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To the Director of Major Projects:

We appreciate this opportunity to comment on the FASB's Exposure Draft, "Share-Based Payment an amendment of FASB Statements No. 123 and 95." Air Products is a multinational major supplier of chemicals, industrial gases and related equipment with annual sales exceeding \$6 billion, assets of \$9 billion, and a worldwide workforce of 18,500 employees.

Air Products has various share option plans under which employees receive awards of options to purchase common stock. Under all option awards, the terms are fixed at the grant date, and generally the exercise price equals the market price of the company's stock on the date of grant. Air Products applies APB Opinion No. 25 (APB No. 25) in accounting for its share option plans, and no compensation expense has been recognized. If the company had recognized compensation expense in accordance with SFAS No. 123, net income would have been reduced by \$38 million in fiscal year 2003.

Summary

We believe current accounting properly reflects the economic impact of granting share options on shareholders through the calculation of fully diluted earnings per share. The granting of share options represents an equity transaction, a dilution of ownership interest, which should not result in a book accounting expense. No out-of-pocket cash cost is or will be incurred by the company. The granting of share options may represent an opportunity cost to the company, but the existing accounting framework does not provide for the expensing of opportunity costs. Accounting costs do not consider foregone opportunities.

Nontransferable share options are being provided to motivate employees to work to increase the share price of the company. Share options are participation rights in the appreciation of the company share price. The options only have value to employees when the share price increases since the employees cannot sell the options separately. Current accounting effectively recognizes the dilution impact of share price increases under the treasury stock method of calculating diluted earnings per share.

The proposed accounting for share options recognizes the company could have sold the options for cash and recognizes that valuation as a current period expense. Underlying the proposed accounting, it argues that the company has sold call options to employees. However, future gains and losses related to settling those call options are not taken into account. In the event a conclusion is reached to require the expensing of share options, we recommend a mark-to-market approach. Expense should be measured initially at fair value on the grant date and subsequently remeasured each reporting date until the share options are exercised. We do not support the grant date fair value approach with no remeasurement as proposed in the Exposure Draft.

Analysis of Current Accounting

We believe the methodology in APB No. 25 is the best accounting to properly reflect the impact that granting share options has on the company's financial statements. We do agree that the company is giving something of value when it grants share options to its employees. We also agree that you can estimate the value that someone would pay for these share options using a reasonable valuation methodology. However, this value represents an opportunity cost to the company. Introducing opportunity cost as the basis for expense recognition is inconsistent with the existing accounting framework and incorrectly portrays the true impact on shareholders of granting share options. No other opportunity costs are accounted for anywhere in the financial statements. Subsequent to the grant date, as share price increases, this impact is properly reflected in the financial statements via the diluted earnings per share calculation. The granting and exercising of share options never translates into a cash outflow and therefore should never trigger a book accounting expense.

An example of an opportunity cost which is not recognized in the financial statements is one where the company signs a long-term contract to supply products to a customer. Presumably, that contract has value based upon the profit which it would earn for the company. Therefore, the company could go out and sell that contract to a competitor to supply the customer. Should the company record a gain based upon signing the contract? Using the logic, which argues for recording an expense for share options based on the fair value at issuance, the answer would be yes.

Mark-to-Market Approach

The discussion below elaborates on why we prefer a mark-to-market approach if the expensing of stock options is required. Our proposed approach is comparable to that required by the Exposure Draft for share-based programs to be settled in cash. Specifically, the three items below outline the approach and reasons why it would be preferred.

- **Expense Equal to Compensation Delivered**

Accounting expense should reflect the compensation actually delivered. In our view, employee share options only have value to the extent employees' benefit from them. An option which expires worthless and is never exercised does not have value to an employee. When an option expires worthless, no expense should be recognized. When an option's fair value increases or decreases subsequent to the grant date, this change in fair value should be reflected in the financial statements by adjusting compensation expense accordingly.

- **Cash vs Equity Settlement**

If share options are to generate an expense, the cumulative expense should be the same as similar transactions, whether those transactions will be settled in cash or equity. Under the Exposure Draft, transactions settled in cash are true-up to actual cost while transactions settled in equity are not remeasured subsequent to the grant date. If share appreciation rights to be settled in cash expire worthless, the share-based liability is adjusted to zero through the income statement. If share options with the same terms and conditions expire worthless, there is no reversal of the expense. We cannot justify a different expense for these transactions which are similar in substance.

