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Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

Letter of Comment No: 5536
File Reference: 1102-100

Re: File Reference No. 1102-100

Dear Director:

We are writing in response to your invitation to comment on the Proposed Statement of Financial Accounting Standards, *Share-Based Payment an amendment of FASB Statements No. 123 and 95* ("Exposure Draft").

KeyCorp ("Key"), headquartered in Cleveland, Ohio, is a bank-based financial services company that at March 31, 2004 had assets of approximately \$84 billion and roughly 20,000 employees.

Key is a strong believer in transparent financial reporting and related disclosures and in fact adopted Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, ("SFAS No. 123") and began expensing stock options issued after January 1, 2003. Key believes that stock options are a form of compensation and therefore should be expensed in the issuing entity's financial statements. For this reason, Key is generally supportive of the issuance of the proposed accounting guidance related to share-based compensation as set forth in the Exposure Draft.

We appreciate the opportunity to comment on the Exposure Draft. Following are Key's comments regarding three aspects of the share-based compensation accounting guidance set forth in the Exposure Draft.

Share Option Valuation (Issue 4(b))

With respect to share option valuation, the Exposure Draft states that "a lattice model is preferable" to a closed-form model (such as Black-Scholes). Key believes the final standard should not give preference to any particular option-pricing model. A more flexible and less prescriptive approach

is favored which would allow companies to use their choice of an option-pricing model that appropriately reflects their specific circumstances as long as that model 1) meets the overarching criteria set forth in paragraph B5 of the Exposure Draft (e.g., model is based on well-established principles of financial economic theory and generally accepted by experts in that field), and 2) takes into account, at a minimum, the six factors noted in paragraph B19 of the Exposure Draft.

Under the International Accounting Standards Board's ("IASB") *International Financial Reporting Standards 2, Share-based Payment*, companies are permitted to determine the appropriate valuation model based on the characteristics of their compensation arrangements. In the interest of ongoing convergence with the IASB, Key would favor a similar approach in the Financial Accounting Standard Board's ("FASB") final standard.

The Black-Scholes model, which is used by the vast majority of public companies, is a well-established and respected model. If the FASB indicates a preference for the lattice model in this proposed accounting guidance it may worsen perceptions of the credibility of the Black-Scholes model. While the limitations of Black-Scholes as a valuation model for company-issued stock options are widely acknowledged, there has been no general acceptance of any other particular valuation model as ideal. Until other models are developed and recognized as preferable, Key believes that it is unwise for the FASB to discredit the only model whose use is generally prevalent.

This argument for not giving preference to any particular option-pricing model is consistent with the Board's comment in paragraph C25 (in Appendix C "Background Information and Basis for Conclusions"), that "valuation techniques for financial instruments, including share options, continue to evolve, and that.....may lead to the development of improved commercially available valuation techniques."

Furthermore, Key and other financial services companies use a number of different models for valuing/measuring various financial instruments for purposes of implementing existing accounting guidance and related financial disclosures. For example, EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, although implicitly requiring the use of a model, does not prescribe or give preference to a particular valuation method or model in its requirements.

If the Board decides to retain the preferability of the lattice model in the final standard, Key would suggest that, for valuation purposes, there be a transition period provided before the preferred use of the lattice model—for example, deferring preference for the model's use until at least one or two years after the final standard's effective date. It is Key's understanding that the expanded lattice models envisaged by the Exposure Draft are not widely available at this time and are not expected to be made available quickly. Providers will likely not release a final product until some period subsequent to the issuance of a final standard so as to ensure that their models will comply with the valuation guidance in the final standard.

Companies, including Key, will also need sufficient time to evaluate the available products and their software providers, pricing and other related factors. Time will also be needed to convert from existing systems and to implement and test a new model. Finally, in changing to a lattice model, time will be required to identify, compile, and analyze significant amounts of detailed information

about past exercise behavior to incorporate assumptions about likely exercise patterns into the model. Many companies, including Key, have never accumulated such information, and doing so may require the purchase or development (and testing the accuracy of) new systems or software packages for tracking and analyzing the necessary data.

