



Letter of Comment No: 5862
File Reference: 1102-100

June 30, 2004

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

File Reference No. 1102-100 – Proposed Statement of Financial Accounting Standards
Share-Based Payment, an amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein:

U.S. Bancorp appreciates the opportunity to comment on the Proposed Statement of Financial Accounting Standards Share-Based Payment, an amendment of FASB Statements No. 123 and 95 ("Exposure Draft"). U.S. Bancorp is the seventh largest financial services holding company in the United States. Major lines of business include wholesale banking, consumer banking, private client, trust and asset management, and payment services.

Fair Value Measurement

U.S. Bancorp agrees that share-based payments to employees are a valuable form of compensation to employees. In addition, we agree that binomial or lattice models take into consideration important factors related to the unique characteristics of employee stock options such as lack of transferability and length of term which are not incorporated into Black-Scholes or other closed form models. However, we do not believe that the Board should indicate that one model is required or preferable over other models available. Binomial models are more complex and costly to implement and may be a burden for smaller companies. The additional burdens for compiling the data required to value options using a binomial model may far outweigh the benefits of a more precise valuation result. In addition, new models may be developed in the future that are an improvement over currently existing models. We recommend that the Board provide for the possible development of other models in the future and allow for flexibility between binomial and Black-Scholes models without stating a preference for either method, thus, allowing financial statement preparers to select the model that best fits their circumstances.

Attribution of Compensation Cost

U.S. Bancorp agrees that compensation cost for share-based payments should be recognized over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. However, U.S. Bancorp does not agree with the Board's decision to require share-based payments with graded vesting schedules to be accounted for as separate awards and treated as prescribed in FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28). Compensation cost should be

recognized as the employee provides the service (i.e., earns the award) and the company receives the benefit for the services rendered. FIN 28 provides for a disproportionately high allocation of compensation to the earlier vesting years and a much lower allocation in the later years. For example, under FIN 28 a four-year stock option with graded vesting provisions that provides for 25% of the award to legally vest each year on the anniversary of the grant date would result in compensation expense in the first year equal to approximately 52.1% of the total value of the award even though the employee has earned only 25% of the total award at the end of the first vesting year. If the employee terminates employment immediately after the first vesting year, the employee has earned the right to exercise only 25% of the total award; consequently, the company must reverse compensation cost equal to 27.1% of the total value of the award (52.1% less the 25% actually earned). This approach results in expense patterns that are not representative of the economic benefit provided by the employee.

In addition, most companies that grant graded vesting options consider the award to be a single award for administrative purposes. U.S. Bancorp believes that the disconnect between the accounting attribution method and the legal vesting adds complexity to the accounting without much practical or theoretical merit. The Board stated in the Exposure Draft that Statement 123 permitted the straight-line method in part because it is simpler than the method required by FIN 28. Further, the Board stated in the Exposure Draft that it wishes to eliminate alternatives wherever possible and appropriate because doing so simplifies accounting standards. We believe that requiring the attribution method defined by FIN 28 complicates the accounting operationally for share-based payments and results in expense recognition that is not representative of the economic benefit provided and received. We strongly recommend that the straight-line method of attribution be allowed or required for share-based awards with graded vesting schedules.

Income Taxes

The Board reconfirmed in the Exposure Draft the conclusion reached in Statement 123 that compensation cost recognized in the financial statements gives rise to a temporary difference to be accounted for under FASB Statement No. 109, "Accounting for Income Taxes ("SFAS 109")" and any deferred tax assets recognized for those temporary differences is not remeasured at subsequent balance sheet dates for changes in the amount that would be deductible for tax purposes.

In addition, the Board concluded that the tax effects of a share-based award to an employee relate to two separate transactions: 1.) compensation which is an income statement event and 2.) share price changes between the grant date and the date the award is exercised or otherwise settled. Under this approach, the fair value of the award on grant date is compensating the employee for services rendered and should be reflected in the income statement as compensation cost and any changes in value of the award between grant date and the date the award is exercised or otherwise settled is an equity transaction.

Consistent with Statement 123, the Board concluded that tax deductions in excess of recognized financial reporting compensation costs (i.e., tax deductions that result from increases in intrinsic value after the grant date) are due to an equity transaction and should be reflected in paid-in capital. U.S. Bancorp agrees with this conclusion. Statement 123 also requires that, if the tax deduction is less than the amount of the

previously recorded deferred tax asset, the write-off of the deferred tax asset should be recognized in the income statement, except to the extent of any remaining paid-in capital attributed to previously recognized excess tax deductions related to awards previously accounted for using the fair-value based method. However, the Exposure Draft proposes a change to that treatment that would require recognition of the full amount of any deferred tax asset write-offs for tax deficiencies through the income statement. We do not understand how this proposal is consistent with the Board's view that the effects of share price changes after the award is granted are equity transactions. We believe treating deferred tax asset write-offs for tax deficiencies inconsistently with the accounting for excess tax deductions also resulting from share price changes is not logical when both are clearly related to an equity transaction. Therefore, we strongly disagree with the Board's conclusion that deferred tax asset write-offs resulting from share price changes should be recorded in the income statement. We recommend the Board finalize the standard with a method that treats all tax-related adjustments resulting from share price changes consistently as equity transactions recorded in paid-in capital (hereafter referred to as "View 1").

