

# Procter & Gamble

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Financial Accounting Standards Board  
Attn: TA & I Director  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

Subject: FASB Project on Equity-Based Compensation

We support the Board's project to comprehensively address the accounting for equity-based compensation arrangements. We certainly recognize that the accounting for equity-based compensation presents difficult considerations relative to the conceptual framework. We offer our perspective on a key element of this matter to assist the Board in ensuring that the project results in a high-quality accounting standard.

While we support the project, we continue to struggle with the inherent valuation limitations of equity-based compensation. We fear that the inaccuracy and volatility of equity-based compensation measures will lead financial statement users to disregard stock compensation charges in order to effectively evaluate an enterprise's performance over a time period and relative to its peers. Thus, we encourage the Board to thoroughly analyze the various fair value models and adequately address the aspects of employee stock options that make their valuation different from the more typical options that existing models were designed to value (e.g., non-traded, longer term).

The element that we would like to provide perspective on is income taxes. We are discouraged by the Board's tentative decision at its November 19, 2003 meeting that enterprises would be required to include in earnings any unrealized tax benefits previously recognized for equity-based compensation. It is difficult to appreciate the conceptual merits of the proposed model, in which higher deductions on a tax return are recognized as a credit to additional paid-in capital while lower deductions are recognized as a charge to the income statement unless there is a "bank" of excess tax deductions from previous stock option exercises. We believe the Board's previous tentative conclusion on this issue is preferred. More specifically, accounting for the income tax impacts of options based on an existing intraperiod tax allocation principle, such that the amount of income tax expense recognized for equity-based compensation plans is reflective of the amount of compensation recognized in earnings, with differences in all realized tax effects, both higher and lower, recognized in additional paid-in capital along with the impacts of underlying option exercise. Under this approach, the accounting for income tax effects of options would match the approach to account for the compensation expense (i.e., the compensation expense and related income tax effect would be set at grant date).

We would like to highlight that the bookkeeping of the tax effects of stock option awards will be a very burdensome process under the Board's tentative conclusion. While Board deliberations typically focus on the effect of an accounting model relative to the U.S. tax code, multinational enterprises will have to devise a comprehensive system to accurately track and reflect the tax effect of each stock option award. As an illustration, suppose a multinational enterprise grants a stock option award to a key manager based in the United Kingdom. The stock option award has a ten-year life. The key manager may relocate to other taxable jurisdictions during the term of the stock option, requiring a continuous reassessment of the tax effects of the outstanding stock

award in order to properly track and forecast actual benefits relative to the amount initially estimated. As you can imagine, the management of this complexity for a broad-based stock option award in multiple tax jurisdictions for multinational enterprises poses a significant administrative effort. A model that recognizes all differences in tax effects on stock options between the amount initially recognized and ultimately realized as additional paid-in capital would have the added benefit of greatly simplifying the requisite accounting effort.

Furthermore, while we are conceptually supportive of international convergence, we do not support the IASB's tentative decision to recognize all tax effects on equity-based compensation arrangements in the income statement. This approach may have a degree of conceptual merit as a measure of ultimate cash benefit associated with the transaction, but we do not believe it is as sound as the intraperiod tax allocation principle under FAS 109. It also fails, in our view, relative to the ultimate litmus test – providing decision-useful financial information to users – because we believe users would object to the potential for companies to report income for higher tax deductions resulting from its share price increasing above the initial compensation expense estimate, particularly prior to realization.

The recent tentative decision is even more difficult to accept given the Board's conclusion that the modified prospective method will be the sole transition provision. Under FAS 148, the Board permits three separate application models for stock-based compensation. Although the retroactive restatement method can be burdensome, this transition provision results in the highest degree of decision-useful information for financial statement users because it displays a true comparative trend in equity-based compensation. As a matter of fact, the virtues of the retroactive restatement were recently validated with the issuance of the FASB's Exposure Draft to revise APB 20. It is incomprehensible to disallow the retroactive restatement method and require the modified prospective method as the sole transition method for equity-based compensation project, but conclude that the retroactive restatement transition method is preferable in the short-term convergence project.

As you know, the retroactive restatement method also has the benefit of permitting enterprises to build a "bank" of credits in additional paid-in capital for excess tax deductions that can be used to minimize the income tax expense exposure for any unrealized tax benefits for subsequent grants. As a result of the Board's tentative conclusions, we can foresee some enterprises pre-empting the new equity-based compensation standard by adopting FAS 123 and FAS 148 just before the new standard's effective date in order to utilize the retroactive restatement method. However, this further compromises the quality of financial reporting, since the modified prospective method could yield another period of non-comparability.

If you have any questions on this comment letter or would like to discuss any of our views further, please feel free to contact me at 513-983-3874.

Sincerely,

*Teri L. List*

T. L. List

Vice President, Corporate Accounting