

Citigroup Inc. 153 East 53rd Street New York, NY 10043

June 30, 2004

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

Letter of Comment No: 22 A File Reference: 1102-100

Re: Proposed Statement of Financial Accounting Standards, Share-Based Payment – an amendment of FASB Statements No. 123 and 95

Dear Mr. Smith:

Citigroup is pleased to provide detailed comments on the Proposed Statement of Financial Accounting Standards, Share-Based Payment – an amendment of FASB Statements No. 123 and 95 (Exposure Draft). This letter is a follow up to our comment letter dated April 5, 2004 in which Citigroup expressed strong support for the private sector standard setting process and opposition to legislative intervention in the rule making process for accounting for stock options.

Citigroup supports the principle in the Exposure Draft that stock options and other forms of employee share-based payments represent valuable compensation and should be recorded as an expense on the income statement. We agree that the grant date is the most appropriate measurement date for equity-settled transactions and that compensation expense should generally be recognized over the vesting (requisite service) period for all awards that vest. We believe that current valuation models provide a reasonable estimate of the fair value of stock options and that those models will continue to improve over time.

There are two primary areas where Citigroup would suggest that the Board consider changes to the Exposure Draft. These two areas are accounting for the income tax consequences of expensing options and the transition rules.

In addition, we have several other areas of concern where Citigroup would suggest additional changes to the document as well as suggestions for clarification of some of the principles the proposed standard establishes. We have included these comments, as well as certain technical suggestions, as a separate attachment to our main response.

Detailed comments on Citigroup's two primary areas of concern are provided below.

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## **Income Taxes**

All Excess Tax Benefits and Tax Deficiencies Should Be Recorded in APIC

Citigroup does not support the guidance in the Exposure Draft on accounting for 'excess tax benefits' and 'tax deficiencies.' The Exposure Draft would require that any excess tax benefit be recorded as additional paid-in capital (APIC), while any tax deficiency be recognized in the income statement as an increase to income tax expense. We believe that a better accounting model is to record *all* book-tax differences, other than differences related to compensation expense recorded on the income statement, in APIC.

We do not understand why only certain increases in the share price (that is, those above and beyond the grant date fair value) are considered equity transactions. Paragraph C129 of the Exposure Draft concludes that excess tax deductions result from increases in the share price after the grant date and "are due to an equity transaction." We believe that concept should apply equally to tax deficiencies. A tax deficiency occurs when the entity's share price decreases or does not increase at least as much as the grant date fair value of a stock option. Tax expense for financial reporting purposes should be calculated based on the compensation expense recorded on the income statement. All other book-tax differences relate to movements in the entity's share price and should be reported in equity, not income.

In paragraph C131, the Board states that income tax effects should focus on each individual employee as opposed to a portfolio approach. Note that our proposed model is not a portfolio approach. We are not proposing that tax deficiencies should be recorded in APIC to the extent that the entity has recorded excess tax benefits in prior periods. Instead, our model is based on the principle that changes in the entity's share price (equity transactions) should not impact net income.

# Remeasuring the Deferred Tax Asset at Each Reporting Date (IFRS 2 Model)

We do not support the model in International Financial Reporting Standard 2, Share-based Payment (IFRS 2), which requires remeasuring a deferred tax asset at each reporting date, based on the current market price of the entity's stock. The IFRS 2 model adds an additional layer of complexity and can result in additional volatility in income tax expense. We support the Board's conclusion that a deferred tax asset should not be re-measured for changes in the amount that would be deductible at subsequent balance sheet dates.

# Reporting Income Tax Effects on the Statement of Cash Flows

The same principles discussed above should apply to reporting on the statement of cash flows. All excess tax benefits or tax deficiencies relate to movements in the entity's share price (an equity transaction) and should be classified as financing activities.

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## **Transition**

We object to the proposed modified prospective transition method. Citigroup adopted the recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation (Statement 123) using the prospective method, as permitted by FASB Statement No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure (Statement 148). The Exposure Draft does not change the general measurement and recognition model in Statement 123. As such, we believe that the Exposure Draft should either (a) contain the same choice of transition methods as Statement 148 or (b) require the prospective method.

Included as a separate attachment are Citigroup's further comments.

We thank the Board for its consideration and would welcome the opportunity to further discuss our comments with Board members and their staff. Please do not hesitate to contact me at (212) 559-7721.

Sincerely,

Robert Traficanti

Vice President and Deputy Controller

Bob Traficanti

Citigroup



### Fair Value Measurement

### General Guidance on Fair Value Measurement

Overall, the Exposure Draft provides useful, principles-based guidance on fair value measurement. Citigroup would not support prescriptive rules, such as a single method of estimating expected volatility or a uniform volatility assumption for all entities. Fair value measurement must take into account entity and plan-specific facts and circumstances. With that in mind, the framework in the Exposure Draft should result in sufficiently reliable fair value measurements across entities and industries. Furthermore, the requirement for an entity to disclose the significant assumptions used to estimate fair value of awards provides useful information to financial statement users.

