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Letter of Comment No: 6398 File Reference: 1102-100

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
File Reference No. 1082-200
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Proposed Statement of Financial Accounting Standards – Share-Based Payment (File Ref. No. 1102-100)

Dear Directors:

Prudential is pleased to take this opportunity to comment on the proposed standard captioned above (the ED). Prudential supports the Board's efforts to address the concerns of the financial statement user community with regard to representing economic transactions involving the issuance of shares as a 'currency'; to eliminate alternative accounting practices where alternatives are not necessary; and, at the same time, to approach international convergence.

In particular, Prudential supports the expensing of stock options granted in exchange for goods and services, including options granted to employees, based on grant-date fair value. Employee stock options represent a valuable incentive provided to employees, and a cost to the company's shareholders. Not reflecting that value as a component of total compensation cost for options granted to employees does not provide a faithful representation of the economics involved. When a shareholder pays a cash expense on behalf of a company, the company reflects the related expense and records a capital contribution – it should follow that a non-cash expense should also be reported by the company.

We provide in this letter what we hope the Board will find to be useful and thoughtful commentary and suggestions for certain aspects of the ED, and we would be happy to discuss any of these issues with the Board or Staff. Our comments and suggestions are more thoroughly discussed later in the letter, but in summary our key points are as follows:

- The final Statement should retain the option available under FAS 123, to follow a straightline cost attribution methodology, rather than requiring a company to treat an award with a graded vesting as multiple awards.
- The Board should reconsider the treatment of the excess tax benefits, on the income statement and the statement of cash flows. We recommend that all tax effects associated

with an employee stock option plan should be reflected on the income statement, rather than apportioning the element of a tax deduction greater than that associated with the fair value of a grant to the equity section. Further, the Statement should not amend FAS 95, to require that the excess tax benefits be presented as a financing activity.

- The proposed transition rule is not appropriate. The Statement should require companies to apply full retrospective application of the new guidance. A determination of whether it is practicable to do so should be performed by each company, based on its particular circumstances.
- The ED describes a set of objectives to be met by companies in their disclosures about share-based payments. The related appendix then provides an extensive list of minimum required disclosures, many of which are in addition to the disclosures previously required under FAS 123. The Statement should refer to the list in the appendix as potential disclosure items for companies to consider, when determining whether the disclosure objectives have been met.

Attribution to periods

Under FAS 123, a company could look at each 'tranche' of options in a graded vesting schedule as a separate award and attribute associated costs to each sub-award, or they could look at the total period covered by the graded vesting schedule and attribute costs more evenly over the period, e.g., a straight-line attribution (subject to ensuring that at least the vested shares have been expensed).

Recording a compensation expense based on the fair value of the options is meant to be a measure of the value of an employee's services to the company. A graded approach is not true to that concept. Most options granted by Prudential Financial vest 1/3rd on each of the first three anniversary dates of the grant. Following a graded vesting approach, a company like Prudential Financial would attribute a much larger proportion of the total cost to the first year of an employee's services, than to the later years – 61% of the total compensation cost would be attributed in the first year; 28% in the second year; leaving only 11% for options vesting in the third year (ignoring any differences in value per option in each tranche, since the graded attribution model would require separate valuation). This is the exact opposite result of what we are trying to value, in that this result implies that an employee's services received by a company in the twelve months following a grant are more than twice as valuable as the services received in the second year, and more than five times as valuable as services in the third year. Employees become more valuable with additional experience and tenure with the company, not less. A straight-line approach simply results in a better reflection of what we're valuing.

We could have made our options grant $1/6^{th}$ semi-annually over the three year period; or $1/36^{th}$ monthly. Each of those alternatives would carry with it an additional administrative burden, but each of those alternatives successively comes closer to the company's view and purpose in granting options. The graded vesting schedule is a practical alternative that is in the spirit of a prorata vesting (e.g., where some shares vest each day) without the significant administrative burden. It would be an totally unrealistic and impractical to treat a grant with a pro-rata vesting schedule as 1,095 (365×3) separate grants, of (in some employee's cases) less than one option each; yet that is what the ED would require.

Those are the high level reasons why Prudential Financial did not adopt a graded approach when we began expensing stock options in 2003. We continue to believe that straight-line attribution is

a better application of the matching principle and a better reflection of the intent of the Company's Compensation Committee in granting the options. Therefore, I truly hope that the Board restores the straight-line approach when it redeliberates this issue.

There are other, more practical reasons why the Statement should not require graded attribution, and they really boil down to a lot of extra work for questionable benefits, in terms of accuracy and representational faithfulness in financial reporting, recognizing especially that the compensation expense is an estimated cost dependant upon a large number of assumptions.

Treatment of income tax effects

In preparing the ED, the Board has carried forward from FAS 123 a view that during the life of an employee stock option, the option evolves from a transaction with an employee (through the vesting date) to an arrangement with an equity holder. Under this view, events occurring through vesting trigger income statement impacts, as they represent compensation, while events after vesting generally impact capital. As described in the ED, in applying this view to the income tax effects of an employee option, some of the tax deduction flows through earnings as a reduction of income tax expense, and some is credited to Paid in capital. However, this approach does not recognize that all of the tax effects arise from the fact that the option was granted to an employee options simply written in the market on a company's own stock would not result in taxable income or deductions; the tax effects arise from an employee's decision to exercise the options granted by the employer as part of that employee's total compensation package. The excess tax benefit is simply a permanent GAAP/tax difference arising from use of a different measurement attribute. All of the tax effects of the compensation decision, including the 'excess tax benefits', should be included in the company's computation of income tax expense. The ED already requires shortfalls in the tax deduction to be recorded in the income statement; that is appropriate as a shortfall results in reversal of a deferred tax asset that was previously established as a deferred tax benefit. Symmetry in the reporting treatment of excess benefits and deduction shortfalls eliminates what would otherwise be a complex and confusing approach. The Board should ensure that the final Statement reflects the excess benefits in income as well, for the reasons described above.

