

Letter of Comment No: 6463  
File Reference: 1102-100

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**Federated**

WORLD-CLASS INVESTMENT MANAGER<sup>®</sup>

July 1, 2004

Director of Major Projects – File Reference No. 1102-100  
Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**Re: Proposed Statement of Financial Accounting Standards “Share-Based Payment, an amendment of FASB Statements No. 123 and 95” (File Reference No. 1102-100)**

Dear Director:

Federated is one of the largest investment management companies in the United States with over \$193 billion in managed assets as of March 31, 2004. The majority of Federated’s revenue is derived from advising and administrating Federated mutual funds, separately managed accounts and other Federated-sponsored products, in both domestic and international markets.

We appreciate the opportunity to comment on the proposed Statement of Financial Accounting Standards “Share-Based Payment, an amendment of FASB Statements No. 123 and 95” (Proposed Statement). We support the FASB’s efforts to achieve consistency in reporting for stock-based compensation across all public companies. We have concerns regarding several issues raised in the Proposed Statement.

**Issue 4(b):** Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. 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?

**Response**

We understand that the Proposed Statement indicates a lattice model as the preferred method for valuing share-based payments; however, it is unclear whether use of alternative methods, including the Black-Scholes-Merton model, is acceptable indefinitely or if all companies will be expected to use a lattice model when they have the historical data used to support the assumptions in this model. The Proposed Statement should be clear on this point.

**Issue 4(d)**: This Proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

**Response**

We agree that compensation cost should be recognized only for instruments that vest. However, we disagree with the Board's elimination of the alternative that allows companies to record forfeitures as they occur. We believe that this option should be allowed for cost-benefit reasons. Estimated forfeitures would be an additional assumption that would need to be constantly monitored to determine if another estimate is more accurate. Many of Federated's options have a ten year vesting period over which employee turnover rates could vary significantly and would require significant efforts to track.

In addition, it is unclear how forfeitures for awards that were granted earlier than the initial adoption of the Proposed Statement will be addressed. Our interpretation of paragraph 21 of the Proposed Statement is that companies would follow the same forfeiture method as elected under the original provisions of SFAS 123. For companies that have used the actual forfeiture method as allowed under SFAS 123, there will be inconsistencies in the timing of expense recognition between grants before and after adoption of the Proposed Statement. We strongly encourage the Board to maintain the option for recording forfeitures as they occur as currently allowed in SFAS 123.

**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?

**Response**

While we agree that it may be appropriate to account for some awards with graded vesting schedules in this manner, we feel that it is inappropriate to generalize all options with graded

vesting into one category. For example, Federated has issued options to employees that vest incrementally over ten years. However, the employee is unable to exercise any of the vested options until the entire ten year period has elapsed. We feel that in a situation like this, the employee's service is provided evenly over the entire vesting period and no more of his service is provided in year one than in year ten. As such, we believe that a straight-line method would more appropriately mirror the service provided by the employee. We encourage the Board to allow companies to consider the unique characteristics of each grant and choose the method of amortization that best matches the pattern in which the services are provided.

**Issue 11:** This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. 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?

**Response**

We do not support the method of accounting for income taxes established by this Proposed Statement. We recommend that no distinction be made in the accounting for tax benefits and tax deficiencies. We believe that both the benefits and deficiencies should be recognized in full in equity. These tax consequences, whether benefits or deficiencies, arise from fluctuations in the market price of the grantor's stock and represent equity investment activity. Therefore, the tax benefits and deficiencies should be treated consistently by an entry to equity.

**Issue 13:** This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. 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?

**Response**

Effective January 1, 2003, Federated voluntarily adopted the fair-value-based method of accounting for stock-based awards under the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" using the prospective method as permitted under SFAS 148, "Accounting for Stock-Based Compensation – Transition and Disclosure". Federated adopted the fair-value-based method of accounting to increase transparency in the financial reporting of stock-based compensation. We believe that it is inappropriate to have companies that have voluntarily adopted the provisions of SFAS 123 under the various methods as permitted under SFAS 148 to have to readopt under an alternative method as prescribed in this Proposed Statement.

If, however, the staff determines against allowing voluntary adopters to maintain the method of adoption allowed under SFAS 148, we encourage the staff to allow companies to apply the retrospective restatement transition method over the modified prospective method in order to provide comparability between periods presented in the financial statements.

In addition, situations may arise that will produce very confusing financial results under the modified prospective transition method. For example, when unanticipated forfeitures occur after

the adoption of the Proposed Statement related to grants issued prior to the adoption of the Proposed Statement, a credit to income will be recognized to reverse expense that had never been recorded. The use of either the prospective transition method or the retroactive restatement transition method would eliminate these accounting anomalies.

**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?

**Response**

Federated presents its Statement of Cash Flows using the indirect method. In accordance with SFAS 95, Federated discloses any excess tax benefits associated with stock-based compensation as an adjustment to reconcile net income to net cash flows from operating activities. We do not support the classification of these tax benefits as financing cash inflows simply because they do not represent cash receipts.

Please feel free to contact me at 412-288-1222 to discuss these specific concerns at your convenience.

Sincerely,  
/s/ Thomas R. Donahue  
Thomas R. Donahue  
Chief Financial Officer