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committee on corporate reporting

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Re: File Reference No. 1102-100

The Committees on Corporate Reporting ("CCR") and Taxation ("COT") of Financial Executives International ("FEI") would like to comment on certain of the revised conclusions reached by the Board in its re-deliberations of the FASB's Proposed Statement of Financial Accounting Standards ("SFAS"), 'Share–Based Payment, an amendment of FASB Statement Nos. 123 and 95' (the "ED"). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR and COT are technical committees of FEI, which review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by U.S. and international agencies and organizations. This document represents the views of CCR and COT and not necessarily those of FEI.

CCR and COT remain very concerned with the Board's approach to accounting for the income tax effects of share-based payments. While we acknowledge that the Board may be attempting to be responsive to its constituents' comments on income tax effects in its redeliberations of the ED, its revised conclusions do not resolve the principal issues we had with this aspect of the ED. Specifically, it fails to respond to one of our major concerns with the ED – the potential for asymmetrical handling of tax effects of options, in which excess tax benefits ("excess benefits") on the exercise of options are credited to equity, while tax shortfalls, wherein the tax benefit realized is less than the initial benefit recorded ("excess deferred tax assets"), are reflected as charges to earnings in some cases but not in others. This letter also provides our position relative to the effective date of the final standard.

Practically speaking, for many companies, the accounting under the Board's decision to revert to the requirements included in SFAS 123 is not substantially different from the requirements in the ED. For example, none of the companies that adopt the standard using the modified prospective transition method would have the "bank" of excess credits built up in equity from exercises of prior grants accounted for under the fair value alternative of SFAS 123. Thus, all excess deferred tax assets related to exercise or expiration of existing options would need to be charged to earnings. This would also be the case for many companies that have either already adopted or will elect to adopt the fair value method of expensing share-based payments using a retrospective approach. This is due to the large number of existing stock options that will expire either out of the money or at nominal gains as a result of the overall behavior of the equity markets over recent years. Accordingly, for companies that fall into either of these categories, which we expect could be a majority of public companies, the effect will be to require expensing of all or a majority of the excess deferred tax assets.

More importantly, we believe the approach in SFAS 123 is without conceptual merit and are at a loss to explain the logic in the asymmetrical result to our internal business partners. In fact, the Board's own Basis for Conclusions to SFAS 123 provides no support for this inherent inconsistency. We believe the current project to amend SFAS 123 provides the Board with the opportunity to correct this deficiency. Specifically, we believe 1) the amount of income tax benefit recognized for the option grant should be reflective of the amount recognized as compensation expense, and 2) any subsequent differences in realized tax benefits, both excess benefits and excess deferred tax assets, should be recognized in additional paid-in capital along with the effects of underlying option exercise.

The foundation for our position is our belief that the granting of an option by an employer and the exercise of that option by the employee represent two distinct transactions that should be accounted for as such. We believe the granting of the option represents a compensation transaction executed by the company, whereas the exercise of the stock option represents an equity transaction executed by the option holder. Importantly, the Board has acknowledged the conceptual merit of this position in both SFAS 123 and the ED. Paragraph 228 in the Basis for Conclusions to SFAS 123 addresses the accounting for excess benefits and provides that they should be reflected in equity because they are attributable to an equity transaction. This view is mirrored in paragraphs C128 and C129 of the ED (Basis for Conclusions) wherein the Board concludes that the grant and exercise are separate transactions (the former being consideration for services and the latter being an equity transaction).

Interestingly, however, the Basis for Conclusion for SFAS 123 provides no rationale for why the Board concluded that the write-off of the excess deferred tax asset should be recognized in the income statement except to the extent that there is paid-in capital arising from excess tax deductions from previous awards under stock-based employee compensation arrangements accounted for using the fair value based method. We believe any rationale in support of this treatment would be inconsistent with the two transaction framework, with the asymmetrical result being both arbitrary and unnecessarily punitive.

As set forth in our earlier comment letters on the ED, we believe there are two alternative models that would drive an accounting result consistent with our position as set forth above. The first would be to simply revise the SFAS 123 approach to require that all subsequent differences in realized tax benefits, both excess benefits and excess deferred tax assets, be recognized in additional paid-in capital along with the effects of underlying option exercise. The second would be to recognize a deferred tax liability for the fair value of the prepaid compensation issued at the grant date, with that liability reduced as the underlying compensation is recognized in earnings. Under the latter model, all tax benefits resulting from the exercise of the stock option are recognized as a credit to equity. Both of these models are consistent with the Board's underlying theory that the effects of stock price changes subsequent to grant date associated with the option are part of an equity transaction.

Finally, the SFAS 123 approach to accounting for income taxes results in unnecessary complexity in the accounting for equity-based compensation plans, while producing financial statement results that, in our view, are not decision-useful information to the users of the financial statements. Complexity results from the requirement to track tax effects separately for each option grant, which can be a very significant effort for companies with broad-based option plans. While complexity in and of itself may not be a sufficient rationale for not following a preferred accounting method, we believe the SFAS 123 model is not preferential for the reasons discussed above. Further we believe a model that treats the tax effects differently depending on their direction will confuse users, especially when the impact is counter-intuitive (i.e., in a situation in which a company's stock does not perform as well as expected, lower intrinsic values upon exercise will result in less value to employees and higher expenses for the company due to write-off of deferred tax assets to earnings). It is difficult to rationalize this one-way, partial true up of net stock option expense – and we believe the result is less meaningful and more confusing to users than our proposed, less complex approach.

For the reasons discussed above, as well as the reasons set forth in our earlier comment letters on the ED (attached for your convenience), we request that the Board reconsider its revised conclusions on accounting for the tax effects of share-based payments and that you give further consideration to the alternatives we have provided.

We also understand the Board is reconsidering the effective date requirement of the ED. In that regard, we wish to point out to the Board that even if the final standard is revised to reduce the overall level of complexity and eliminate the stated preference for a binomial lattice model, there remain other broader operational issues associated with adopting such a broad-based accounting change, which require time for education, communication and incorporation into internal and external processes. As noted in our previous comment letters, public companies currently are devoting significant resources to manage major changes to their processes, most notably to comply with the various provisions of the Sarbanes-Oxley Act (i.e., Section 404). There are other significant internal management issues that companies will be required to deal with as a result of the guidance in the final standard that will impact organizations well beyond the core accounting function. Some of those issues include:

- Considerations relative to changes in overall plan designs, including reviewing effects with compensation committees of Boards of Directors,
- Designing and educating management on choices that must be made relative to how the effects of share-based payments will be budgeted, reflected in internal management reporting and allocated to business units,
- The need to educate companies' investors on the effects of expensing the awards, including providing updated earnings guidance, and

- The need to address Section 404 effects for the execution and accounting for share-based payments.

Given these considerations, we believe an effective date for fiscal years beginning at least six to twelve months after the ultimate issuance date of the standard is appropriate in order to prepare for effective implementation of the final standard.

We would welcome the opportunity to discuss this matter further with you at your convenience. Please feel free to contact Frank Brod at (989) 636-1541 or Teri List at (513) 983-3874 with any questions.

Sincerely,

Frank H Brod

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cc: Sir David Tweedie
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