settled share-based payments, the proposed requirements are appropriate.

Question 20

For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

Response: The proposed requirements are appropriate.

Question 21

The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

(a) the nature and extent of share-based payment arrangements that existed during the period,

(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and

(c) the effect of expenses arising from share-based payment transactions on the entity's profit or loss.

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

Response: These specific disclosure requirements are appropriate.

Question 22
The draft IFRS proposes that an entity should apply the requirements of the IFRS to grants of equity instruments that were granted after the publication date of this Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (i.e., the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

Response: In the sprit of international convergence, we propose that the transition provisions be similar to those in FASB Statement 148, *Accounting for Stock-Based Compensation-Transition and Disclosure.*

Question 23
The draft IFRS proposes a consequential amendment to IAS 12 (revised 2000) *Income Taxes* to add an example to that standard illustrating how to account for the tax effects of share-based payment transactions. As shown in that example, it is proposed that all tax effects of share-based payment transactions should be recognized in the income statement.

Are the proposed requirements appropriate?

Response: No, Microsoft believes that when realized tax benefits from equity awards differ from the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference should be directly recorded to additional paid-in capital. We believe this is consistent with intraperiod tax allocation.

Question 24
In developing the Exposure Draft, the Board considered how various issues are dealt with under the U.S. standard SFAS 123 *Accounting for Stock-Based Compensation*, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following.

(a) Apart from transactions within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share- based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;

- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognize transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (paragraphs BC70-BC74 in the Basis for Conclusions give an explanation of intrinsic value); and

- unlisted (non- public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75- BC78 in the Basis for Conclusions give an explanation of minimum value).

(b) For transactions in which equity instruments are granted to employees, both SFAS 123 and the draft IFRS have a measurement method that is based on the fair value of those equity instruments at grant date. However:

- under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.

- under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognized for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognized for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore

the amount of compensation expense measured at grant date but not yet recognized is recognized immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity
should continue to recognize the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

(e) SFAS 123 requires liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70-BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

(f) For a share- based payment transaction in which equity instruments are granted, SFAS 123 requires realized tax benefits to be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognized in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) *Income Taxes*, proposes that all tax effects of share-based payment transactions should be recognized in profit or loss, as part of tax expense.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment.

(Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

Response: Our response to the FASB's Invitation to Comment is included in Attachment B.

Question 25
Do you have any other comments on the Exposure Draft?

Response: As stated in our cover letter, there are strong arguments on both sides of the debate of whether stock options should be expensed and it is critical that standard setters perform an objective, in-depth analysis of the comment letters received. However, once that analysis is performed, standard setters need to decide on this issue and then all constituents in the standard setting process need to move on. Given the current crisis in confidence in the accounting profession, it is imperative that all involved in the financial reporting process strive individually and collectively to create a new environment of integrity and accountability.

Attachment B

Microsoft Corporation Tel 425 882 8080
One Microsoft Way Fax 425 936 7329
Redmond, WA 98052-6399 http://www.microsoft.com/

January 31, 2003

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: File Reference No. 1102-001

Dear Sue:

Microsoft appreciates the opportunity to respond to the Invitation to Comment (ITC), "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, *Share-based Payment*". We commend the FASB staff for what we believe is a thorough and well written ITC. In connection with drafting our response to this ITC, we are also in the process of drafting a response to the IASB's Exposure Draft (ED). In drafting our response to that ED, we found ourselves confused on a number of the proposals and, instead of referring to the ED's Basis for Conclusions and Implementation Guidance, we found ourselves referring to the ITC for the much needed clarity. Going forward, this ITC should serve as the model for comparing U.S. GAAP to proposals from the IASB. In addition, as indicated in the ITC that the FASB is not seeking comments on certain issues at this time, this response letter does not comment on whether stock options granted to employees results in compensation expense for the issuing entity.

As indicated in FASB Concepts Statement 2, *Qualitative Characteristics of Accounting Information*, relevance and reliability are the two primary qualities that make accounting information useful for decision making. However, as also indicated in CON 2, comparability is a quality that interacts with relevance and reliability to contribute to the usefulness of information. Microsoft is a strong proponent of principles-based accounting standards and we believe that the amount of interpretive and implementation guidance in accounting standards to try to ensure comparability between entities is the biggest culprit in driving much of the detail and complexity in current accounting standards. However, we do recognize that the relative weight to be given to relevance, reliability, and comparability must vary according to circumstances.

We are aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options at grant date and believe it is incumbent on the FASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Given this comparability issue, Microsoft believes that an accounting standard should mandate an option-pricing model for valuation purposes that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

Microsoft believes that expected volatility should be excluded from the current Statement 123 calculation of the fair value of an employee stock option for public entities, similar to the current Statement 123 calculation for nonpublic entities. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life under Statement 123, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account in Statement 123 when valuing employee stock options, such as the effect of blackout periods.

