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Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
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Subject: File Reference No. 1102-100

Dear Ms. Bielstein:

We are writing to provide our views on the Exposure Draft, *Share-Based Payment*. While we accept the Board's tentative conclusion on the threshold issue of whether stock options should be expensed and its proposed guidance related to determining fair value, we do not support the ED as a whole because we strongly disagree with provisions in the ED related to the accounting for income taxes and transition. We also question the need for the proposed additional disclosures.

Income Taxes

Our views of the ED, and indeed of SFAS 123, are strongly tempered by their income tax accounting provisions. One of our most difficult challenges has been explaining to management and directors, who in turn are accountable to financial statement users, that the total net earnings charge associated a stock option grant will change – will actually increase – if the underlying options convey less value to their holders by failing to reach a certain intrinsic value. This stands in marked contrast to the absence of a countervailing credit to earnings when the option grant conveys significantly more value than the amount measured at the grant date.

To characterize the ED's accounting as counterintuitive is to be very kind. The asymmetry in the treatment of tax benefits is a critical weakness in the approach, both from a technical standpoint under FAS 109, and from a conceptual standpoint, given the ED's characterization of an employee stock option as containing both compensation and equity transaction elements. We acknowledge that the tax accounting proposed in the ED first appeared in SFAS 123, but suspect that it drew little attention for two reasons: first, few companies adopted the voluntary SFAS 123 expense recognition provisions, so the tax accounting question arose infrequently; second, and consequentially, paragraph 44 of SFAS 123 is not as clear on this point as it might be. The combination of these two factors meant that this question has only recently begun to garner the attention it deserves.

In this light, we think it is in the best interests of all constituents – including the Board, preparers, users, regulators and auditors – to adopt this counterintuitive approach only if it is the only one available. Fortunately, it is not. Fortunately, it may not even be the best answer according to accounting theory, a point that we shall demonstrate in the following paragraphs. And in the circumstance that accounting theory and business intuition support the same answer, we believe the Board should embrace it and declare a well-deserved victory.

Following is the basis for the tax accounting conclusions, as we understand it, from paragraph C129 of the ED:

- Each stock option transaction comprises both a compensation transaction and an equity transaction. (We agree.)
- To the extent that, upon exercise, intrinsic value exceeds the option's fair value at the date of grant (usually all time value) tax benefits affect the equity transaction, not the compensation transaction. (We agree.)
- As compensation expense is recognized, a temporary difference is created that is associated with the time value, and that difference must be recognized as a deferred tax asset. (We disagree, and recommend a better approach below.)
- When, upon exercise, intrinsic value is less than the grant date fair value, the deferred tax asset that arose from the compensation transaction must first be recovered; any shortfall results in the reversal of that previous benefit through operations. (We disagree, and recommend a better approach below.)

To summarize our difficulties with the deferred tax asset approach, it is clear under SFAS 109 that deferred tax accounting deals with differences between accounting and tax law when measuring temporary differences. The ED's approach of determining the consequence based on the lesser of compensation cost or tax benefit stands without analogy so far as we can ascertain, seems to have been constructed out of whole cloth, and seems clearly to contravene the fundamental theory of SFAS 109.

Our approach to this question is constructed on a single principle that is critical to the evaluation of the proper tax accounting:

For traditional fixed price stock options there is no tax deduction for an employee option's time value under U.S. tax law. Ever. Consequently, a deferred tax asset cannot be recognized. Rather, a deferred tax liability is created, as we discuss further below. The only sensible choice is to net the tax effect of the option's time value against the equity component of the transaction.

