

JONES APPAREL GROUP, INC.

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Letter of Comment No: 3251

File Reference: 1102-100

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

Delivered by e-mail to director@fasb.org

Re: File Reference 1200-001, Exposure Draft on *Share-Based Payment (an amendment of FASB Statements No. 123 and 95)*

To the Members of the Board:

I would like to take the opportunity to comment on the above-mentioned exposure draft. Jones Apparel Group currently expenses all share-based payments using the fair value method set forth in FASB Statement 123, so we are generally in agreement with the current exposure draft. However, there are two areas of the proposed standard that appear to be based on inconsistent or erroneous reasoning – the treatment of both the income tax and cash flow effects of the settlement of share-based payments (such as the exercise of employee stock options or the vesting of restricted stock) as outlined in Issues 11 and 16.

Issue 11 – The Issue of Income Taxes (paragraphs 15, A44, C128-C131)

The proposed standard would require that any tax “windfall” resulting from a tax deduction in excess of compensation cost recognized for financial statement reporting be recorded as additional paid-in capital under the theory that the additional tax savings are the result of an equity transaction. Yet if the tax deduction turns out to be less than the recorded compensation cost, the additional tax “payment” (technically the writeoff of a deferred tax asset) is to be recognized on the income statement (presumably, then, this is not a result of an equity transaction?). However, both of these possible outcomes are the result of the exact same type of equity transaction – in fact, paragraph C129 admits that the total tax deduction contains compensation cost, which is an income statement item, and “An equity transaction, such as the exercise of share options. That equity transaction will be affected by share price changes between the date an award of options is granted and the date the award is exercised or otherwise settled.” So why, according to the proposed standard, if the share price rises are cash “inflows” recorded as equity transactions but if the share price falls, cash “outflows” are recorded as expenses? I can find no theoretical justification for an expense arising out of an equity transaction.

Treating tax effects of equity transactions as an expense seems contrary to Statement of Concepts 6 paragraphs 80 to 89. Paragraph 81 states “Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity’s ongoing major or central operations.”

The tax effect resulting from the exercise of employee stock options or the vesting of restricted stock doesn't seem to meet this definition of an "expense" - unless the entity is in the business of selling stock options and restricted stock. Likewise, paragraphs 82 and 83 define gains and losses as transactions that increase or decrease equity (net assets) *except those that result from transactions with (i.e., investments from or distributions to) owners*. Since the exercise of employee stock options or the vesting of restricted stock are transactions with owners, the tax effects would seem to not qualify as reportable gains or losses as well.

If this treatment of tax effects becomes part of the final standard, an inconsistency will exist in the treatment of identical transactions and the effects of equity transactions can affect reported net income. Logically, it would seem the proper treatment would be to record all tax effects of equity transactions as additional paid-in capital, no matter what "direction" the cash flows. In this regard, the approach taken by Statement No. 123 (while not perfect) would seem preferable. The final standard's treatment of tax effects could also affect the calculation of diluted earnings per share, although this discussion is outside the scope of the present topic.

Issue 16 – Treatment of Tax Effects on the Statement of Cash Flows (paragraphs 17-19 and C139-C143)

This issue is closely related to Issue 11 discussed above. If the tax effects are, in theory, adjustments to the cash received from an equity transaction, then it stands to reason these cash flows should be reported as cash flows from financing activities. But the proposed standard only defines cash "inflows" (where tax deduction exceeds compensation expense) as financing activities while cash "outflows" (where the tax deduction is less than the recognized compensation expense) are considered operating activities. This is the same inconsistency as Issue 11 viewed from a different angle. Why are inflows equity transactions while outflows aren't? The tax effects should be financing activities no matter which direction the cash flows.

Another issue with the treatment on the statement of cash flows is the determination of exactly how much cash actually flows (and when it flows) from the exercise of an employee stock option or vesting of restricted stock. For example, assume the tax deduction for an exercise of an employee stock option is \$100 while the recorded compensation expense is only \$75. If the entity's effective tax rate is 40%, the tax "windfall" would be \$10. But does the entity actually have a \$10 cash inflow? Maybe it does, but maybe it doesn't.

If the exercise of this option happened in the first quarter of the year, and the entity uses the annualized income method of calculating its estimated tax payments, the \$25 difference between "book" and "tax" could actually generate a reduction in the required quarterly tax payments by more than \$10 for the first three quarters of the year and theoretically could even cause a fourth-quarter reverse cash flow if option activity is not evenly spread throughout the year (due to "underpaying" in the earlier quarters as a result of the calculation method). Thus, the tax effect of one option exercise can influence cash flow differently each quarter. So what should be reflected on the quarterly statements of cash flows – the \$10 that will result when the tax return is finalized or the actual effects on the reductions of the quarterly estimated tax payments? Since the statement of cash flows is supposed to show actual cash flows *when they happen*, then it would seem appropriate to report the actual reduction in estimated tax payments resulting from the option exercise when the estimated payments are actually made rather than when the related option exercise occurs (because until the estimated payment is actually made, no cash has "flowed" anywhere). So if the exercise occurs in the first quarter, and the estimated payment is made in the second quarter, the resulting effect on the entity's estimated tax payment should be reported in the second quarter, not the first. Since the effect on the second quarter estimated tax payment will be different than for the first quarter, there will be a further "adjustment" of the cash flow when the second payment is made, and so on for the third and fourth quarterly payments. In a company such as ours, where we have thousands of option exercises throughout the year, it will be a difficult and time-consuming task to isolate these effects.

To summarize, if tax effects are to be reported as cash flows from financing activities, then all cash flows should be treated the same – not just cash “inflows.” And if these cash flows are indeed financing activities, the final standard should clarify exactly what amounts are to be reported as cash flows and in what period(s) these cash flows should be reflected (since one transaction could affect four quarterly estimated tax payments in different ways).

Sincerely,

A handwritten signature in black ink that reads "Stephen C. Troy". The signature is written in a cursive style with a large, looping 'S' and a long, sweeping tail on the 'y'.

Stephen C. Troy
Vice President of Accounting and Financial Reporting