



Christopher R. Reidy
Vice President & Controller

One AT&T Way
Bedminster, NJ 07921

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Letter of Comment No: 4218
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Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft – Share-Based Payment: An amendment of FASB
Statements No. 123 and 95

We thank you for allowing us the opportunity to comment on the above-referenced exposure draft (ED) and share our opinions on the proposed changes.

Overall, we agree that employee services received in exchange for equity instruments do give rise to recognizable compensation cost and that fair-value accounting is the proper method for valuing these awards. Therefore, we agree with the Board's conclusion that compensation costs should be recognized in the financial statements for equity instruments. However, we do not agree with certain issues related to the valuation methods, cost recognition method, Employee Stock Purchase Plan accounting, income tax accounting, transition method, and effective date, as noted below.

Fair Value Models and Assumptions

Although we agree that the binomial lattice model is more flexible than closed-form models such as the Black-Scholes formula, we are not certain about its effectiveness in valuing employee stock options. Furthermore, we believe that the use of this model will add additional complexities and significantly more work, which will result in additional administrative costs. For example, we understand that only a limited number of valuation experts have the approved software, and companies may be required to incur significant costs in some cases to value their option grants. Depending on the extent to which these valuation experts are engaged, we understand the costs for the initial valuation can range up to \$250,000.

Although we understand the Board's desire to provide consistency among the financial statements of all companies, we do not agree that the Board should prescribe the model to be used to value stock options. Rather than require companies to use a certain model, we believe that the final standard should allow firms the option to choose among the different valuation models based on their particular situation, and require disclosure of the method and assumptions used to value their option grants.

With regards to the specific assumptions to be used in the fair value models, we do not agree with the current proposal to prescribe a specific method of estimating expected volatility. We believe that the Board should provide guidance to assist companies in developing their expected volatility. However, we do not believe that companies should be discouraged from using historical volatilities to develop their estimate of future volatility as this may be the best indicator of future volatility for some firms.

We do agree that the expected term should be less than the contractual life. However, we are not certain if this alone will properly adjust the value for the unique characteristics inherent in an employee stock option. Employee stock option portfolios are non-transferable, non-marketable, and non-diversified. Furthermore, it's been generally acknowledged that the employee population tends to be more risk averse than the average investor community, and would therefore require a higher risk premium. For example, the FASB should provide guidelines to adjust other assumptions, such as discounting the risk-free rate, in consideration to address potential shortcomings of the particular model in valuing employee stock options.

Recognition of Compensation Costs

With regards to the overall cost recognition, we agree with the Board's decision that compensation costs should only be recognized for those awards that vest. Furthermore, we support their decision to require companies to assume a forfeiture rate at the time of grant and to eliminate the ability for companies to choose this method or to recognize forfeitures as they occur.

With regards to the cost recognition for awards with a graded vesting schedule, we do not agree with the Board's decision to account for each tranche as a separate award. Given that employees are deemed to provide the same level of service over the vesting period (regardless of whether the vesting terms are cliff or graded), we believe it is appropriate to view an award with graded vesting as a single award and account for it on a straight-line basis. Moreover, after the initial ramp-up of compensation expense under the ED's proposed methodology, the annual on-going expense would be comparable to the expense amounts that would be recognized under a ratable or straight-line approach. Therefore, we believe companies should still be allowed to choose straight-line attribution, as long as this method provides cumulative compensation cost equal to or greater than the vested portion of the awards.

Employee Stock Purchase Plans

We agree with the general idea that if an employee can purchase shares for a lower price than that available to all shareholders, the favorable terms should be accounted for as compensation costs. However, we believe that Employee Stock Purchase Plans are not designed to compensate the employee, but rather to “encourage” share ownership amongst the employee base. As a result, we believe that the current provisions of SFAS No. 123 should be maintained which would allow plans offering a nominal discount to be considered non-compensatory.

Income Tax Accounting

We do not support aspects of the proposed accounting for the income tax effects of share-based payments outlined in the ED. We believe the requirement that all excess tax benefits be recorded in additional paid-in capital and all shortfalls be recorded in the income statement is illogical. This inconsistency can produce results that are inequitable and difficult to explain. Instead, we believe the two separate transaction model outlined in the ED for compensation costs should be followed consistently for tax accounting purposes such that differences between the tax benefits estimated and realized should be recorded in equity. We further believe the requirement to track awards exercised on an individual basis is impractical and costly to implement and does not seem warranted when valuation of options is done on a portfolio basis rather than by individual grant. Each of these two points is further discussed below.