Rarely are accounting transactions as independent of analogy as this one. Specifically, it is extremely rare for both the method and timing of measurements to differ for accounting and tax purposes. Indeed, the only analogy we can find arises from accounting for convertible debt when proceeds are separated into debt and equity portions based on fair value at issuance date. IAS 32 requires such accounting, and resulting tax effects under IAS 12 provide a powerful analogy that we believe should be extended to stock options. We have attached the relevant

portion of IAS 12 illustrating this accounting treatment, but the critical portions are the following:

- Convertible debt must be divided into debt (which reflects the time value discount attributable to the debt host) and equity portions based on fair value at the date of issuance.
- The time value portion will be recognized as expense on the interest method, that is, as time passes. This is accretion of original issue discount for book purposes. Such time value accretion is not deductible for tax purposes, just as the time value of stock options is never deductible.
- In IAS 12, Example 4, the discount on the debt gives rise to a taxable temporary difference that is recognized as a deferred tax liability, but recorded in equity. This is similar to the deferred tax liability associated with the ED's prepaid compensation, which we view as an asset that is displayed as an offset in equity. We believe this deferred tax liability approach to be consistent with other assets that have a book but no tax basis. Because the deferred tax liability is caused by an equity transaction in both cases, stock option accounting should follow the convertible debt example and record the tax debit in equity.
- As interest on the convertible debt accumulates, the deferred tax liability is required to be reversed to earnings. Similarly, recognition of compensation expense would consume the deferred tax liability we set up on grant date.
- All actual tax effects resulting from exercise of the stock option would be recognized under this approach as adjustments to equity. This is proper because they result entirely from stock price changes between grant date and exercise date – they are therefore indisputably related to the equity transaction element of the stock option.

While U.S. standards do not require this bifurcation of convertible debt, we certainly believe the IASB's tax accounting to be appropriate under SFAS 109. In fact, this approach is similar to that required by SFAS 109 for tax effects of other equity transactions. Consider the example of an asset acquired with a combination of cash and a commitment to issue a fixed number of shares of equity at a certain future date. For tax purposes, the value of the stock issued (and thereby the tax basis of the asset acquired) is determined based on the stock's fair value at the future date when it is legally issued. If the value of the shares when issued differs from the value at commitment date, a deferred tax results, and paragraph 36(c) of SFAS 109 requires that deferred tax to be recognized in equity as an adjustment to the proceeds of the shares. Issuing shares to employees is, in our view, essentially the same kind of transaction, and the accounting logically should follow the same principles.

There is no question that there is a real economic benefit to the enterprise associated with tax deductions related to employee stock option exercises. Over the life of an option, the amount of the intrinsic value captured in option exercises gives rise to a tax benefit to shareholders that is not recognized in earnings. We are willing to accept that result provided that the Board adopts an accounting model that makes sense. Our recommended accounting for the income tax effects of options is more consistent with FAS 109 than that proposed in the ED and is conceptually

sound. In addition, our proposed model is symmetrical and even-handed with respect to changes in stock prices subsequent to the grant date. We recognize that there will be implementation issues (for example, options granted in the money) but we believe that these are solvable under the approach we recommend.

Transition

In 2002, GE elected to voluntarily adopt the fair value based method of accounting for stock options under FAS 123 using the prospective approach, which was permitted under the provisions of FAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*. Like other companies that adopted the preferable accounting method under FAS 123, we did so with a reasonable expectation that the FASB's decision in FAS 148 to permit companies to adopt the fair value method using the prospective approach would not be reversed by FAS 123R. Our view was based, in part, on the reasoning in paragraph A12 of FAS 148, which states:

“...the Board believes that the new disclosures required by this Statement mitigate those [comparability] concerns by providing information that enables users of financial statements to make comparisons.”

We agree with the Board's view that the revised disclosures required by FAS 148 (which provide the total amount of compensation expense, split between amounts recognized in earnings and pro-forma amounts) are sufficient to allow meaningful comparisons among entities despite differences among them related to transition methods and timing of expense recognition. We note that the proposed requirements in the ED would not adversely affect the utility of those disclosures.

We believe it is wholly inappropriate for the Board to require those companies that have voluntarily adopted the accounting provisions of FAS 123 prospectively, as permitted by FAS 148, to have to “readopt” under the revised standard. Given the way that the Board positioned FAS 148, the subsequent imposition of a blanket requirement to apply the modified prospective approach would appear to some as dealing in bad faith. A prospective approach to applying the provisions of the new standard is the fairest way to deal with those companies that have already adopted FAS 123.

