Lockheed Martin Corporation 6801 Rockledge Drive Bethesda, MD 20817 Letter of Comment No: 58 35 File Reference: 1102-100

LOCKHEED MARTIN

Rajeev Bhalla Vice President and Controller

June 30, 2004

Director of Major Projects – File Reference 1102-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Sent via email to director@fasb.org

Re:

File Reference 1102-100

Proposed Statement of Financial Accounting Standards:

Share-Based Payment

Lockheed Martin Corporation welcomes the opportunity to provide comments on this proposed standard. Lockheed Martin is a publicly traded corporation principally engaged in the research, design, development, manufacture and integration of advanced technology systems, products and services. We reported 2003 sales of \$31.8 billion.

While we disagree with the conclusion that stock options represent compensation cost to the corporation, we believe that the time for debate over this point is past and accept FASB's (the Board's) decision on this issue. We do, however, have concerns with a number of the provisions of this Exposure Draft (ED), and our comments, presented below, will focus on those areas of concern. We are particularly opposed to the introduction of accounting complexity that does not appreciably improve the resulting financial reporting. We believe many of the proposed provisions concerning income taxes add unnecessary complexity, and urge the Board to apply its third objective cited in the "Reasons for Issuing This Proposed Statement" section on page x. of the ED: "Simplifying U.S. GAAP."

Following are our comments, organized by issue as presented in the ED.

Issue 1: Requirement to recognize compensation cost in the financial statements

In our view, the Board and others have argued in favor of recording compensation cost for stock options by considering only one side of the transaction, namely whether the recipient has received something of value as compensation. We believe that an analysis of the other side of the equation leads to a different conclusion.

We continue to believe that, because no corporate assets have been consumed nor liabilities created, the issuance of a stock option conceptually does not result in an expense to the corporation. We believe a cost (in the form of dilution) is experienced by the stockholders individually, but not from the perspective of the corporation and not in a form that can or should be recorded in the accounting records of the corporation (other than in the calculation of earnings per share on a diluted basis).

That having been said, however, we also believe that the Board's conclusion to the contrary is unlikely to be reconsidered at this point, and our comments on this issue are more for the historical record than to further the debate.

Issue 2: Proforma disclosures an inappropriate substitute for recognition of compensation cost?

We believe this issue is inseparable from Issue 1 above. If one does not agree that compensation cost to the corporation exists, then the issue of "substitution" is moot. If it is stipulated that compensation cost exists, then we agree that proforma disclosure is not an adequate method for reporting that cost.

Issue 3: Fair value as the measurement attribute, and grant date as the measurement date?

We believe that fair value, if determinable, is the appropriate means by which to estimate compensation cost. We further agree that the grant date is the appropriate measurement date.

Issue 4(a): Sufficient guidance to implement fair value measurement objective?

Determining fair value requires the exercise of judgment, and we believe the level of guidance in the ED provides a sufficient framework on which to base the evaluation and judgment process. In our view, a more prescriptive approach could likely restrict, rather than enhance, the ability of the preparer to appropriately determine fair value.

Issue 4(b): Fair value measurable with sufficient reliability?

No model has yet been demonstrated to precisely compute the fair value of employee stock options, given the various restrictions inherent in employee stock options that are not present in the broader market-traded options for which most valuation models were designed. However, various "work-around" practices have developed that attempt to compensate for the flaws in the

models to a greater or lesser degree. In our view, the techniques now available arguably provide at least the minimum level of reliability necessary with which to calculate fair value.

We do not believe there is currently a "one size fits all" approach that provides the most appropriate calculation of stock option fair value in every circumstance, nor one model that is clearly preferable to the others in all cases. For this reason, we encourage the Board to allow for flexibility to be exercised by preparers in selecting and adapting a fair value model for use, and in migrating to improved models that we expect will be developed in the future.

We would further note that, in our view, valuation models become increasingly burdensome in their complexity and cost of operation to the extent that they attempt to address all possible facts and circumstances. Administrative costs are real, can be significant, and will be perpetual (not just related to transition). We urge the Board to consider and allow for the exercise of incremental cost-benefit analyses in the choice of a specific valuation model and its application. The cost of operating a more complex model may not be justified if only marginal improvement in the quality of the estimate of fair value is the result.

Issue 4(c): Specific method of estimating expected volatility?

Consistent with our response to Issue 4(b), we believe no one method of estimating expected volatility is appropriate in all cases, and encourage the Board to allow for the exercise of judgment, based on the implementation guidance provided, in the selection of a method of estimating volatility. To that end, historical volatility should be an acceptable method on which to base estimates of future volatility under the appropriate circumstances.