Income Taxes (Issue 11)

The FASB's decisions regarding income tax accounting in the Exposure Draft are based on a "two event" approach. Under this approach, the grant of an option relates to a transaction in which employees render services as consideration for the award; thus, the grant of an option represents compensation cost. Transactions following the grant date such as the exercise of share options are considered to be equity transactions. The application of this two-event approach in the Exposure Draft requires excess tax benefits to be recorded as a credit to shareholders' equity, while shortfalls in the tax benefit would be recognized as tax expense. This is a significant change from SFAS No. 123. Under SFAS No. 123, shortfalls in the tax benefit can be charged to additional paid-in capital to the extent that there is remaining additional paid-in capital from excess tax deductions relating to previous share-based awards.

SFAS No. 123's requirement to first allocate any effects of shortfalls in tax benefits to paid-in capital to the extent of remaining tax effects of previous awards was based on a portfolio view of income tax effects of share-based awards. Key supports this continued approach as set forth in SFAS No. 123, as it would ensure symmetry between the treatment of excess tax benefits and shortfalls. This approach also provides *consistency* with the accounting for the awards. It seems inconsistent to require, as does the Exposure Draft, that excess tax benefits be credited to shareholders' equity while tax shortfalls have to be recognized as income tax expense.

Key thus views the Exposure Draft's changed income tax accounting treatment relating to tax shortfalls as being inconsistent with the theory underlying its two-event approach. Furthermore, Key is concerned with the potential for unexpected volatility in effective tax rates and increased tax expense relating to the changed income tax accounting treatment relating to shortfalls in tax benefits.

Transition (Issue 13)

At the end of 2002, FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*. For companies electing to voluntarily adopt the fair value provisions of SFAS No. 123 (prior to fiscal years beginning after December 15, 2003) three transitional methods were permitted: the prospective, retroactive restatement, and modified prospective methods. Effective January 1, 2003, Key adopted SFAS No. 123's fair value method prospectively as permitted under SFAS No. 148's transition provisions.

The issuance of SFAS No. 148 was prompted by an increasing number of companies adopting or announcing their intention to adopt SFAS No. 123's fair value method of accounting for share-based awards. The standard was also in response to constituent concerns about the prospective method being the single method permitted by SFAS No. 123. Importantly, it was Key's understanding that SFAS No. 148 was intended to encourage the adoption of the accounting

provisions of SFAS No. 123 (especially by adding a “sunset provision” precluding use of the prospective method by companies adopting the fair value method in fiscal years beginning after December 15, 2003).

The Exposure Draft as currently written would require all public companies to use the modified prospective method, even those that voluntarily adopted the fair value method of SFAS No. 123, regardless of the transition method used upon adoption.

In the spirit of SFAS No. 148’s intentions, Key strongly believes that those companies who early adopted the fair value provisions of SFAS No. 123 should be able to continue applying their chosen transition approach until all share-based compensation has been included under the provisions of the final standard. Key does recognize that the proposed method in the Exposure Draft resulted from the Board’s desire to improve consistency of reporting among public companies. Our view is that any comparability issues, regardless of transition method employed, will be short-lived as most companies’ share-based awards vest over a period of three to four years. Any disadvantages in the short-term that may exist with respect to comparability issues will be far outweighed by the disruptions and costs involved in converting to a mandated method only a very brief amount of time after allowing for optional adoption methods.

We hope these comments are useful and positively influence the final standard. We welcome the opportunity to discuss these issues in more detail. Please feel free to contact Chuck Maimbourg, Director of Accounting Policy & Research, at 216-689-4082 or me at 216-689-3564.

Sincerely,

Lee G. Irving
Executive Vice President
& Chief Accounting Officer