We also disagree with the proposed amendment to FAS 95. Under FAS 95 as issued, all income taxes paid are reflected as an operating cash flow. At the time the Board deliberated FAS 95, it considered whether it would be appropriate to apportion taxes paid among operating, investing and financing flows in response to comments received on the exposure draft, and the Board determined that any such allocation would be complex and arbitrary. In the ED, the Board has concluded that the excess benefits can be allocated, without an arbitrary or complex allocation process.

While it is true that the amount of the excess benefits can be separately determined, as they will arise at the time an option is exercised, tracking the cash flow impact of that deduction will in many cases continue to involve an arbitrary allocation process. The proposed amendment to FAS 95 does not seem to consider situations involving, for example, companies that are in an NOL position for tax purposes. Such companies will carry forward the potential benefit, and in a future year when some part of the NOL is utilized, the company would need to determine how to allocate the cash benefit between Financing and Operating activities on its cash flows statement. Additional complications arise for companies that are paying Alternative Minimum Tax.

If the Board believes that the amount of the reduction to tax expense and tax payments in the period is useful information, such information would more appropriately be provided by way of disclosure. The tax deductions claimed in determining the period's tax expense would be the more

useful disclosure item as compared to the cash benefit, which as described cannot be reliably determined. As previously noted and as discussed in more detail later in this letter, such disclosure could be recommended as an item to consider disclosing, but should not be listed as a required minimum disclosure.

Note that the discussion above related to the FAS 95 amendment assumes that it was the Board's intent that reporting a cash inflow from a financing activity would occur in the period taxes paid were actually reduced by the benefit. To clarify that intent, if the final Statement keeps the amendment to FAS 95 as proposed in the ED, the illustration in paragraph B68 should be amended. In that illustration, employees exercise an option on the last day of the year, and the company reflects a financing cash inflow in that same year. It is much more likely that the cash benefit would impact a future tax payment.

Transition

The proposed transition provision ignores the Board's own view, that retrospective application with restatement would be the best transition method. Full retrospective application was determined not to be appropriate for anyone, because it will not work for everyone. The FASB should be putting forth guidance that requires the application of rules the FASB believes are best; companies will need to determine whether those rules are practicable, and it is appropriate for the Statement to include provision for companies that find it impracticable.

Comparability between companies won't be improved, as intended by the Statement, until all nonvested options have been valued and charged to earnings in accordance with the Statement. For Prudential Financial, that would not be until our 2008 financial statements under the ED's transition provisions. More and more companies will get there earlier, if retrospective application were required, or at least permitted. While we won't know for sure until we have analyzed the final Statement, at this point we expect that Prudential Financial would find it practicable to apply the guidance retrospectively.

The 'modified prospective' approach described in the ED, however, is an appropriate compromise that should be applied by those companies that determine it is impracticable to apply the changes retrospectively.

Disclosures

The Board has an opportunity to embrace a principles-based approach to disclosures in the Statement, and the ED has taken a step towards that. I encourage the Board to take that next step, and have the final Statement reflect the information listed in paragraphs B191-B193 of the ED as information companies should consider in determining how best to achieve the objectives described in the main body of the Statement. The basis for conclusions could also describe the Board's expectation that most or all of the listed information would be included in the notes to the financial statements for those companies with significant stock options activity, while at the same time permitting a company with a less significant plan to provide a less overwhelming set of information.

It is not always clear how an item listed in the ED as required minimum disclosures relate to achieving the disclosure objectives. To assist companies in applying a principles approach to the Statement's disclosures, it would be helpful for the Statement to include some commentary linking the proposed disclosure points back to the principles. In particular, a number of the new disclosure items in the ED relate to intrinsic value measures of outstanding options at various points in time;

these items do not appear to satisfy any of the objectives. Prudential Financial's 2003 Annual Report included a note on stock-based compensation that already spans 7 pages and does not once refer to the intrinsic value of any outstanding options. Before we consider expanding the disclosure to include additional information, we would want to understand how it relates to the objectives.

As a final point on disclosures, consider the ED's requirement to disclose the unrecognized compensation cost associated with nonvested options. In a principles-based environment, a company whose share-based payments represent a significant driver of profitability should disclose this information, but a company with a much less significant plan may not need to. Further, where a company does disclose this information, the company could consider scheduling out the periods over which the unrecognized compensation cost is expected to vest.

Other matters

Cancellation of nonvested awards

The ED describes the cancellation of a nonvested award as comprising an accelerated vesting, and a repurchase by the company for no value. The associated accounting then requires the immediate recognition of the unrecognized compensation cost. Breaking down the cancellation of an award on that basis involves the assumption that an employee would surrender a vested option simply because the company asked them to; a fairly unrealistic assumption. A more realistic accounting presentation recognizes that a company benefits ratably for employee services provided; any compensation cost previously recognized is not reversed. However, no further compensation cost should be recognized.

Forfeiture rate

Prudential Financial incorporates an estimate of forfeiture rates in its determination of the amount of compensation cost to recognize each period. However, we would support continued availability in the literature of not incorporating a forfeiture rate estimate, and picking up the forfeitures as they occur. Some would argue this is a better match – the company has granted the options, and when they are returned to the company, the return would be recorded.

Separately, it would be helpful to have the Board's views on whether voluntary separation is the only aspect that should be considered in developing an estimate of the forfeiture rate, or whether actions the company might take that might impact the vesting should affect the forfeiture rate assumption – for example, anticipated or announced termination plans.

Sincerely.

Dennis G. Sullivan Deputy Controller