

Letter of Comment No: 3
File Reference: FSP123R-C
Date Received:

October 7, 2005

Mr. Lawrence W. Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: File Reference No. FSP FAS 123(R)-c, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board (the "FASB" or "Board") on its proposed FASB Staff Position No. FAS 123(R)-c, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (the "proposed FSP"). We support the Board's efforts to address implementation issues related to FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R)), including those involving the calculation of the historical pool of windfall tax benefits.

FAS 123(R)'s Income Tax Accounting Model

In our response to the exposure draft that led to the issuance of FAS 123(R), we indicated our preference for an income tax accounting model under which all of the income tax effects of share-based payments would be recorded in the income statement (the income statement approach). This approach includes recognizing a deferred tax asset based upon the compensation cost recorded for financial reporting purposes. On the settlement date, any adjustments to account for the differences between the tax effects of the compensation cost recognized for financial reporting purposes and the tax benefit of the actual deduction realized (i.e., both "windfalls" and "shortfalls") would be recorded as part of income tax expense in the income statement. We continue to believe that this approach (i) would be simpler to apply, (ii) would better reflect the economic substance of the tax implications of such compensation arrangements, and (iii) would be more intuitive to preparers and users of financial statements. At that time, we also reaffirmed our belief that the two-event approach for income tax

accounting of FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123), should not be carried forward.

Subsequent to the release of FAS 123(R), a number of implementation issues have arisen regarding the accounting for the income tax effects of share-based payments. Many of these issues have been discussed by the FASB's FAS 123(R) Resource Group. We believe that these implementation issues are largely the result of FAS 123(R)'s two-event approach.

Additionally, FAS 123(R) provides a different income tax accounting model than International Financial Reporting Standard 2, *Share-based Payment* (IFRS 2). IFRS 2 requires that the income tax effects of share-based payments be recognized based upon the implied value of the tax deduction at the end of each reporting period with shortfalls recognized in the income statement and windfalls recorded in equity. Because the unit of accounting under IFRS 2 is an individual award, a company does not need to determine and maintain a pool of windfall tax benefits.

In light of the above, we recommend that the Board consider undertaking a short-term convergence project to reduce the differences in accounting for the income tax effects of share-based payments between FAS 123(R) and IFRS 2.

Alternative Transition Approach for Calculating the Historical Pool of Windfall Tax Benefits

Accepting the practical limitations of completing a short term convergence project quickly, we recognize that the recordkeeping and implementation issues related to calculating the pool of windfall tax benefits, as required by paragraph 81 of FAS 123(R), need to be addressed. The transition election provided by the proposed FSP addresses the circumstances where a company lacks the data to calculate the pool of windfall tax benefits. It does not, however, address the implementation issues that have arisen as to how a company should calculate its pool of windfall tax benefits. Those issues will still need to be resolved, regardless of whether the proposed FSP is approved, in order for a company to determine its pool of windfall tax benefits after adopting FAS 123(R). Additionally, a company that elects to calculate its historical pool of windfall tax benefits using the transition method described in paragraph 81 will need guidance on the outstanding implementation issues in order to accurately calculate its historical pool of windfall tax benefits. We urge the Board to expeditiously address those implementation issues in order to ensure the consistent application of FAS 123(R).

In order to address the recordkeeping issues related to the historical pool of windfall tax benefits, we recommend the following approach, which we believe is more consistent with the income tax accounting model of FAS 123(R).

We propose that the Board provide companies with an election to calculate the historical pool of windfall tax benefits from the effective date of FAS 123(R) back to the earliest fiscal year for which the company is able and willing to perform the calculation. The calculation would

be performed in accordance with paragraph 81 of FAS 123(R), except that a company would not be required to calculate the cumulative balance for all years subsequent to the adoption of FAS 123. Instead, a company would have the option of calculating the pool using any number of consecutive fiscal years, working backwards from the fiscal year immediately prior to the adoption of FAS 123(R).

FAS 123(R) requires a company to calculate its pool of windfall tax benefits beginning in the year it adopted FAS 123 and annually adjust its pool of windfall tax benefits for subsequent windfalls and shortfalls. In the event a company has shortfalls that are in excess of its pool of windfall tax benefits, the subsequent year will begin with a zero balance in the pool as the pool cannot be less than zero. Therefore, the pool of windfall tax benefits generated in the most recent fiscal year cannot be greater than the cumulative amount of the pool as calculated from the date of the company's adoption of FAS 123. For example, Company A, a calendar year-end company, commenced operations in 2002, adopted the pro forma disclosure alternative of FAS 123, and has the following annual windfall tax benefits or shortfalls prior to the adoption of FAS 123(R):

	2002	2003	2004	2005
Annual windfall / (shortfall):	\$100,000	\$300,000	(\$350,000)	\$200,000

