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Letter of Comment No: 5285
File Reference: 1102-100



June 24, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Subject: File Reference No. 1102-100

Dear Ms. Bielstein:

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards, *Share-Based Payment*.

EEI is the association of the United States investor-owned electric utilities and industry affiliates and associates worldwide. Its U.S. members serve over 90 percent of all customers served by the investor-owned segment of the industry. They generate approximately three-quarters of all the electricity generated by electric utilities in the country and serve approximately 70 percent of all ultimate customers in the nation. EEI members own a majority of the transmission and generation facilities in the nation.

EEI believes that expensing share-based awards, using a fair value approach, will undoubtedly result in the use of estimates. The following comments call for flexibility in choosing among alternative estimation techniques; simplicity, where possible in the accounting and disclosures; and consistency of requirements both within this new standard, as well as in relation to other standards.

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Issue 4(b): 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?

EEl believes that there should not be a preference of one model (the lattice) relative to another model. FASB should give the users of valuation models the flexibility to use the method that they deem appropriate considering the costs and benefits of all available models applied to the unique circumstances for their company.

EEl believes that no matter what model is used, the various input requirements will be based upon the reporting entity's experience and judgment. Although the lattice model accommodates more complex assumptions, that may not be necessary for all entities. EEl does not believe empirical evidence has been provided that one model is better than another but does believe that the lattice model is more complicated for companies to implement and utilize on a going forward basis. Though the lattice model appears to be based on sound principles and is supposed to reflect the restriction on options issued, there are more complex input variables that do not necessarily provide what would be termed as a more "realistic" price. Therefore, EEl does not agree that the lattice model produces a more realistic valuation versus a Black-Scholes-Merton type model. Both models are built upon various input variables that are produced by the company based on experience and judgment.

Ultimately, the calculation of the fair value is an estimate. Therefore, how can it be said that one model's estimate versus another's is a more accurate estimate when both models allow the variables to be changed period to period. Therefore the FASB should not give preference to one model over another.

Issue 4(c): If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

EEl does not believe that the Board should require a specific method of estimating expected volatility. The ultimate goal in valuing equity compensation using a pricing model is to arrive at the most reliable estimate possible. In that regard, expected volatility of an equity instrument can often be impacted by

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more than just historical volatility. Some other factors that can affect volatility include:

- significant changes in corporate structure (acquisitions, sales, etc.)
- changes in historical cash and stock dividend distributions
- issuance or buyback of common equity shares
- issuance or buyback of preferred equity shares
- significant on-going industry events not occurring in the past

Though many of these factors happen during the normal course of business and can be deemed part of historical volatility, knowledge of significant current or planned events can impact the future volatility. Therefore, EEI recommends that FASB retain the approach in the proposed Statement and also allow other supported factors to be considered in determining expected volatility.

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?

EEI does not agree that the proposed single method of accruing compensation cost for awards with graded vesting schedules should be required, for the following reasons:

- Complexity – this requirement will add significant complexity to the accounting and record keeping for these awards, especially given the proposed treatment of deferred taxes for these awards. EEI does not believe that this additional complexity is cost beneficial.
- Expense pattern – EEI understands the theoretical attractiveness of the multi-award, multi-attribution period approach proposed in the Exposure Draft. However, EEI is not persuaded that the front-end loading of expense that results from this approach is a more proper reflection of the

cost of these benefits. The single award approach leads to a more straight-line expense recognition pattern, which is arguably more consistent with how employees are more likely to attribute value to the awards that vest in the later years of these arrangements; however, under the proposed approach, these later years would have very little cost attributed to them.

For these reasons, EEI believes that the expense recognition option that exists in current literature should be retained.

If the Board does require the proposed method of accruing compensation cost for awards with graded vesting schedules, EEI requests that when the accrued compensation cost would be immaterial to the entity, that the expense recognition option that exists in current literature be allowed.

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.

EEI believes the accounting treatment under existing authoritative guidance (e.g., FIN 44) is simpler to apply and provides an estimate of the additional compensation expense, if any, that is just as accurate as the method(s) prescribed in the ED. In the ED, the rules for modification of vesting conditions and settlements are extremely complex and subject to broad interpretation.

Issue 11: 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?

EEI does not agree with the method of accounting for income taxes proposed in the ED. We believe existing GAAP should be changed to allow for all excesses and benefits to be recognized either in earnings or in equity. EEI believes that

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there is no theoretical rationale for tax benefit excesses and deficiencies, which are essentially identical in nature, to be accounted for differently, as proposed by the ED.

EI believes that tax benefit excesses and deficiencies are caused by differences between GAAP and tax law with regard to the treatment of this element of compensation cost, and that the conceptual framework and SFAS 109 would support the treatment of these differences as components of income tax expense. Conversely, under the Board's approach as described in paragraph C129, both tax benefit excesses and tax benefit deficiencies can be argued to result from "an equity transaction." EI believes that different treatment of excesses and deficiencies is not justified in either of these frameworks. Given the choice between earnings or equity classification, EI believes that earnings classification is more appropriate as these amounts result from differences between tax law and GAAP, and are very 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.