In addition, excluding volatility for public entities would create a level paying field with nonpublic entities under Statement 123. While not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. Accordingly, we are opposed to the IASB's requirement that all entities include expected volatility in calculating the fair value of employee stock options. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy for estimating share price volatility.

Also, Microsoft is strongly opposed to the IASB's units-of-service method and the IASB requirement that all of the tax benefits derived from stock-based compensation arrangements be recognized in the income statement. Our comments on those issues as well as our responses to the other primary issues raised in the ITC are attached. If you have any questions, please do not hesitate to contact me at (425) 703-6094.

Sincerely,

Bob Laux
Director, External Reporting

Attachment

Issue 1: Statement 123 provides a scope exclusion for ESOPs and certain ESPPs, and the Proposed IFRS does not. Which view do you support and why?

Response: Microsoft supports the IASB's view. With respect to ESPPs and in the spirit of principles-based standards, if these rights given to employees are truly immaterial, there is not a need for a specific exclusion.

Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions.

Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?

Response: As indicated in FASB Concepts Statement 2, *Qualitative Characteristics of Accounting Information*:

> *Relevance* and *reliability* are the two primary qualities that make accounting information useful for decision making. Subject to constraints imposed by cost and materiality, increased relevance and increased reliability are the characteristics that make information a more desirable commodity – that is, one useful in making decisions. If either of those qualities is completely missing, the information will not be useful. Though, ideally, the choice of an accounting alternative should produce information that is both more reliable and more relevant, it may be necessary to sacrifice some of one quality for a gain in another.

However, as also indicated in CON 2, comparability is a quality that interacts with relevance and reliability to contribute to the usefulness of information:

> Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the applicability of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

Microsoft is a strong proponent of principles-based accounting standards and we believe that the amount of interpretive and implementation guidance in accounting standards to try to ensure comparability between entities is the biggest culprit in driving much of the detail and complexity in current accounting standards. However, we do recognize that the relative weight to be given to relevance, reliability, and comparability must vary according to circumstances.

Microsoft is aware of a lot of research currently being conducted in efforts to accurately measure the fair value of employee stock options and we believe it is incumbent on the FASB to closely monitor the various research being performed. Nevertheless, we are not currently aware of a valuation model from any of this research that appears to be superior to other methods. For example, we are aware of a binomial model with 16 inputs required in an effort to properly value employee stock options. We can only imagine the comparability problems between companies as each company selects what it believes is its best estimate of each of the 16 inputs to the model.

Accordingly, at the present time and as elaborated upon in our response to the following subissues, Microsoft believes an accounting standard should mandate the use of an option-pricing model for measurement purposes. However, the FASB should continuously monitor developments in this area and revisit this requirement if it becomes apparent that other methods become acceptable that do not cause significant comparability issues.

Issue 2(b): If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why?

Response: Microsoft believes that an accounting standard should mandate an option-pricing model that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate. Again, consistency and comparability between entities weighs heavily upon our position on this issue. Our reasons for excluding the expected volatility of the underlying stock are discussed in the subissue below.

Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?

Response: Disclosures should include the option-pricing model used and the inputs to the model.

Issue 2(d): Statement 123 and the Proposed IFRS require that certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required.

Response: Microsoft believes that expected volatility should be excluded from the current Statement 123 calculation of the fair value of an employee stock option for public entities, similar to the current Statement 123 calculation for nonpublic entities. We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life under Statement 123, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account in Statement 123 when valuing employee stock options, such as the effect of blackout periods.

In addition, excluding volatility for public entities would create a level paying field with nonpublic entities under Statement 123. While not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. Accordingly, we are opposed to the IASB's requirement that all entities include expected volatility in calculating the fair value of employee stock options. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy in estimating share price volatility.

Issue 2(e): Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas?

Response: Microsoft believes that an in-depth discussion of the factors and the use of examples with specific fact patterns would be useful guidance in trying to provide added consistency and comparability of reported results. For instance, guidance such as the items to consider when estimating the expected life of an option along with fact specific examples would be useful.

Issue 3: Do you believe that employee and nonemployee transactions are distinct and, therefore, warrant different measurement dates for determining the fair value of equity instruments granted? If so, why? If not, why not?

Response: While we believe employee and nonemployee transactions are somewhat distinct, the fair value for both transactions should be determined at the grant date, as the complexity inherent in guidance such as EITF Issue No. 96-18 is not justified based on the somewhat limited distinction between these two types of transactions. To be quite frank, we do not believe the use of stock options for nonemployee transactions is all that prevalent as to justify the time and effort that has been expended debating this issue.

Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not?

Response: Yes, as we would hope both counterparties to the transaction would have thoroughly considered the performance conditions before entering into such a transaction.