# Lattice model vs. Closed-form model

Citigroup agrees with the Board's position that a lattice (binomial) model may better reflect the unique characteristics of employee stock options, particularly suboptimal exercise behavior and post-vesting termination. However, we agree that a lattice model should not be required at this time. The Exposure Draft appropriately provides flexibility to permit the use of improved option pricing models.

While the Exposure Draft does not require use of a lattice model, we understand that practice has interpreted the Exposure Draft to require an entity using a closed-form model to demonstrate (a) that it is not practicable for that entity to use a lattice model and/or (b) that a closed-form model would not produce results that are 'materially different' (paragraph B11). We believe that entities that continue to use a closed-form model should not be subjected to a greater 'burden of proof' than those entities that use a lattice model. If the Board's intention is to require an entity to support the use of a closed-form model in this manner, it should clarify the guidance in a final standard. That position would be inconsistent with IFRS 2, which permits the use of either model without additional justification.

### Reload Features

We disagree with the Board's conclusion that reload features should not be included in estimating fair value at the grant date. The proposed guidance is not consistent with the principles of the grant date model. As discussed in the Basis for Conclusions in Statement 123, "The Board continues to believe that, ideally, the value of an option with a reload feature should be estimated at the grant date." The final standard should permit grant date measurement if the entity can demonstrate that its option pricing model provides a reliable measurement. As opposed to an arbitrary prohibition, the final standard should permit professional judgment by the entity and its outside accountants.



#### Other Comments on Fair Value Measurement

- We agree that post-vesting restrictions (such as sale restrictions after the vesting date of share awards) should be incorporated into the grant date fair value measurement.
- We agree that historical data should be adjusted for expected future changes and other available entity-specific and market information.

# **Attribution of Compensation Expense**

Awards with Graded Vesting

sufficient.

We agree with the proposed guidance as it relates to stock options. Each tranche of an award of stock options with graded vesting should have a different expected life and, as such, the entity should separately measure fair value and record expense for each tranche.

Citigroup disagrees with the proposed guidance as it relates to share awards (for example, restricted or nonvested shares). Assuming there are no post-vesting sale restrictions, each tranche of an award of restricted shares will have the same fair value measurement, equal to the market price of the entity's stock at the grant date. An entity should continue to be permitted to record expense on a straight-line basis as an accounting policy, consistent with the guidance in Issue 7 of EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44." In all cases, the entity should be required to record cumulative expense equal to the vested portion of the award at each reporting date, as currently required in paragraph 31 of Statement 123.

Simplify the Detailed, Prescriptive Guidance on Determining the Requisite Service Period While we do not object to the detailed guidance and illustrations provided in the Exposure Draft (paragraphs B37-B49), we question whether such prescriptive guidance is necessary. The general principles that (a) an entity should estimate the most probable requisite service period based on all facts and circumstances and (b) if the entity's estimates change, it should change its expense recognition (consistent with other changes in accounting estimates) is

Paragraph 35(b) would permit recognizing less than the grant date fair value of an award if, at the date of a modification, a performance or service condition is not expected to be satisfied. While we do not object to that guidance, again we question whether it is necessary. The guidance adds a significant amount of complexity through detailed guidance and examples without a significant improvement in the proposed standard. Citigroup would support removing this guidance and just including the principle that an entity should never recognize less than the grant date fair value of an award unless a service or performance condition is not met (that is, unless the award does not vest). That principle is consistent with the guidance in IFRS 2.



#### **Modifications and Settlements**

## Measurement Model

We strongly support the proposed guidance on measuring incremental compensation expense for modifications and settlements. The current guidance in Statement 123, which compares the fair value of the modified award with the fair value of the existing award based on the 'shorter of (1) its remaining expected life or (2) the expected life of the modified option' (paragraph 35 of Statement 123), is inconsistent with the fair value model. The proposed guidance takes all facts and circumstances that exist at the date of the modification or settlement into account. Furthermore, the Exposure Draft is consistent with the guidance in IFRS 2.

## Cancellations and Replacement Awards

FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation (FIN 44), provides a bright-line of six months for determining when to combine a cancelled award with a replacement award for accounting purposes. We do not believe it is necessary to provide a rule because it is unlikely for an entity to cancel an existing stock option or share award without providing some form of compensation to employees. The proposed guidance in paragraph 35B of the Exposure Draft is sufficient.