The disclosure objectives outlined in the ED are reasonable objectives, but EI believes the level of disclosure is excessive in relation to those objectives. As share-based compensation is recognized consistently in the financial statements, EI believes footnote disclosure requirements should change, but not necessarily increase. The level of disclosure should be in correlation with the effect share-based awards have on the base financial statements. This was not an option in the past since the total effect was not presented in earnings.

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Significant disclosure of events that are recurring and not material to the base financial statements should not require over three pages of footnote disclosure, which is what the ED suggests.

EEl suggests that any incremental disclosure above that outlined in SFAS 123, as amended by SFAS 148, be omitted from the final standard. EEl also suggests that after the transition phase ends (all years presented in the financial statements have share-based awards expensed on the same basis), that disclosure of the level of estimated expense, income tax benefits, and cash flows associated with share-based awards be expanded upon in the footnotes to the extent they materially affect the base financial statements. On an ongoing basis, the level of footnote disclosure should be limited to:

- information on the types of plans used, including material changes or expected changes in the habits of issuing awards, and
- 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: 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?

EEl does not agree with the transition provisions of the proposed statement. EEl believes the three methods permitted in SFAS 148, prospective, modified prospective and retroactive restatement, should be allowed, in recognition of the divergent views of the business community on accounting for stock options. This would be an accommodation which would enable companies to adopt the new accounting rules in an expeditious manner appropriate to each company's situation.

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?

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EEl disagrees with the cash flow statement treatment of excess tax benefits proposed in the ED. EEl believes the introduction of "cash effects" rather than cash flows, into the statement of cash flows is in conflict with SFAS 95's focus on presenting categorized actual cash payments and receipts. EEl does not favor creating the precedent of departing from the current SFAS 95 framework.

- Focus on cash flows – SFAS 95 sets forth a very clear and understandable focus on actual cash flows as the information that is to be reported in the statement of cash flows. EEl agrees with this focus, and believes that this focus has contributed to establishing the cash flow statement as a financial report that is very informative and valuable to users.
- Focus on nature of specific cash flow - SFAS 95 segregates cash flows on the basis of the nature of the individual transaction. Transactions with providers of capital are reported as financing cash flows, transactions related to productive assets are reported as investing cash flows, and other transactions, typically related to amounts reported in the income statement, are reported as operating cash flows.

The proposed treatment of excess tax benefits would violate both of these tenets of SFAS 95. First, the proposal would result in the reporting of a "cash effect," and not an actual cash flow. EEl views this as inappropriate, and without precedent. To remain as a clear, understandable and informative statement, the statement of cash flows must remain consistent with its title – it must be a statement of cash flows. There is no discrete, identifiable cash flow associated with the proposed "cash effect." Conceptually, EEl believes that payment of taxes is a basic operating activity and is most meaningful reported in its entirety in the operating section of the statement of cash flows and bifurcating this "cash effect" in the financing section is not necessary. Second, the proposed treatment would classify this "cash effect" based on the nature of the related capital transaction – the acquisition of shares – instead of the actual cash flow – a reduction in taxes paid to a governmental entity (clearly an operating transaction). EEl similarly views this as inappropriate, and without precedent.

EEl also notes that mirror treatment is not provided for deficient tax benefits realized upon exercise/expiration of awards. This inconsistency does not appear to be theoretically justified either, and appears to reflect a punitive focus on providing mechanisms to reduce, but not increase, operating cash flows. EEl believes that similar transactions should be reported similarly.

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EI further observes that many transactions of an investing and financing nature, such as sales of productive assets and early extinguishments of debt, have "cash effects" on taxes that are driven by the related investing and financing transaction. EI believes that isolating this single "cash effect" on a piece-mail basis creates internal inconsistencies with regard to the treatment of income taxes in the statement of cash flows, for little perceived benefit.

Other Issue Identified in the ED

EI also believes that companies should be allowed the choice of estimating forfeitures in advance or accounting for them as they occur, consistent with current practice. The ED acknowledges that the value of compensation associated with share-based awards is an estimate for which flexibility is required to arrive at a proper value. It is inconsistent that the ED would not provide flexibility when recognizing forfeitures. Each company should be allowed to choose and consistently apply a forfeiture recognition policy. Mandating a forfeiture estimate on top of an expense estimate will make the record keeping effects of adoption excessively complicated for companies that do not have methods in place that currently estimate forfeitures. Also, in any given year, there is no evidence to support that a forfeiture estimate will result in a more accurate estimation of expense than accounting for forfeitures as they occur.

EI appreciates the opportunity to respond to the proposed Statement. We hope that our comments will be helpful and look forward to working with the Board in the future.

Sincerely,

/ s /

David K. Owens
Executive Vice President
Business Operations

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