Issue 4(d): Adequacy of methods to reflect unique characteristics of employee stock options?

As noted in our responses to Issues 4(b) and 4(c) above, we believe various adjusting techniques, though imperfect, are necessary to address the flaws in currently available option valuation models, and we believe the preparer is in the best position to judge how such techniques would best be applied. In our view, then, the final standard should not prescribe specific practices, but should allow flexibility in determining which techniques to use and in what manner. We believe this flexibility should extend to include the recording of forfeitures as they occur, if such a practice is appropriate to the circumstances. In our view, particularly where the forfeiture rate is low, the difference in reported results between the use of an estimated forfeiture rate versus an "as you go" recording of actual forfeitures is not likely to be significant, nor is it likely to justify the added expense of developing and maintaining a forfeiture model.

Issue 5: Use intrinsic value when fair value not determinable?

If the intrinsic value method has been found lacking to such a degree that (as proposed) it is no longer acceptable for most issuers of options, we see no conceptual basis for reintroducing the method as a limited-use alternative. We believe the appropriate treatment, when fair value is not determinable, would be to defer recording the compensation cost until the fair value of the option

can be determined, accompanied by disclosures including the fact that fair value can't be determined and an explanation of why this is the case. This would be consistent with (among other standards) FAS 5, where a liability that is not quantifiable is disclosed but not recorded, and FAS 142, where intangible assets with indefinite lives do not begin to be amortized until the asset life (amortization period) is determined to be finite.

Issue 6: Plan not compensatory if terms to employees no more favorable than to others?

We agree with the Board's conclusion on this issue, although we believe that a plan providing for a minimal discount should not be viewed as compensatory if the provision is clearly designed to achieve employee stock participation rather than compensation. The encouragement of employee stock ownership as a means to better align employee interests with shareholder interests is a widely accepted technique and can be unrelated to compensation in both fact and appearance.

We also believe the Board's view on this issue validates our position on Issue 1. That is, we see no conceptual link whereby the incurring of cost to the corporation depends on the perceived receipt of value by the option recipient. If cost truly has been incurred (assets consumed or liabilities created), why are the different terms to recipients relevant? Either cost has been incurred, or it hasn't. We continue to believe the latter.

Issue 7: Requisite service period the appropriate period for attribution?

We agree that, if it is stipulated that the option represents compensation cost for services provided, the cost should be recognized over the vesting period, which represents the service period under this scenario.

Issue 8: Guidance on determining requisite service period sufficient?

In our view, the ED provides ample guidance on this topic.

Issue 9: Should graded vesting mean accounting as if separate awards, resulting in front-loaded compensation costs?

We believe the Board's premise that the fair value of options with graded vesting should be measured as if multiple, separate awards were issued ignores the intent and perception of both the issuer and recipient as they relate to a single option grant. We also think this is contrary to the Board's theoretical justification for considering such options as compensation cost in the first place, in that the services for which compensation is being paid are themselves performed ratably over the total vesting period. We therefore believe the entire option grant is earned ratably over the total vesting period and should be so recorded (as long as the vesting schedule calls for a proportionate number of shares to be vested evenly throughout the total grant vesting period).

Even if we concurred with the Board's position on this issue, we believe that the cost of accounting for single grants as multiple awards with multiple fair values would far exceed the

implied benefit of more precise measurement, particularly given the acknowledged imprecision inherent in the valuation models as a whole.

Issue 10: Are principles concerning modifications and settlements appropriate?

In our view, the principles in the ED are generally appropriate. We do think that the Board should more clearly differentiate between modifications of a plan, versus the activation of features initially provided for in the plan which should already be considered in the original calculation of fair value at the grant date.

Issue 11: Agree with method of accounting for income taxes?

We disagree with the Board's views on a number of counts, and find them to be conceptually inconsistent and unnecessarily complex.

In our view, accounting for income taxes should be consistent with the accounting for the associated transactions. That is, income taxes should be provided for based on the compensation cost calculations made and recorded at the grant date. The exercise of the stock option by the employee is an equity transaction, and any difference in the income tax benefit realized, from that recorded at the grant date, is a result of the equity transaction and should be accounted for as a part of that equity transaction with a further adjustment to additional paid-in capital.

