PEPSICO

700 Anderson Hill Road Purchase, New York 10577 www.pepsico.com
Tel. (914) 253-3406 Fax (914) 253-3667

Letter of Comment No: 4809
File Reference: 1102-100

PETER A. BRIDGMAN
SENIOR VICE PRESIDENT
AND CONTROLLER

June 25, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects - File Reference No. 1102-100
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Ms. Bielstein:

We commend the FASB for seeking to improve the transparency of information provided to investors by requiring income statement reporting of stock-based compensation expense. While most companies elected the disclosure-only option of SFAS 123, *Accounting for Stock-Based Compensation*, recent events and the IASB and FASB projects have provided ample opportunity to again consider the issue of expensing stock-based compensation. Accordingly, we welcome the opportunity to comment on the FASB's Exposure Document. Current practice is diverse and a consistent approach to the presentation of stock-based compensation will ensure the comparability and transparency of financial statements.

Compensation Programs at PepsiCo

Every three years, PepsiCo undertakes a comprehensive review of the design of all of its compensation programs. During 2003, we undertook our regular review while also evaluating the merits of expensing stock-based compensation. Upon completion of our review, we decided to expense stock-based compensation. We believe that expensing stock-based compensation encourages companies to take a broader view of employee compensation. Employers must look at the stock-based compensation as part of employee compensation packages and the all-in cost of any hiring decision. The playing field is also leveled for all stock-based compensation alternatives, such as restricted stock units (RSUs), eliminating the bias toward stock options. Further, investors benefit from the broader approach to compensation and the inclusion of the estimated expense of these programs in companies' income statements.

As a result of our 2003 compensation review, we voluntarily adopted SFAS 123, *Accounting for Stock-Based Compensation*, in the fourth quarter of 2003 using the retroactive restatement method. Our stock-based compensation expense was $407 million in 2003, $435 million in 2002 and $385 million in 2001, representing approximately 2% of our recurring expenses.

As a context for our comments, we believe it is important for the FASB to understand the nature of PepsiCo's stock compensation program. Our program is a broad-based program designed to attract and retain employees while also aligning employees' interests with the interests of our shareholders. Employees at all levels participate in our program. Executive grants are made at fair market value of the underlying shares to over 3,000 executives and provide for the choice of either restricted stock units (RSUs) or stock options at the date of grant. Our broad-based grants, also known as SharePower grants, are made at fair market value of the underlying shares to 75,000 employees in over 50 countries. We value options at the grant date using a Black-Scholes model. The employee population is stratified, with different assumptions determined by employee band. Both executive and Sharepower grants cliff vest, generally in 3 years.

Response to FASB Proposal

Summary

Given the nature of our grants and our experience in adopting SFAS 123, we believe:

- **The lattice model is unduly complex and unlikely to improve the transparency of reporting. The lattice model's complexity, and the increased number of assumptions compared to the Black-Scholes model, render the lattice model vulnerable to inappropriate manipulation. The lattice model in many cases is not sufficiently preferable to justify the effort. Companies should be given the latitude to select the model that best aligns with the circumstances of their plans.**

- **The FASB should require restatement of financial statements to enable reporting comparability.**

- **Tracking tax benefits by individual is inconsistent with the intent of stock-based compensation plans where grant decisions are made for groups of employees. Further, the burden of tracking the tax benefits in this manner is extreme for companies with broad-based plans.**

- **The terms of most employee share options/RSUs provide for immediate vesting upon death, disability and early retirement. In accordance with these terms, the options remain exerciseable for the remainder of the original contractual term. To impose SFAS 150 accounting in these circumstances would create an unnatural bias towards restricted stock.**