# Modifications of Awards Granted before the Effective Date of the New Standard

Statement 123 contains 'special' measurement and recognition rules for awards granted before the adoption of Statement 123 that are subsequently modified. We request that the final standard clarify that the guidance in the Exposure Draft on measuring incremental compensation expense for modifications and settlements applies to *all* awards, regardless of whether those awards were granted before or after adoption of the final standard.

## **Disclosures**

Overall, the disclosure requirements in paragraphs B191-193 are reasonable and provide useful information to the users of financial statements. However, the 'minimum disclosure requirements' should be moved into the body of the standard. The disclosure objectives are helpful to understand why the relevant disclosures are required and should be included in the Basis for Conclusions.

Paragraph B191(k) would require an entity to disclose the expected amount of shares to be repurchased in the next annual period as a result of issuing shares upon option exercise. It may be very difficult for an entity to accurately forecast the amount of shares expected to be repurchased during the next annual period. Share repurchases will depend on a number of factors (for example, the entity's share price, excess cash, and employee exercise behavior). If the final standard retains this requirement, the Board should specify whether and, if so, how an entity should separate expected share repurchases as a result of a policy on share-based payment transactions versus other treasury stock activity.



# **International Implications**

Minimum Statutory Withholding Requirements

Multinational corporations with expatriate employees face significant practical issues because of the current guidance on minimum statutory withholding requirements. For many expatriate employees:

- The employee is required to pay income taxes (including the relevant withholding taxes) in the foreign jurisdiction.
- As part of an expatriate compensation package, the entity will calculate the employee's hypothetical income tax (including the relevant withholding taxes) in the home jurisdiction.
- The entity withholds from the employee's pay the hypothetical tax to be paid in the home jurisdiction, and pays the tax in the foreign jurisdiction.

We request that the Board consider the effects of foreign minimum withholding requirements as well as any contractual employment agreements for expatriate employees. We request that the final standard permit the entity to withhold amounts based on an individual's hypothetical (home country) withholding tax obligations.

# Definition of Employee - Subsidiary Board of Directors

The exception provided in FIN 44 (and carried forward in the Exposure Draft) treats nonemployee members of the board of directors as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder election when the existing term expires. We request that the final standard expand this exception to include nonemployee members of subsidiary board of directors. Citigroup operates in 102 countries. We have separate legal entities in many countries; many of those subsidiaries are 100% owned by Citigroup and are required to have board of director representation. We believe that the same practical exception that applies to nonemployee directors elected by the shareholders should apply to nonemployee directors appointed to the subsidiary boards.

## Definition of Employee Stock Ownership Plans

The definition of employee stock ownership plan currently focuses on the Employment Retirement Income Security Act and the Internal Revenue Code. We recommend that the final standard expand the definition for plans located outside the United States.

## **Other Technical Matters**

Noncompete Agreements (Clawback Features)

The Exposure Draft requires accounting for a clawback feature (noncompete agreement) in the <u>original</u> terms of an award as a contingent asset. The entity does not account for the noncompete agreement until a former employee competes and forfeits rights to an award. We believe that accounting model can lead to inappropriate results and inconsistent expense



attribution methods depending on whether the noncompete agreement is in the original terms of an award or entered into as a separate agreement with an employee who terminates employment.

# Assume the following fact patterns:

- Company A incorporates a substantive noncompete agreement into the original terms of a share award to Employee A. Employee A is required to provide three years of service to vest in the share award (the requisite service period is three years). If Employee A terminates employment, he can continue to vest if he complies with the terms of the noncompete agreement through the end of year three. Employee A terminates employment at the end of year one; he will continue to vest in the share award over the next two years.
- Company B does not incorporate a noncompete agreement into the original terms of a share award to Employee B. Employee B is required to provide three years of service to vest in the share award (the requisite service period is three years). Employee B terminates employment at the end of year one. Company B and Employee B negotiate a substantive noncompete agreement, whereby Employee B will continue to vest in the share award if she complies with the terms of the noncompete agreement over the next two years.

# The Exposure Draft defines requisite service period as:

The period or periods during which an employee is required to perform service in exchange for an award under a share-based payment arrangement. [Emphasis added]

## The Exposure Draft defines *vest* as:

To earn the rights to, which is when an employee has rendered the requisite service. An employee's share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other equity instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. [Emphasis added]

Based on that guidance, it appears that Company A would be required to record all remaining unrecognized compensation expense at the date Employee A terminates employment (at the end of year one). If Employee A forfeits the share award in the next two years, Company A would reverse compensation expense at that point.

Company B's accounting is not specifically addressed in the Exposure Draft. We believe Company B should account for the noncompete agreement as a modification of the share award. Company B would measure additional expense if the fair value of the modified award is greater than the fair value of the original award immediately prior to the modification. It would record any remaining unrecognized compensation expense on the share award (and any incremental expense measured as a result of the modification) over the next two years. If Employee B forfeits the share award in the next two years, Company B would reverse compensation expense at that point.