The further bifurcation of the equity transaction required by the ED doesn't appear to us to be warranted under other accounting literature (FAS 109) and adds an unnecessary level of complexity to the calculations. Worst of all, the Board's asymmetrical application of this approach (an adjustment in one direction is made to earnings, an adjustment in the other direction is made to equity) results in an effect to the financial statements that is not only confusing but clearly counterintuitive to the user (as when lower earnings are reported when "compensation cost" is lower than had been estimated, due to the writedown of the excess tax asset). We do not view this outcome as improved financial reporting, nor do we believe it enhances the user's understanding.

We also question the ED's requirement to account for tax impacts by individual employee. This seems to us to be beyond the bounds of administrative practicality and meaningful utility to the financial statement user. By abandoning a portfolio approach, the ED attempts to achieve a microscopic degree of precision in one element of a project that seems devoid of a similar level of precision anywhere else. We fail to see how such a requirement could achieve a benefit greater than or even equal to its considerable cost.

Issue 12: Are disclosure objectives appropriate? Do required disclosures meet objectives?

In our view, the ED does not go far enough in "scaling back" the previously required disclosures that "substituted for" the recording of compensation cost in the financial statements. We also believe that some of these requirements, particularly related to cash flows and to the extent they

are material, are duplicative of SEC requirements related to items to be included in management's discussion and analysis. In general, we believe the Board should evaluate the degree of disclosure required by considering the materiality of these items, and of compensation cost itself, to the financial statements as a whole.

Issue 13: Agree with required modified prospective transition provisions?

We do not agree with the restrictive transition provisions provided for in the ED. We believe that the circumstances surrounding implementation of this standard are no different than those that led to the issue of FAS 148, and we believe the FAS 148 approach should be emulated here, including the alternative transition methods provided therein.

Issue 14(a): Allow intrinsic value method for nonpublic entities?

Consistent with our view in Issue 5 above, we see no conceptual basis for allowing a discredited method to be used by any group, and see no conceptual basis for a distinction between public and nonpublic entities.

We believe that, in general, employee stock option programs of nonpublic entities are likely to be of more limited scope that those of public entities, and that costs related to implementation of this proposed standard are likely to be proportionately less. We would also remind the Board that public entities do not possess unlimited resources, and that concerns regarding cost of implementation should be held for all preparers, large and small.

Issue 14(b): Appropriate to provide for less stringent requirements for nonpublic entities?

Please refer to our comment on Issue 14(a) above.

Issue 15: Should alternatives be provided for small business issuers?

Please refer to our comment on Issue 14(a) above.

Issue 16: Should excess tax benefits be classified as financing cash inflows?

We disagree with the Board's proposal to amend FAS 95 as described in paragraphs 17 - 19 of the ED. In our view, the Board mistakenly cites the <u>ability</u> to calculate a discrete tax effect and reposition it on the statement of cash flows, as a <u>reason</u> for doing so, regardless of the absence of any solid theoretical justification.

We believe the arguments in favor of classifying a tax reduction as a financing activity cash inflow to be wholly unconvincing and without conceptual merit. Nor do we find the Board's assertion of the uniqueness of these excess tax benefits sufficiently compelling to warrant excepting the reporting of this benefit from the otherwise uniformly applied guidance in FAS 95. If the Board has determined that a new definition of cash flow is in order, it should undertake this

as a separate project and propose to apply it to the entire statement of cash flows. A piecemeal approach to revising FAS 95, one specific application at a time, will not result in improved financial reporting in our view, and certainly is not consistent with the ED's stated objective of "Simplifying U.S. GAAP."

Issue 17: Is the accounting treatment in IFRS 2 preferable?

We do not believe in "convergence for convergence's sake" and support the Board's working approach vis-à-vis the IASB in this project. We do not find the IFRS 2 treatment preferable.

Issue 18: Is this standard understandable by the target audience?

We believe the principles applied in the ED, particularly compensation cost and the service period, are broadly understood. As mentioned above, we believe some provisions of the ED, in the pursuit of a greater degree of precision, are so unduly complex that they offset any benefit to the financial statement user.

As a final comment, we ask that the Board reconsider the proposed effective date of this standard as it continues its deliberations. We are concerned that a final standard issued late this year, at a time when financial statement preparers are already fully engaged in the new internal control certification and audit process required by Section 404 of the Sarbanes-Oxley Act, will make implementation in the first quarter of 2005 extremely difficult. Others, including the Chief Accountant of the Securities and Exchange Commission, have cited the demands of Section 404 and the efforts being expended in this initial year of implementation.

Thank you for considering our comments during the Board's further deliberations.

Sincerely,

/s/ Rajeev Bhalla
Vice President and Controller