- **Estimate vs Actual**

Initial fair value measurement on the grant date serves as an estimate of the options value. This estimate should be updated each reporting period as circumstances change. While option-pricing models can provide an estimate of share option fair value at a point in time, the actual fair value will differ from the estimate. The selection of assumptions used in the valuation model can materially impact the estimate, and actual results can vary significantly from the assumptions. Many other areas of accounting require the use of complex valuation models and/or management judgment in selecting the assumptions which determine the amount of an expense recorded. However, in these other areas of accounting, such as retirement-related benefits, postemployment benefits, environmental accruals, contingent liabilities, depreciable lives, etc., the accounting estimates are eventually trued-up to actual. The estimated fair value of options should be updated each reporting period to ensure financial reporting captures an ongoing up-to-date estimate and eventually the actual cost.

Other Comments

We found the following specific areas of the exposure draft to be troublesome or confusing. The comments below address these areas:

- **Income Tax Effects**

A deferred tax benefit is recognized in the income statement based on the fair value of compensation cost for financial reporting. Under the Exposure Draft, if the amount of the actual tax benefit is lower, the tax deficiency is charged to expense. On the other hand, excess tax benefits are recognized as an addition to paid-in-capital.

The tax benefit recognized in the income statement should always correspond to the compensation cost for financial reporting purposes. This will not be the result if tax deficiencies are charged to expense. If a mark-to-market approach is adopted, the tax benefit recorded in the income statement will always correspond to the compensation cost. If a mark-to-market approach is not adopted, any differences between book and actual tax benefit should be recorded to paid-in-capital so that the tax benefit in the income statement is in agreement with the compensation cost.

- **Valuation Models**

The Exposure Draft expresses preference for a lattice model over a Black-Scholes model. Must a company allocate resources to adopt the lattice model? Or, will the Black-Scholes model be permitted, without negative implications, as a less preferable alternative? Application of lattice models will increase costs of implementation, and we question the benefit from this increased cost. Companies will be incurring actuarial and consulting fees to understand and implement the lattice model. We also believe companies will shop for the model which provides the lowest valuations. We believe continued use of the Black-Scholes model, perhaps even a requirement to use this model, would result in more consistent application across companies and lower implementation expense while generating an adequate reasonable estimate. An estimate that will not be precise no matter what the effort or complexity of the model. A reasonable initial estimate combined with the requirement to mark-to-market would result in proper expense being recognized in the financial statements, including the eventual actual fair value.

- **Equity vs Liability Classification**

The Exposure Draft discusses instruments becoming subject to SFAS 150 upon vesting when an employee can terminate service and still retain the fair value for the remaining contractual term. We read this to imply that once under SFAS 150 there is a likelihood of classification changing from equity to a liability. The Exposure Draft discusses employee share options where continued employee service is not necessary to maintain the exercisability of the instruments. It is not clear as to whether retirement status means the options become subject to SFAS 150.

Even if directed to SFAS 150, we believe most typical employee share-based compensation arrangements will still be classified as equity. Meanwhile, SFAS 150 is very complex resulting in confusion as to why we are being directed to the standard. We recommend the Exposure Draft and supporting basis for conclusions be revised to clarify the circumstances, implications, and likely outcomes of being directed to SFAS 150.

- **Market Conditions**

The Exposure Draft defines market conditions as those which relate to achieving a share price or value indexed to a share price. For programs with market conditions, expense is recognized if the service is rendered even if the market condition is not met. We recommend any expense recognized for programs requiring market conditions subsequently not met be reversed. We do not believe there is a basis to differentiate between market conditions as compared to performance conditions, for which expense is reversed when the conditions are not met. This is another example where no expense should be recognized if no compensation is delivered.

We realize there have been extensive deliberations on share-based compensation and various approaches have already been considered. Nevertheless, as an active participant in the FASB's due process, we wanted to ensure our significant concerns were communicated. We believe the proposed accounting to be incomplete and not reflective of the impact on shareholders. We appreciate your consideration of our comments and we are available to discuss at any time.

Respectfully,



Paul E. Huck
Vice President and
Chief Financial Officer

cc: Kevin O'Hara, KPMG
Chris Voci, KPMG