Complexity and Administrative Burden of Lattice Method

We believe flexibility with regard to valuation methodologies is necessary to allow companies to continue to administer broad-based plans and operate in the current reporting world of accelerated filing deadlines. The administration of broad-based plans with international employee populations is burdensome given the sheer number of participants and data inputs and the diversity of statutory requirements. Employee stock grants are often tracked through a multitude of systems and outside administrators. We doubt the value of pursuing and gathering significantly greater data inputs. The effort, and therefore the cost, of gathering these additional inputs would be considerable. We believe requiring the lattice model would impose an undue burden on most companies for which stock-based compensation expense represents less than 5% of recurring expenses and volatility is stable. In fact, a nationally known compensation consultant has informed us that the lattice model will not produce a significantly different result for companies that thoughtfully determine their Black-Scholes assumptions and have stable volatility. With the proper determination of inputs, all of the various valuation models produce reasonable estimates. As a result, we don't believe any model should be singled out as preferable. We believe the FASB should continue to allow a variety of valuation models, including Black-Scholes, as SFAS 123 permitted. The lattice model does not provide sufficient incremental benefits to be deemed preferable. Companies should be given the latitude to select the model best aligns with the circumstances of their plans. The FASB should emphasize the importance of determining appropriate assumptions for the selected model. Improper or unrefined determinations of assumptions will generate an inappropriate result regardless of the model selected.

We also question the utility of accounting calculations that are so complex as to require numerous judgmental assumptions, outsourcing and specialized computer systems. With such complexity, are the users of the financial statements likely to understand the end results? Further, the lattice model's complexity creates a vulnerability to manipulation. Given the prior requirements of SFAS 123, there already exists a substantial understanding of the Black-Scholes model and related disclosures. It seems that the FASB's objectives of expensing stock-based compensation and transparent reporting would be better served by building on the existing base of understanding rather than requiring a certain valuation model.

Restatement of Prior Year Financial Statements Recommended

We believe that restatement provides investors with the most meaningful information as it eliminates comparability issues. Our experience in implementing SFAS 123 validated this viewpoint. As a result of our use of restatement, financial statement users found both our implementation and financial results easy to understand. For this reason, we recommend that the FASB require the use of restatement rather than the modified prospective method. We believe this position is also aligned with the FASB's and IASB's stated preference for restatement following accounting changes.

Tax Calculation based on Grant, not Individual

Companies with broad-based plans make grant decisions for groups of employees. However, the result of applying the tax calculation to each individual is different from the result when applied to each grant issued to an employee group. Moreover, the burden of tracking the tax benefit by individual is extreme for companies with broad-based plans. Therefore, we believe the accounting for stock-based compensation should be at the grant level, not at the individual level.

Impact of Death, Disability and Early Retirement

We wish to remind the FASB that the terms of most employee share options/RSUs provide for immediate vesting upon death, disability and early retirement. In accordance with these terms, the options remain exercisable for the remainder of the original contractual term. As employees lack the ability to provide continued service in these circumstances, we question if it is really the FASB's intent to eliminate death, disability and retirement benefits by imposing SFAS 150 accounting. Further, we object to the proposed accounting in all circumstances due to the bias it creates. If adopted, the proposed accounting would create a bias towards restricted stock because such instruments do not require exercising.

In the attachment to this letter, we have expressed our views on selected specific questions and other items that appear in the FASB's Exposure Document. The companies that voluntarily adopted SFAS 123 put a great deal of effort into their implementations and now have meaningful fair value reporting experience. We encourage the FASB to strongly consider the views of voluntary adopters and leverage their experiences to create pragmatic guidance.

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that you may have. Please do not hesitate to contact me at (914) 253-3406.

Sincerely,

Peter Bridgman

sdq

cc: I.K. Nooyi, President and Chief Financial Officer
L.A. Leva, Partner, KPMG LLP

Attachment

Attachment

This attachment contains our views on selected questions that the Exposure Document poses.

Issue 1: **The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.**

We believe that stock-based compensation should be reflected as an expense in financial statements. See accompanying letter.

Issue 2: **Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?**

Current practice is diverse and a consistent approach to the presentation of stock-based compensation will ensure the comparability and transparency of financial statements. The inconsistency of some companies expensing stock-based compensation while others merely disclose the impact cannot continue. We believe that stock-based compensation should be reflected as an expense in the financial statements of every company. Once stock-based compensation is expensed, companies will be able to take a broader view of employee compensation. Investors benefit from the inclusion of the estimated expense in companies' income statements as the impact of these programs is more transparent to the reader.