Company A's pool of windfall tax benefits based only on the most recent year (2005) would be \$200,000. If Company A calculated its cumulative pool for only 2004 and 2005, the balance would still be \$200,000 because the shortfalls in 2004 could not have reduced the pool below zero as of the end of 2004. The cumulative pool of windfall tax benefits for the years 2003 through 2005 only would also be \$200,000 ($\$300,000 - \$300,000 + \$200,000$) because \$300,000 of the shortfalls in 2004 would reduce the pool and \$50,000 of the shortfalls in 2004 would have been included in the income tax provision in the FAS 123 pro forma footnote. The pool of windfall tax benefits as of the date Company A adopts FAS 123(R), calculated according to paragraph 81 of FAS 123(R), would, however, be \$250,000 ($\$100,000 + \$300,000 - \$350,000 + \$200,000$).

In the above example, Company A could elect to use \$0 (if Company A chooses not to calculate its historical pool), \$200,000, or \$250,000 as its pool of windfall tax benefits as of the date it adopts FAS 123(R), depending upon how far back it elects to calculate the pool of windfall tax benefits.

Under our proposed transition approach, a company would be motivated to perform the calculation for as many fiscal years as possible in order to increase its pool of windfall tax benefits prior to adopting FAS 123(R). A company that opted not to calculate its pool for all years from the adoption date of FAS 123 through the effective date of FAS 123(R) could only have the same pool of windfall tax benefits that would otherwise be available under paragraph 81 of FAS 123(R) (or a smaller pool). A company that opted not to calculate its pool for any years prior to adopting FAS 123(R) would begin with a zero balance in its pool of windfall tax benefits. Companies would have discretion to decide how far back they calculate the pool,

and that decision could be driven by cost/benefit considerations, whether necessary records are available, or the complexity of the calculation.

Under our proposed transition approach, we would suggest that a company finalize its historical pool of windfall tax benefits (i) in the period in which a net shortfall is incurred either for financial statement purposes or for purposes of calculating assumed proceeds under the treasury method for diluted earnings per share or (ii) within one year of adopting FAS 123(R), whichever occurs first.

Additionally, under our proposed transition approach, a company would calculate the ongoing impact on the pool for partially or fully vested awards on the date of adoption as if the company had always followed a fair-value-based method.

We believe that our proposed transition approach has the following advantages over the transition election in the proposed FSP:

1. It is more consistent with the income tax accounting model in FAS 123(R).
2. It addresses the concerns expressed by companies regarding the lack of available data. Under our proposed approach, a company can choose to calculate the pool for as many fiscal years as they are able or willing, and could choose to begin with a pool of zero.
3. It provides companies with an incentive to calculate the pool of windfall tax benefits for as many years as possible. The decision to calculate the pool for fewer years would not result in a benefit to the company by potentially overstating the amount of the pool of windfall tax benefits. This approach also eliminates a company's ability to create an inflated pool of windfall tax benefits by calculating the pool under alternative methods and selecting the election that results in the larger amount.
4. It is consistent with the "ordering" requirements of FAS 123(R), whereby the net windfall or shortfall is calculated on an annual basis, unlike the transition election in the proposed FSP, under which the pool would be calculated using cumulative amounts over several years.

In summary, we believe that our proposed transition approach provides a practical and conceptually sound alternative to the transition method required by paragraph 81 of FAS 123(R). It addresses the concerns surrounding the lack of available data in historical periods, while providing companies with an incentive to perform the calculation for as many years as possible.

Transition Election of the Proposed FSP

If the transition election of the proposed FSP is pursued, we encourage the Board to clarify the following aspects of the proposed FSP:

1. In calculating its “current blended statutory tax rate, inclusive of federal, state, local, and foreign taxes” as required by paragraph 5, it is unclear whether a company should include its foreign statutory tax rate if share-based payment awards were not previously tax deductible in that jurisdiction. Additionally, it is unclear for which period or at what point in time the tax rate should be calculated.
2. In paragraph 5, “cumulative gross compensation cost” may include compensation cost for awards that are not generally deductible for U.S. tax purposes, such as incentive stock options, as well as foreign awards where the necessary chargeback arrangements to obtain a local tax deduction were not in place. As written, the compensation cost associated with such awards would be included in the calculation of the pool; however, in theory, the cost associated with nondeductible awards should not be included.
3. In paragraph 5, it is unclear as to whether the definition of “cumulative gross compensation cost” should include awards issued by non-public companies that were valued using the minimum value method; for example, a company that went public in 2000 and used the minimum value method to value awards prior to its initial public offering.

We appreciate the opportunity to express our views on the proposal. If you have any questions regarding our comments, please contact Brett Cohen (973-236-7201) or John Horan (973-236-4997).

Sincerely,

PricewaterhouseCoopers LLP