We agree that a deferred tax asset should be recorded as compensation expense is accrued and that the deferred tax asset should not be adjusted solely as a result of changes in stock price. Since compensation expense is based on grant date valuation measurement and is not adjusted for subsequent changes in stock price, we concur with the treatment of not adjusting tax expense for stock price changes. Consistent with the Board’s characterization of the issuance of options as two separate transactions - compensation expense during vesting and an equity transaction such as the issuance of capital at exercise – we believe the tax accounting should follow these two transactions. This approach would record an estimated income tax benefit based on the compensation expense recorded for financial reporting purposes and treat any differential between the estimated and actual tax benefit received as equity for the capital transaction on exercise. The ED requires bifurcating individual exercises between those with higher than estimated tax deductions and those with lower than estimated tax deductions and provides for different financial reporting for each type. We believe this methodology is inconsistent and find little rationale for recognizing certain tax effects in the income statement. An approach that recognizes in equity all differences between the actual tax benefits received and the income tax benefits assumed based on grant date fair values would eliminate this inconsistency. This treatment would follow the approach of SFAS No. 109 for the tax consequences of other equity transactions. Paragraph 36c of that standard requires the tax effect of increases or decreases in contributed capital to be recorded in equity (e.g., the tax benefit of tax-deductible offering costs are recorded as an adjustment to the proceeds from the stock issuance).

There are several arguments in support of equity accounting upon exercise. This methodology is the only one that matches the accounting for the tax consequences to the amounts recorded in the income statement for compensation cost. We believe the income tax accounting for stock options should match the income statement recognition of option expense. As there is no true up to compensation expense based on the value of options at exercise date, any differences between the deferred tax assets recorded based on grant-date fair values and the actual tax benefits received should be recorded in equity. Recognition in the income statement of the actual tax consequences, either greater or less than amounts initially recorded based on recorded compensation expense, would distort operating results as a result of an employee conversion of one form of equity to another or an option expiring unexercised. These events are capital raising equity transactions and should be recognized in equity. In addition, this would be consistent with the objective of moving toward principles-based standards, as it would match recognition in the income statement of the tax effects to the costs of options recognized in the income statement. Lastly, a methodology that takes differences between the tax benefits recorded and actual tax benefits received to equity in all situations is less costly and complex for companies to administer.

The ED requires that the tax benefit of the tax deduction for an individual employee's equity instruments exercised be true-up to the deferred tax asset recorded for those instruments. We do not support the ED requirement to calculate this true up by individual employee. The detailed tracking needed to account for each individual's instruments separately is onerous and impractical where estimates are used of tax rates which vary based on individual employees that are employed at different legal entities with varying statutory tax rates. Most companies use an average effective state tax rate and it would be unprecedented to calculate true-ups to the state tax rate of an individual employee. Moreover, the ED does not account for each option grant by individual and permits the use of group experience to value each option grant. Since the initial set-up of the deferred tax asset is based on the value determined for the group as a whole, even if the actual tax benefit received is measured by employee, the true-up will still reflect a component based on the portfolio for the prorata portion of the deferred tax asset recorded. We also do not believe the added burden of tracking the deferred tax asset by individual is cost beneficial and urge the FASB to reconsider this proposal in the ED. Alternatively, we support determination of the true up on a portfolio basis, which is consistent with the portfolio determination of both valuation and grant date tax accounting.

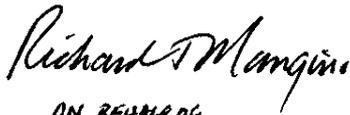
Transition Provisions and Effective Date

We do not agree with the Board's decision to require companies to adopt the standard using the Modified Prospective Method. We believe that the current provisions of SFAS No. 148 should be maintained, which would allow companies to choose between three separate adoption methods - Restatement, Modified Prospective or Prospective adoption. At a minimum, we do not agree that those companies who have already voluntarily adopted fair-value accounting should be required to re-adopt using the modified prospective approach.

Unless the final standard addresses the concerns expressed in this letter, in particular, those related to preserving flexibility in valuation methodologies and those noted in the tax accounting section, we believe that the effective date should be delayed one year. The proposed changes to the valuation methods and tax accounting would create significantly more work for companies, and we believe that since the final standard will not be issued until late in 2004, companies will need more time to modify their current systems in order comply with the new provisions. Not providing companies adequate time to update and test their systems would jeopardize the effectiveness of their internal controls surrounding these processes.

If you have any questions regarding this letter or would like to discuss our views further, please contact me at (908) 234-6100.

Sincerely,



ON BEHALF OF

Christopher R. Reidy