Moreover, if the Board retains the modified prospective approach in the final standard we would expect comparability to suffer. We understand that some benefits consultants are advising companies that had not previously adopted FAS 123 to consider cliff vesting all outstanding unvested options prior to adoption of FAS 123R on January 1, 2005. This would result in a large pro-forma charge in 2004 and ramp-up for 2005 and later years that would mirror a prospective method of adoption. Given that many of the options in question may be significantly out of the money, the loss in retention value for doing so may be trivial compared with the comparative benefits to earnings in 2005 and beyond. Ironically, such actions would not benefit companies that early-adopted FAS 123. While we would not consider doing so, it is important to understand the potential implications of the proposed transition requirements on those companies that have, and have not, adopted the expense provisions of FAS 123.

We ask that Board think carefully about its decisions regarding transition methods in light of these concerns. Inevitably, transition issues require the Board to make trade-offs among

competing objectives and they involve an element of pragmatism that takes into consideration the differing circumstances of companies prior to adoption. We believe that a reasonable compromise would be to allow companies that have chosen to voluntarily expense stock options using the prospective method to continue to apply that approach upon adoption of the final standard. We hope that the Board will affirm the decisions it made in FAS 148 and continue to permit a prospective approach.

Disclosures

Given that the focus of this project was to require recognition and measurement of the cost of stock options in financial statements, one would have expected that less disclosure in financial statements would be necessary than under the disclosure option in FAS 123. We note that the robust set of disclosures required by FAS 123 was intended to compensate for the fact that the standard did not require stock options to be expensed. The ED appears to expand significantly on those disclosures. For example, paragraph 191(h) requires disclosure of the total unrecognized compensation cost and the weighted average period over which it is expected to be recognized in earnings. At the end of any given year, this amount will not usually provide users with a forecast of compensation expense that will actually be recognized in future years because of changes in the composition of options outstanding, including: forfeitures, cancellations, the addition of new grants in the new reporting period, etc. The ED also requires an exhaustive list of disclosures about the intrinsic values of options, disclosures that seem odd for a proposed standard that requires recognition of options at fair value.

We believe that the level of disclosure far exceeds the needs of investors and other financial statement users. It also is unclear to what use these new disclosures will be put – the basis for conclusions provides little direct insight or support. We believe that if the disclosures proposed cannot be persuasively supported as fulfilling a specifically identified user need, they should be deleted.

Please feel free to contact me at (203) 373-2458 if you have any questions regarding this response.

Sincerely yours,



Example 4 - Compound Financial Instruments

An enterprise receives a non-interest-bearing convertible loan of 1,000 on 31 December X4 repayable at par on 1 January X8. In accordance with IAS 32 *Financial Instruments: Disclosure and Presentation* the enterprise classifies the instrument's liability component as a liability and the equity component as equity. The enterprise assigns an initial carrying amount of 751 to the liability component of the convertible loan and 249 to the equity component. Subsequently, the enterprise recognises imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the enterprise to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

The temporary differences associated with the liability component and the resulting deferred tax liability and deferred tax expense and income are as follows:

	X4	X5	X6	X7
Carrying amount of liability component	751	826	909	1,000
Tax base	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
Taxable temporary difference	249	174	91	-
	=====	=====	=====	=====
Opening deferred tax liability at 40%	0	100	70	37
Deferred tax charged to equity	100	-	-	-
Deferred tax expense (income)	-	<u>(30)</u>	<u>(33)</u>	<u>(37)</u>
Closing deferred tax liability at 40%	100	70	37	-
	=====	=====	=====	=====

As explained in paragraph 23 of the Standard, at 31 December X4, the enterprise recognises the resulting deferred tax liability by adjusting the initial carrying amount of the equity component of the convertible liability. Therefore, the amounts recognised at that date are as follows:

Liability component	751
Deferred tax liability	100
Equity component (249 less 100)	<u>149</u>
	<u>1,000</u>
	=====

Subsequent changes in the deferred tax liability are recognised in the income statement as tax income (see paragraph 23 of the Standard). Therefore, the enterprise's income

statement is as follows:

	X4	Year X5	X6	X7
Interest expense (imputed discount)	-	74	83	91
Deferred tax (income)	---	(30)	(33)	(37)
	-	---	---	---
	-	45	50	54
	====	=====	=====	=====