

■ Ernst & Young LLP 5 Times Square New York, NY 10036 ■ Phone: (212) 773-3000 www.ey.com

October 8, 2005

Letter of Comment No: 4
File Reference: FSP123R-C
Date Received:

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

> Proposed FASB Staff Position No. FAS 123(R)-c "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards"

We appreciate the opportunity to comment on the Proposed FASB Staff Position No. FAS 123(R)-c "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards." We support the issuance of a final FSP based on the concepts described in the proposed FSP.

We expect that some commenters may criticize the transition election as being unfair to various constituents because it fails to approximate the results of applying the existing transition requirements for the pool of excess tax benefits ("APIC pool"), or produces counterintuitive results. For example, assume a company measured and recognized compensation cost for awards granted after the adoption of FASB Statement No. 123, Accounting for Stock-Based Compensation, based on their fair value (as would be the case if the company adopted Statement 123 for recognition purposes or granted nonvested stock). In that circumstance, the compensation cost recognized in the financial statements would have reduced any excess tax benefit recognized in additional paid-in capital (because only the excess tax benefit would be recognized in additional paid-in capital). However, that compensation cost (multiplied by the blended statutory tax rate) also would be deducted from the calculated APIC pool in applying the alternative transition approach (essentially deducting the tax effect of the compensation cost twice). That is, the APIC pool calculated under the proposed alternative by a company that measured share-based payments to employees under Statement 123 would be less than the pool of a company that granted the same awards but accounted for them under APB Opinion No. 25, Accounting for Stock Issued to Employees. We believe that seemingly anomalous results arise in other circumstances as well.

While we acknowledge that the results of the alternative calculation are somewhat arbitrary, we note that there is no compelling conceptual basis for the transition requirement for the APIC pool described in paragraph 81 of Statement 123(R), so we are not troubled by any perceived problems or inconsistencies between the current requirement and the proposed alternative. The proposed alternative does address most constituents' primary concern with the existing transition

III ERNST & YOUNG

Director, TA&I-FSP

October 8, 2005 Page 2

requirement; that it may be extremely difficult or even impossible to calculate the transitional APIC pool. However, we do believe there will be certain entities that unfortunately have not retained their footnote and financial statement support for the past 10 years. If concerns about the specific form of the proposed alternative or records retention policies lead the FASB to conclude that the proposed alternative is not appropriate, we recommend that the FASB permit companies who cannot reasonably calculate the APIC pool to start with an APIC pool of zero on the effective date of Statement 123(R).

We also recommend that the FASB consider clarifying the transition requirements. For example, assume a company adopted Statement 123(R) using the modified retrospective transition method and initially based its income tax accounting on an APIC pool calculated under the proposed alternative method. Further, assume that within one year of adoption the company chooses to change its method of calculating the transitional APIC pool to that described in footnote 81. If it had applied the method described in paragraph 81 at initial adoption, it might not have recognized certain deferred tax asset write-offs in income tax expense. We assume that because transition is not specified, FASB Statement No. 154, Accounting Changes and Error Corrections, would require retrospective application of the change. However, we believe that many constituents may not realize that Statement 154 would apply in this circumstance and, therefore, we recommend that the transition be made explicit in the FSP.

We have the following suggested editorial comments on the proposed FSP:

- We believe that the FASB should clarify whether the increases in additional paid-in capital described in paragraph 5 should be based on the gross or net change in additional paid-in capital and the period the change should be measured. We believe the alternatives include:
 - Measure all increases in the additional paid-in capital on a gross basis, so that all excess tax benefits increase the pool and no deficiencies reduce the pool. For example, if a company granted primarily nonvested stock, the net increase in additional paid-in capital during the period could include both increases and decreases (that is, excess tax benefits and tax deficiencies could arise in the same period). Under this approach, the deficiencies would be ignored and the excess benefit would be accumulated for purposes of the calculation. While a gross calculation would seem to be more appropriate conceptually (otherwise deficiencies are effectively double-counted because of the requirement to deduct the product of the recognized compensation cost and the blended statutory tax rate from the APIC pool), we acknowledge that a requirement to use gross increases in the calculation would increase the complexity of the calculation and might reduce the benefit of offering a simplified alternative, or

Director, TA&I-FSP

October 8, 2005 Page 3

o If the FASB believes a net approach to measurement of the increases in additional paid-in capital is warranted, we note that even if the alternative is based on net increase in additional paid-in capital, this increase could be measured differently based on what period the company accumulates the increases (if, for example, an increase in the first quarter was offset by a deficiency in a subsequent quarter of the same fiscal year).

We believe that there are three alternatives under a net approach:

- Net the changes in additional paid-in capital recognized during all periods between the effective date of Statement 123 and the effective date of Statement 123(R).
- Net the changes in additional paid-in capital recognized during a single fiscal year.
- Net the changes in additional paid-in capital recognized during a single fiscal quarter.

