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An Integrated Energy Company

**Glenn P. Barba**  
Vice President, Controller  
and Chief Accounting Officer

June 30, 2004

Ms. Suzanne Q. Bielstein  
Financial Accounting Standards Board  
Director of Major Projects  
File Reference No. 1102-100  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

RE: File Reference No. 1102-100, *Share-Based Payment*

Dear Ms. Bielstein:

This letter contains the comments of CMS Energy Corporation and Consumers Energy Company (collectively, the Company) with regards to the Exposure Draft for the Proposed Statement of Financial Accounting Standards, *Shared-Based Payment*.

CMS Energy Corporation, whose common stock is traded on the New York and Midwest Stock Exchanges, is a diversified international and domestic energy company also engaged in independent power production, natural gas transportation, interstate transportation, storage and processing, energy marketing, services and trading, and international electric distribution. CMS Energy Corporation's consolidated assets total \$14 billion, and annual operating revenues approximate \$5.5 billion. Consumers Energy Company, the principal subsidiary of CMS Energy Corporation, is the nation's fourth-largest combination electric and gas utility.

While the Company agrees with the general conclusions reached in the proposed Statement, we would like to address the following issues as they are outlined in the Exposure Draft:

***Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.***

The Company agrees with the general conclusions reached in the proposed Statement of Financial Accounting Standards, *Share-Based Payment*.

***Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?***

The Company agrees with the Board on the issue of pro forma disclosures. The use of pro forma disclosures as a means of recognition of the compensation cost of employee stock options should not be allowed.

***Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?***

The Company agrees with the Board that fair value is the relevant measurement attribute.

***Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?***

Regardless of the type of valuation model used, the Company believes that these criteria are sufficient required minimum inputs to ensure that the objective of consistency and comparability between entities is achieved.

***Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of***

*employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board’s conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board’s conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?*

The Company does agree that the fair value of employee share options can be measured with sufficient reliability, but disagrees that one option-pricing model is preferable over another. The Company understands that a Lattice Model may provide greater flexibility in reflecting the unique characteristics of employee share options for some companies, but does not agree that a Lattice Model would produce a materially better estimate of fair value than other models. In our own circumstance, we have found that there is very little difference between Black-Scholes-Merton and a binomial model in estimating the fair value of our stock options. Therefore, the Company believes the FASB should allow the use of either a closed-end model, such as Black-Scholes-Merton, or a binomial model, such as the Lattice Model, and should not give preference to one of two equally acceptable modeling tools.

*Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.*

The Company agrees that using historical volatility as the sole determinate of the volatility assumption would be inappropriate, and believes that the Exposure Draft provides sufficient guidance. Further, we do not support a specific method or factor to determine expected volatility. There may be company-specific relevant factors, such as significant on-going industry events not occurring in the past, or changes in dividend distributions, etc., not encompassed by this guidance, that should be considered in determining an accurate measure of volatility. Therefore, the Company does not believe that the lack of a specific method for estimating expected volatility would create a consistency issue between entities in calculating fair value because of the unique characteristics that may influence an entity’s volatility calculation outside of the factors set forth in the Exposure Draft.

*Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option’s*

*contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.*

The Company agrees that the methods set forth by the Board do give appropriate recognition to the unique characteristics of employee share options. However, we believe companies should be allowed the choice of estimating forfeitures or accounting for forfeitures as they occur. Each company should be allowed to choose and apply consistently its own policy regarding forfeitures. Mandating a forfeiture estimate and reconciliation will only complicate record keeping. Furthermore, there is no evidence that a forfeiture estimate will result in a more accurate determination of expense than accounting for forfeitures as they occur.

*Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?*

The Company agrees that the intrinsic value method with remeasurement through the settlement date is an appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value.

*Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?*

The Company agrees that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. In addition, *de minimus* benefits related to employee stock purchase plans, such as waiving brokerage commissions, should not negate the non-compensatory determination of these types of plans.

*Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?*

The Company believes that the requisite service period is the appropriate basis for attribution.

*Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?*

The Company believes that the guidance in the Exposure Draft is sufficient to analyze the terms and conditions of an award when the award contains more than one service, performance, or market condition.

***Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?***

The Company understands the rationale behind accruing compensation cost for awards with a graded vesting schedule. However, this requirement would add a significant additional layer of complexity to the accounting and record keeping for these awards; especially given the proposed treatment of deferred taxes related to those awards.

