

June 30, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
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Re: File Reference No. 1102-100

The undersigned wishes to comment on behalf on The Boeing Company (the "Company") on the Exposure Draft, *Share-Based Payment – an amendment of FASB Statements No. 123 and 95*. In 1998, The Boeing Company became one of only two Standard & Poor's 500 companies that voluntarily adopted the recognition provisions of FASB Statement No. 123, by recording share-based compensation expense in our financial statements based on fair value. We applaud the FASB's efforts to improve accounting for share-based compensation; however, we wish to convey certain comments on the Exposure Draft, as set forth herein. Our two key concerns pertain to the following general topics:

- Determination of the fair value for nonvested equity shares or nonvested equity share units, and
- Accounting for income tax effects of share-based compensation.

Determination of the fair value for nonvested equity shares or nonvested equity share units

We believe that the fair value of all share-based compensation awards, regardless of design, should be determined using the concepts present in an option pricing model. We believe that valuation based on market price on grant date generally results in inflated compensation charges, because it does not take into account important factors (such as volatility, expected dividends, and risk free interest rate) that impact the ultimate economic benefit that may be distributed to an employee. However, those factors are incorporated into the use of the lattice or other option-pricing model, and we believe use of such a model is appropriate. Therefore, we strongly suggest that the term "fair value" in this context be clarified to indicate that it implies (or at a minimum, allows) use of an option pricing model.

Consistent with our view above, we believe the guidance in paragraph 18 regarding determination of fair value of nonvested equity shares or share units should be expanded. The Exposure Draft indicates that grants of non-vested equity shares (or share units) shall be measured at fair value, but does not elaborate any further (in paragraph 18, the section that addresses measurement methods) on how fair value might be estimated. We note that in the Exposure Draft discussion regarding valuation of share options, there is helpful dialog regarding the sources and methods that can be used to measure the fair value of share option awards. We believe it would be helpful to include a similar level of guidance in the discussion about fair value of nonvested equity shares and share units. We identified a reference elsewhere in the Exposure Draft which strongly imply that the fair value of nonvested equity shares or

share units may be determined based on use of an option pricing model (paragraph B48). But since that reference is not explicitly linked, nor is the language used to describe the type of stock awards integrated with paragraph 18, it is unclear whether it is intended to provide further guidance.

Accounting for income tax effects of share-based compensation

We believe that all adjustments to previously recognized deferred tax benefits arising from changes in fair value of a company's stock, whether positive or negative, should be recognized as additional paid-in capital. The Exposure Draft specifies that deferred tax assets shall be recorded when share-based compensation expense is recorded. When the ultimate tax benefits become known and require adjustment in the financial statements, adjustments are to be recorded as follows: an increase in tax benefits would be recorded with an offsetting entry to additional paid-in capital, yet a decrease in tax benefits would be recorded with an offsetting entry to decrease earnings. Discussion in Appendix C of the Exposure Draft indicates that increases in tax benefits shall be adjusted through additional paid-in capital, because "increases in intrinsic value after the grant date are due to an equity transaction."

We agree with this view, but also believe that *decreases* in intrinsic value after the grant date would likewise be related to an equity transaction. In other words, we believe that once a share-based award is granted, any subsequent changes in intrinsic value reflect the results of an equity transaction, regardless of the direction of those changes. Accordingly, all subsequent adjustments to tax benefits measured at the date of grant should impact additional paid-in capital.

Additionally, even if the above recommendation is not reflected in the final rules, we believe it is appropriate to use a portfolio approach, rather than an individual-employee-instrument approach for tracking and reporting actual realized tax benefits and estimated accrued tax benefits. The discussion in Appendix C of the Exposure Draft indicates that the Board believes it is inappropriate to reduce volatility in the income statement by allowing a tax deficiency for one employee's award to be netted against an excess tax benefit for another employee's award. However, we believe the proposed practice of tracking and reporting tax benefits and compensation expense at the level of individual employees may not necessarily reflect the employer's stock-based compensation goals, which in many cases may be directed more at share ownership by an employee group as a whole, as opposed to specific individuals. Additionally, we strongly believe that such tracking at an individual employee level would be unduly burdensome from an administrative and cost perspective.