Issue 5: Do you believe the notion of issuance is conceptually of importance in the design of a standard on stock-based compensation? If so, why? If not, why not?

Response: Yes, Microsoft believes that if an accounting standard defers to the expected value of options to be issued in measuring services received, the notion of whether the options are actually issued is conceptually important.

Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined by Statement 123, at the grant date? If so, why? If not, why not?

Response: No, equity instruments are not issued until the issuer has received valuable consideration in exchange for the equity instruments.

Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimate of fair value per equity instrument (IASB approach)? If so, why? If not, why not?

Response: As indicated previously, we believe there are a number of items that could be incorporated into the estimate of fair value per equity instrument. However, with regards to the important issues of consistency and comparability, Microsoft believes that an accounting standard should mandate an option-pricing model that takes into account the following five factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.

Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that award? If so, why? If not, why not?

Response: Absolutely, if an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instruments, we fail to see a recognition event requiring recording in the financial statements.

Issue 9: Do you agree that the result of the IASB's approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value? If so, why? If not, why not?

Response: We would readily admit that excluding expected volatility from an option pricing model does not theoretically result in fair value. However, in our opinion, excluding volatility from an option pricing model is similar to the substitution of expected life for contractual life, which is a way to adjust for the effect of the nontransferability of employee stock options. Microsoft believes excluding volatility is a way to adjust for other factors not taken into account when valuing employee stock options. Also, while not having in-depth expertise on this issue, we concur with the FASB's observations concerning the difficulty nonpublic entities would encounter in estimating expected volatility. In addition, we were quite taken aback with the comments in paragraph BC139 of the IASB's ED which indicates that the expected volatility of net assets or earnings could be used as a basis for estimating expected share price volatility. We trust that standard setters would not even suggest that results from a mixed attribute accounting model including historical costs and fair value measurements would serve as a proxy in estimating share price volatility.

Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why?

Response: The attribution method prescribed by Statement 123. While there are a number of reasons we believe the attribution method prescribed by Statement 123 is more representationally faithful, it is also important that standard setters recognize the complexity inherent in the IASB's units-of-service method. As indicated in the FASB's Proposal, "Principles-Based Approach to U.S. Standard Setting", an increase in the complexity of accounting standards negatively impacts the quality and transparency of financial accounting and reporting. For instance, we observe that it takes ten pages (noting the actual standard is only sixteen pages) to provide four examples with somewhat straight forward fact patterns for the IASB to try and explain the units-of-service method in their ED. In addition, the FASB found it necessary to provide yet more examples in the ITC in order to illustrate the difference between the two standards.

Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not?

Response: Microsoft is strongly opposed to the IASB's units-of-service method.

Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by an enterprise? If so, why? If not, why not?

Response: Yes, if an award holder fails to satisfy the conditions inherent in an option grant and an entity is not required to issue the corresponding equity instruments, we fail to see a recognition event requiring recording in the financial statements.

Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not?

Response: Yes, for reasons elaborated upon above.

Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not?

Response: The fair value for transactions with employees and nonemployees should be determined on the grant date, as the complexity inherent in the guidance in EITF Issue No. 96-18 is not justified based on the somewhat limited distinction between these two types of transactions.

Issue 15: Do you believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not?

Response: No, when realized tax benefits from equity awards differ from the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference should be directly recorded to additional paid-in capital. This is consistent with paragraph 35 of FASB Statement No. 109, *Accounting for Income Taxes*, which indicates the following:

> Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders . . . The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

Accordingly, the income tax benefit reflected in the income statement related to stock-based compensation should be based on the expense for stock-based compensation actually recognized in the income statement. Assuming there are no discontinued operations or extraordinary items, any differences between the tax benefit recognized on the income statement and the actual income tax benefit received should be recorded directly to shareholders' equity.

Issue 16: As discussed in paragraph 83 of this Invitation to Comment, the Proposed IFRS expands on the disclosure requirements in Statement 123. Do you believe that those expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?)

Response: The incorporation in the IASB ED of financial reporting disclosures currently required under Statement 123 indicates to us a lack of a "clean sheet" approach in examining what information would be most informative to users of financial statements. For instance, if standard setters decide that the fair value of stock options should be recognized in the financial statements based on grant date fair value using an option pricing model, we fail to see the need for the extensive disclosure of the weighted average exercise price of options outstanding at a particular point in time. The earnings per share footnote already provides information on the dilutive effect of stock options and we find it somewhat curious that if standard setters reject intrinsic value as a measurement of the fair value of stock options, that disclosures that convey that information would still be so prevalent.

Issue 17: Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.

Response: With respect to Statement 123 and entities that elect to estimate at grant date the amount of equity instruments expected to be forfeited, we believe a disclosure of the percentage of equity instruments expected to be forfeited would be useful for purposes of comparability between entities.