Under Statement 123 companies were allowed to accrue for compensation costs for awards with graded vesting using a straight-line method. Under either method, the same total amount of compensation cost is recognized. Therefore, it is our position that the original provisions of Statement 123 on this issue should be maintained and companies be allowed to select either the proposed separate awards/separate vesting periods method or the straight-line method to calculate compensation expense related to awards with graded vesting.

***Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.***

The Company finds the principles related to accounting for modifications, settlements, and cancellations of awards comprehensive and appropriate. We agree that additional guidance is necessary to appropriately recognize the additional compensation expense related to the modification of an award.

***Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board’s rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?***

The Company disagrees with the underlying theory in the Exposure Draft of taking tax deficiencies to earnings while taking benefits to equity. Tax benefits and deficiencies should be recognized in either earnings or equity. Tax benefits and deficiencies are the result of differences between GAAP and tax law. Overall, the Company believes that an earnings classification is more appropriate for both tax benefits and

deficiencies, as these differences between GAAP and tax law are similar to other non-temporary differences under SFAS 109, which are recognized in earnings.

***Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.***

For many companies, share-based payment arrangements represent an immaterial component of compensation expense. For these companies, requiring a significant increase to existing disclosure requirements, as proposed in the Exposure Draft, would be especially onerous with little added benefit. For any company, recognition of the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for (1) sufficient detail to disclose matters that make a difference to users, yet (2) sufficient condensation to make the information understandable, keeping in mind costs of preparing and using it. We believe that the objectives set forth in the Exposure Draft go beyond the minimum disclosures required to provide sufficient, understandable detail related to share-based payment arrangements. We do not believe that the added disclosures proposed in the Exposure Draft add value to financial statement users nor add information that makes those financial statements more understandable. The Company suggests that on an ongoing basis the footnote disclosures for share-based payment arrangements be limited to, (1) information on the types of plans used, including material changes or expected changes in the habits of issuing awards, and (2) the assumptions and policies used to measure the cost of those plans, including the Company's policy for forfeitures and amortization methods, and any significant changes in those assumptions or policies among the years presented to the extent those changes are material.

***Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?***

The Company agrees with the transition provisions of the Exposure Draft, but believes that entities should be permitted to elect either the prospective, modified prospective, or retrospective application methods as permitted in Statement 148 in applying the Proposed Statement. In recognition of the divergent and conflicting views within the business community, selection of one of the three methods permitted under Statement 148 would enable companies to adopt the new accounting rules in a manner appropriate to each company's situation.

***Issue 14–Issue 15:*** These questions deal with non-public entity/small business issues. Consequently, we have chosen not to comment, as these issues are not applicable to the Company.

***Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax***

***benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?***

The Company disagrees with reflecting excess tax benefits as financing cash inflows. The reduction of taxes paid to a taxing authority is an operating activity and should not be considered an equity transaction and thus recorded as a cash flow from a financing activity. We view the tax accounting as a result of an equity transaction a separate non-equity transaction. This approach is in alignment with the Company's position of reflecting both tax benefits and deficiencies in earnings in Issue 11. The cash flow reporting requirement proposed in the Exposure Draft is inconsistent with SFAS No. 95, and diverges from International Accounting Standards. The Company believes the Board should retain SFAS No. 95 classification for taxes and continue reflecting excess tax benefits in cash flows from operating activities. This has the additional advantage of being in convergence with IFRS.

***Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?***

The Company believes convergence with IFRS 2 should only occur when convergence is theoretically supportable and practicable. Our primary concern is the difference in accounting for income tax effects. The Company supports the Board's conclusion that the tax effects for share-based payment arrangements result solely from different measurement dates. Therefore, we support a departure from IFRS 2 related to income tax effects of share-based payment arrangements.

***Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?***

Although there are still some areas of the proposed statement that are open to interpretation and further analysis, we believe that the Statement, taken as a whole, can be read and understood by those possessing a reasonable level of accounting knowledge.

As always, the Company appreciates the opportunity to participate in the standard setting process.

Sincerely,

/s/ Glenn P. Barba  
Vice President, Controller and Chief Accounting Officer  
CMS Energy and Consumers Energy