We recommend that if the FASB provides for a "net increase" approach, it should specify that the net increase should be measured on an annual basis that, among other things, would provide for consistency between public and nonpublic entities as well as consistency with the accounting for excess tax benefits after the adoption of Statement 123(R).

- We recommend that the examples include periods in which tax deduction deficiencies are charged to APIC to further clarify the calculation as discussed in the preceding bullet.
- We recommend that paragraph 5 be clarified such that it is clear that the "current blended statutory tax rate" is the rate as of the date of adoption of FAS 123(R). Additionally, we anticipate that a significant number of questions would arise in calculating the current blended statutory tax rate described in paragraph 5. For example, if an entity has operations in several tax jurisdictions with different statutory tax rates and granted share-based payments to employees in only a few of those tax jurisdictions, should the entity, in calculating its blended statutory tax rate, take into account the statutory tax rate only for those jurisdictions where there have been share-based payment grants? Also, how should anticipated tax credits effect the blended rate calculation? As such, we recommend that the FSP either provide further guidance as to how a current blended statutory tax rate should be determined or that the staff consider a more simplistic approach such as requiring the use of an entity's parent company statutory tax rate.

II ERNST & YOUNG

Director, TA&I-FSP

October 8, 2005 Page 4

• We believe language similar to the following should be added to the last sentence of paragraph 7 to avoid any confusion about how the pool of excess tax benefits is subsequently adjusted:

"to the extent that the amount of the APIC Pool before any such deduction exceeds the amount of the resulting tax deficiency. The amount, if any, by which the resulting tax deficiency exceeds the amount of the APIC Pool shall be recognized in the income statement."

- We recommend that the FSP describe how the alternative transition method should be applied by a public entity that (1) was not public for some period of time after the required effective date of Statement 123 and (2) used the minimum value method for either recognition or pro forma disclosure purposes during that period. In such cases, we suggest that the alternative calculation include increases in additional paid-in capital and compensation cost recognized beginning in the year in which the entity became public. This approach would be more consistent with the calculation and compilation of an APIC pool upon and after the date of adoption of Statement 123(R) by a nonpublic entity that previously used the minimum value method.
- In the paragraph below the first table on page 4, the blended statutory tax rate (presumably 40 percent) has been omitted.
- We believe the fifth sentence in the last paragraph of the FSP should be revised as follows to recognize the fact that for companies that adopt Statement 123(R) using the modified prospective transition method, the calculation of the APIC pool is not consistent with the actual entries in additional paid-in capital for awards that were partially vested on the effective date:

"Pursuant to the provisions of Statement 123(R), upon exercise of the award Entity A would adjust the APIC pool for an excess tax benefit or tax deficiency as if it had always followed the fair value measurement principles for recognition purposes. However, the actual write-off of any excess deferred tax asset to additional paid-in capital would be based on the excess of the deferred tax asset recognized in the financial statements (exclusive of any pro forma deferred tax asset) over the realized tax benefit."

Finally, with regard to the background discussion in the FSP, we note that the FASB observed that it did not receive feedback during the public comment period that entities were unable to

■ Ernst & Young

Director, TA&I-FSP

October 8, 2005 Page 5

compute an APIC pool. While we do not disagree with the FASB's observation, we note that the income tax model described in the Exposure Draft on which the public comments were based did not require the calculation of an APIC pool. Rather, the Exposure Draft provided that all tax deficiencies would be charged to income tax expense. While we understand that some commenters suggested that the FASB retain the existing income tax model described in Statement 123 (which the FASB ultimately agreed to do), many other commenters, including Ernst & Young, suggested that all excess tax benefits and tax deficiencies be accounted for in the same manner (generally in additional paid-in capital, while some suggested all such adjustments be recognized in income tax expense), which would not have required the calculation of an APIC pool. Because the FASB did not expose the changes to the proposed Statement for public comment, many constituents may not have considered this revised requirement with sufficient care prior to the issuance of the final Statement.

We also note that the Statement 123(R) requirement that "a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable" represents a change in practice that requires many entities to perform new calculations to determine the transitional APIC pool under the existing requirements. Several commenters, including Ernst & Young, advised the FASB that this requirement would represent a significant change in practice.

Finally, while we support the proposed FSP, we believe that as the FASB considers convergence with International Accounting Standards, it should reconsider the income tax model described in Statement 123(R). We believe that the distinction between deferred tax assets that are writtenoff to additional paid-in capital and those that are charged to income tax expense does not result in useful information for users of financial statement, yet this distinction results in significant complexity that substantially increases the risk of unintentional misapplication of Statement 123(R). We recommend that the FASB and IASB work together to develop an income tax model for share-based payments that is easier to apply.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernet + Young LLP

Footnote 82 to paragraph A94 of Statement 123(R).