In substance, the companies and their employees are in the same economic position after the employees terminate employment. However, the Exposure Draft could result in different



expense attribution methods and amounts. We believe that recording all remaining compensation expense at the date Employee A terminates employment ignores the fact that Company A will receive a benefit in future periods for the employee's agreement not to compete. In both fact patterns, the employees have not earned the right to receive or retain the benefit from the share awards until the end of year three. Expense should be recognized over three years.

We request that the Board address this issue in the final standard, perhaps by way of an additional illustration in Appendix B or by modifying the definitions of requisite service period and vest. In our view, the principle is that an entity should recognize compensation expense over the period that it benefits from the employee's service or other substantive undertakings. We believe this guidance would more appropriately reflect the terms of an award that contains a substantive noncompete agreement in its original terms. If the Board has concerns that entities will inappropriately smooth expense over periods extending beyond the requisite service period, the guidance could limit the maximum attribution period to the service period (for example, an entity that grants awards with a three-year service period and a five-year noncompete agreement should record compensation expense over three years). In practice, we would expect the service period to coincide with the expiration date of the noncompete agreement.

More generally, we request that the Board address the accounting for noncompete agreements in more detail in the final standard. The guidance should compare the accounting for noncompete agreements in the original terms of an award with the accounting for noncompete agreements negotiated at the date an employee terminates employment. Where the accounting (measurement and expense attribution methodologies) are different, the Board should address why those differences are appropriate in the Basis for Conclusions.

Interplay Between the Exposure Draft and FASB Statements No. 133, Accounting for Derivatives and Hedging Activities (Statement 133) and No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (Statement 150)

The final standard should reconcile potentially conflicting guidance on classification and measurement in the Exposure Draft, Statement 133 and Statement 150. One example where the guidance may conflict is outperformance options (options indexed to the entity's stock price performance relative to the S&P 500 or some other market index).

Paragraph 11(a) of Statement 133 concludes that a contract is not considered to be a derivative instrument within its scope if the contract is both (1) indexed to the entity's own stock and (2) classified in stockholders' equity in the balance sheet. EITF Issue No.01-6, "The Meaning of 'Indexed to a Company's Own Stock," concludes that the scope exclusion in paragraph 11(a) of Statement 133 does <u>not</u> apply to contracts indexed to the issuer's own stock and an observable market or index (for example, the S&P 500). The contract would be accounted for as a derivative, marked to market through earnings.

Paragraph 12 of Statement 150 requires certain obligations to issue a variable number of shares to be classified as a liability. If the monetary value of an obligation is based on



variations in something other than the fair value of the issuer's shares (for example, the S&P 500), that obligation is a liability and is marked to market through earnings.

Under the Exposure Draft, it is unclear whether an outperformance option should be accounted for as an equity-settled transaction (fixed measurement of fair value at the grant date) or as a liability (marked to market at each reporting date through the exercise date). The Exposure Draft implies that the outperformance option would contain a 'market condition' and that fair value should be measured once at the grant date. However, the Exposure Draft does not explicitly address what is considered an equity instrument and whether the guidance in Statement 133 and Statement 150 should be used to make that assessment. It is critical that the final standard resolve these potential conflicts, more clearly consider and address the classification and measurement guidance in the three standards, and lay out the Board's basis for conclusions on why that guidance should be different for share-based payment transactions versus other contracts.

# Diluted Earnings per Share Treatment of Purchased Call Options

FASB Statement No. 128, Earnings per Share (Statement 128), requires the use of the treasury stock method to calculate the diluted earnings per share (EPS) impact of stock options and share awards. Paragraph 25 of Statement 128, however, excludes purchased call options from the calculation of diluted EPS because their effect would be antidilutive. We believe that this asymmetrical guidance lacks conceptual merit. We believe that an entity should be permitted to include purchased call options in the calculation of diluted EPS if, for example:

- The purchased call options meet the requirements for equity classification in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," and
- The entity documents and designates the purchased call options as a hedge of its economic exposure to the grant of stock options or share awards. The entity would not apply hedge accounting as defined in Statement 133 because neither the awards to employees nor the purchased call options would be marked to market through earnings going forward. However, documentation similar to that required in Statement 133 would be helpful to demonstrate the linkage between the purchased call options and the awards to employees.

We request that the FASB address this issue as part of its reconsideration of the Exposure Draft and its current project on EPS.

FASB Technical Bulletin No. 97-1, "Accounting for Certain Employee Stock Purchase Plans with a Look-Back Option" (FTB 97-1)

The final standard should incorporate and supersede the guidance in FTB 97-1.