We recognize that the tax accounting proposed in the Exposure Draft has similarities to the tax accounting specified in Statement 123. However, very few entities have adopted the fair value method of accounting, and most of those that have adopted the fair value method did not elect to do so on a retroactive restatement basis. As a result, the tax accounting required by Statement 123 has not yet impacted the financial statements of many of the companies that have adopted the fair value method and we believe this issue has not gained as much attention as it deserves. U.S. Bancorp adopted the fair value method of accounting effective January 1, 2004 and elected the retroactive restatement method. As a result, we are implementing the tax accounting required under Statement 123 and understand the operational complexities, theoretical inconsistency and unexpected financial implications associated with the tax accounting proposed in the Exposure Draft.

U.S. Bancorp recommends the Board also consider an alternative method to account for the income tax impacts of share-based compensation payments as described below (hereafter referred to as "View 2"):

View 2

View 2 is based on the deferred tax accounting under SFAS 109 and the guidance it provides on measuring timing differences between accounting recognition and tax law. Fundamental to View 2 is the assertion that a typical stock option granted with zero intrinsic value (i.e., the stock price on the grant date equals the option exercise price) has a fair value at the date of grant that is entirely time value. Under U.S. tax law there is never a tax deduction for the time value of an option; therefore, no timing difference exists and no deferred tax asset should be recognized. Instead a deferred tax liability should be recognized and the offset to this tax effect of the option's time value should be charged against equity. This alternative method is similar to the international accounting for convertible debt when proceeds are separated into debt and equity portions based on fair value at issuance date. IAS 32 describes this accounting and when combined with the accounting for the tax effects as described under IAS 12 could be applied by analogy to stock options and other share-based payments. This alternative is more fully described in General Electric Company's June 8, 2004 comment letter on the Exposure

Draft. General Electric Company outlined the key points of the analogy to IAS 32 and IAS 12 as follows:

- 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 Exposure Draft's prepaid compensation, which we view as an asset that is displayed as an offset to equity. We believe this deferred tax liability approach to be consistent with other assets that have a book but not 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 stock options.

We believe this concept has merit and is appropriate under the general concepts of Statement 109. This method would require further analysis to determine the application to stock options that have intrinsic value at grant date and for restricted stock awards, but we believe acceptable guidance for those types of awards could be developed under this approach.

U.S. Bancorp believes View 1 is a variation of the approaches defined in both the Exposure Draft and Statement 123. View 1 does not involve any significant new concepts and therefore is the easier route for the Board to achieve consistent accounting treatment for excess tax benefits and tax deficiencies. However, U.S. Bancorp also believes the method described in View 2 has merit and should be considered.

Transition

U.S. Bancorp believes the retrospective restatement method of adoption should be allowed as an alternative to the modified prospective method as it is the only method that provides for maximum amount of comparability between periods and thus enhances the usefulness of comparative financial statements.

Disclosures

The Exposure Draft is unclear on how some of the specific requirements outlined in paragraph B191 assist with meeting the disclosure objectives in paragraph 46. In addition, we believe there is less need for disclosures, rather than more, since share-based compensation will be included in the income statement. We do not understand why an exhaustive list, specifically paragraph B191 b. through d., of exercise prices, fair values, and intrinsic values is required when the impacts of potential exercises are included in diluted earnings per share calculations. In addition, paragraph B191 h. requires disclosure of total compensation cost related to unrecognized nonvested awards (i.e., unamortized compensation expense) and the weighted-average period over which it is expected to be recognized. We do not believe this disclosure provides useful information to financial statement users. It is not possible to ascertain the amount of stock-based compensation in future years from this disclosure due to new grants and forfeitures on existing grants and the impact of unamortized compensation expense is included in diluted earning per share calculations when appropriate. We recommend that the disclosures referenced above be eliminated in the final standard.

Effective Date

The Exposure Draft requires adoption for public companies prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value based method of accounting. U.S. Bancorp adopted the fair-value based method of accounting using the retrospective method in January 2004, and consequently gained an understanding of the operational accounting complexities related to income taxes and earnings per share following Statement 123. To our knowledge there are no share-based payment administrators whose systems properly account for these more complicated features of Statement 123. It is our understanding that many share-based payment administrators, including ours, have not completed all programming changes required by the Exposure Draft and will not have their product ready for wide-spread distribution to their clients as of the proposed effective date. Significant enhancements are needed to computer systems to be fully compliant with the requirements of Statement 123 and any changes required by the Exposure Draft. We recommend that the effective date of adoption for public companies be for periods beginning after June 15, 2005.

Thank you for your time and consideration with respect to our views on this matter. Please contact me at (612) 303-4352 with questions or if you need additional information.

Sincerely,

Terrance R. Dolan
Executive Vice President and Controller