In addition to the two key comments conveyed above, we also wish to express our views on the following topics:

- Accounting for cash flow impacts of tax effects
- Identification of factors that constitute modifications of awards
- Accounting for modifications of performance- and service-vesting conditions
- Accounting for cancellation and replacement of awards
- Required disclosures regarding intrinsic value

Accounting for cash flow impacts of tax effects

We believe there should be symmetry in the cash flow statement presentation of income tax effects of stock based compensation, and such effects should be reflected in the financing section. The Exposure Draft would require that excess tax benefits be reported as cash inflows from financing activities in the statement of cash flows, yet tax deficiencies would be reported as cash outflows from operating activities. Consistent with our view expressed above that changes in tax benefits arising from stock price increases and decreases after the grant date are due to equity transactions, we believe that any such changes in tax benefits (whether upward or downward) should be reflected in the financing section of the statement of cash flows. This presentation would most accurately reflect the nature of the tax impact as an equity transaction.

Identification of factors that constitute modifications of awards

We believe the proposed rules should be expanded to specify factors that would constitute a modification of an award. The Exposure Draft defines a "modification" in Appendix E as "a change in any of the terms or conditions of an award of share-based compensation, including changes in quantity, exercise price, transferability, settlement provisions, and vesting conditions." Based on this definition, if a company enacted a stock-split, and made corresponding adjustments to the exercise price and quantity of outstanding options to keep its option holders economically whole, this would seem to be deemed a modification, strictly based on the definition provided. However, we would disagree that such adjustments should be treated as modifications for accounting purposes. And while the Exposure Draft contains several illustrations of accounting for modifications of awards, it does not provide further clarification of how to treat adjustments that might arise due to a stock split, for example. Accordingly, we believe further guidance should be provided regarding the types of changes in stock-based compensation arrangements that would or would not be deemed modifications.

Accounting for modifications of performance- and service-vesting conditions

We believe more clarity is needed regarding the definition of "probable" that is used in the four categories of modifications of performance- and service-vesting conditions that are described in paragraph C103 of the Exposure Draft. The language in paragraph C103 indicates that a performance- or service-vesting condition that is "probable" is one that is expected to be satisfied or achieved, and conversely, a condition that is "improbable" is not expected to be satisfied or achieved. We believe that paragraph C103 should include a specific reference to Statement No. 5 in order to clarify the meaning of "probable" (as is the case for guidance contained in paragraphs 26A and B76).

Accounting for cancellation and replacement of awards

We believe the Exposure Draft should provide clear guidance on accounting for the cancellation and replacement of awards in situations where the fair value of the replacement award is less than the fair value of the cancelled award. The Exposure Draft addresses the

accounting treatment for “incremental” compensation cost that may result from cancellation and replacement of an award. Yet, for replacement awards with lower fair values than the cancelled awards, the main body of the Exposure Draft indicates that this situation will be rare, and the accounting is not explained, except as demonstrated in Illustration 13(b). First of all, we disagree that the issuance of replacement awards with lower fair values than the original awards would be so rare that the accounting should not be clearly set forth. For example, when replacement awards are granted, employees receiving the awards are aware of terms that impact the economic value to them (such as exercise price, term, etc.). However, they normally are *not* aware of changes in various other assumptions that are used from a financial accounting perspective to determine the award’s fair value (such as volatility, risk free interest rate, etc.). So while we agree that most employees would not accept a replacement award with terms that economically disadvantaged them, those employees would not necessarily be concerned with whether the company’s fair value assumptions that changed in such a way as to result in a lower fair value from an accounting perspective. Secondly, we believe that the accounting guidance currently provided in Illustration 13(b) should be incorporated somewhere into the discussion contained in paragraphs 35 to 35B, so it is not so easily overlooked. In summary, we believe the proposed rules should incorporate clear accounting guidance to anticipate a situation in which a replacement award may have a lower fair value than the cancelled award, and that guidance should be provided in a clear discussion, rather than buried as part of an appendix illustration.

Required disclosures regarding intrinsic value

We believe the proposed disclosures regarding intrinsic value should be eliminated. Among other things, the Exposure Draft would require the following new disclosures to be made:

- Total intrinsic value of options exercised and total intrinsic value of shares vested during the year for each year that an income statement is provided, and
- The intrinsic value of options outstanding, and options currently exercisable as of the date of the latest balance sheet.

Addition of these intrinsic value-based disclosures would create extra work for companies in preparing their disclosures, and at the same time, would detract from the proposed standard’s deliberate focus on fair value-based accounting for stock-based payments. Therefore, we suggest elimination of these intrinsic value-based disclosure requirements.

We appreciate the opportunity to comment on this topic and your attention to our comments.

Sincerely,

Harry S. McGee III
Vice President Finance and Corporate Controller
The Boeing Company