Issue 4(b): **Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers**

Attachment

This attachment contains our views on selected questions that the Exposure Document poses.

Issue 1: **The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.**

We believe that stock-based compensation should be reflected as an expense in financial statements. See accompanying letter.

Issue 2: **Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?**

Current practice is diverse and a consistent approach to the presentation of stock-based compensation will ensure the comparability and transparency of financial statements. The inconsistency of some companies expensing stock-based compensation while others merely disclose the impact cannot continue. We believe that stock-based compensation should be reflected as an expense in the financial statements of every company. Once stock-based compensation is expensed, companies will be able to take a broader view of employee compensation. Investors benefit from the inclusion of the estimated expense in companies' income statements as the impact of these programs is more transparent to the reader.

Issue 4(b): **Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers**

greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

We believe that the fair value of employee share options can be measured with sufficient reliability. However, we believe requiring the lattice model would impose an undue burden on most companies when stock-based compensation expense represents less than 5% of recurring expenses and volatility is stable. In fact, a nationally known compensation consultant has informed us that the lattice model will not produce a significantly different result for companies that thoughtfully determine their Black-Scholes assumptions and have stable volatility. With the proper determination of inputs, all of the various valuation models already produce reasonable estimates. As a result, we don't believe any model should be singled out as preferable. We strongly believe the Board should continue to allow a variety of valuation models, including Black Scholes, as SFAS 123 permitted. The lattice model does not provide sufficient incremental benefits to be deemed preferable. Companies should be given the latitude to select the model that best aligns with the circumstances of their plans. The FASB should emphasize the importance of determining appropriate assumptions for the selected model. Improper or unrefined determinations of assumptions will generate an inappropriate result regardless of the model selected.

Issue 11: **This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, *Share-based Payment.* Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?**

We disagree with the method of accounting for income taxes proposed by the Exposure Document. The proposed recognition of unrealized deferred tax assets in the income statement would create significant administrative burdens and inconsistent results if applied to each individual employee. Currently, at PepsiCo the tax benefit related to individual employees is not reported centrally or on a quarterly basis. The proposed accounting would require extensive changes in companies' recordkeeping and reporting to track tax benefits centrally and on a quarterly basis.

With regard to the inconsistent results, consider this example -

- 100 employees get 1000 options each @ $50.00 (100,000 total options)
- Black-Scholes value of $15.00 based on 3 year life vesting and 6 year expected average life (no forfeiture assumption for simplicity)
  - $1,500,000 cumulative pretax expense over three years
  - $420,000 deferred tax asset, $4.20 tax asset/option (28% tax rate reflecting blended domestic and international rate)
- 50 employees exercise in Year 4 @ $60.00
  - Actual tax benefit $140,000
  - Recorded DTA $210,000

  - Reverse unrealized DTA of $70,000 to income statement
- 50 employees exercise in Year 8 @ $70.00
  - Actual tax benefit $280,000
  - Recorded DTA $210,000
  - Record "excess" of $70,000 to equity

- Effect - Recognize less than effective tax rate benefit in the income statement even though in aggregate the original Black-Scholes assumptions for the total grant were met.
  - Total tax benefit recognized in income statement $350,000
  - Results in 23% tax rate over the life of the options and distorts the effective tax rate.

The total tax benefit recognized in the income statement is $350,000 (23%) under the proposed method versus $420,000 (28%) under the current SFAS 123 approach. As these plans are designed and implemented for pools of employees rather than individuals, the accounting should be directed at the total grant rather than the individual. As a result, we believe the SFAS 123 approach should be maintained.

Issue 13: **This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?**

We disagree and believe that restatement is preferable. See accompanying letter.

Issue 16: **For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, *Statement of Cash Flows,* to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?**

We disagree with the FASB's proposal to bifurcate the presentation of the income tax benefit between operating and financing cash flows. For the majority of companies in most industries, excess tax benefits from stock-based compensation are not materially distortive to reported operating cash flows. We believe this issue is primarily isolated to the high tech industry. We believe that separate identification within Operating Cash Flow of the tax benefits from stock option exercises would provide investors sufficient information. The proposed bifurcation is more likely to produce confusion rather than greater transparency for users of financial statements.