Letter of Comment No: 5506 File Reference: 1102-100



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

Subject: Comment Letter Regarding Share-Based Payment

American Electric Fuvver

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Dear Director:

American Electric Power Company, Inc. (AEP) appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB or the Board) Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, dated March 31, 2004. AEP, a Columbus, Ohio based global energy company, is one of the largest investor-owned utilities operating in the United States, with revenues of over \$14 billion and more than 22,000 employees. We provide energy to approximately 5 million customers in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia and West Virginia.

We support the project to improve the accounting for employee share-based compensation, and in general agree with the proposed fair-value-based method of accounting. However, we are concerned about certain issues, as discussed below.

Fair Value Measurement

Issue 4(b): 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?

We do not believe that a lattice model is preferable for valuing employee share options, since the Black-Scholes-Merton formula can be adjusted for the unique characteristics of employee options by using the expected life of the option rather than the contractual term. With either the Black-Scholes-Merton formula or a lattice model, the value produced is an estimate, and there is no evidence that one model produces a better estimate than the other. In short, there is no definitive best answer; option pricing models at best approximate the fair market value, since employee options are not transferable and not traded. Paragraph B11 provides examples of situations when it is not practicable to use a lattice model; however, we believe that in many cases, it could be difficult for a company to justify the use of the Black-Scholes-Merton formula with its auditors because of the ED's expressed preference for the lattice model.

We note that paragraph 21 of the ED requires measurement of awards granted but not yet vested prior to adoption of the Statement at the original valuation, which would include calculations using the Black-Scholes-Merton formula. Apparently, the Board recognizes that these amounts are reasonably determined, and thus the Black-Scholes-Merton formula should equally be available for valuation of new option grants.

Issue 4(c): If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

We do not believe the Board should require a specific method of estimating expected volatility. We agree that an entity's estimate should be reasonable and supportable, with consideration of the relevant factors, including those noted in paragraph B25.

Income Taxes

Issue 11: 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?

We agree with the proposed method of accounting for deferred taxes; however, we do not agree with the proposed recognition of income tax effects. Instead, we agree with the dissenters' discussion in APB 25, following paragraph 20, that "The tax effect of such difference is related, therefore, to an item affecting the determination of income and not to the amount of an employee's investment in the stock of the employer corporation. Accordingly, the tax effect should be reflected as a reduction of income tax expense." We are not aware of any other cases where a tax deduction is not reflected as a credit to tax expense.

If the Board maintains the requirement to credit excess tax benefits to equity, we believe the approach in FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123), paragraph 44, should be maintained, which allows a deficiency to be charged to additional paid-in capital to the extent of previously recorded excess tax benefits. We believe it would be excessively burdensome to account for the tax effects on an individual basis. Accounting transactions should be summarized monthly and reported externally on a quarterly and annual basis. The direct assignment of the excess of tax above book expense on an individual basis is illusory precision, time intensive and counterproductive to cost/benefit goals.

Disclosures

Issue 12: Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

We generally agree that the disclosure objectives are appropriate, but we believe the minimum required disclosures are excessive. We do not believe there should be any additional disclosures that were not required in FAS 123, as amended by FAS 148. With respect to the disclosure objective in paragraph 46(d) pertaining to cash flow effects, we do not believe that knowing the cash flow effects of share-based compensation is significant to users of financial statements in developing an informed

view of financial condition. In particular, we do not believe the following new disclosure requirements provide useful information to financial statement users:

- Tabular reconciliation of nonvested awards
- Total intrinsic value of options exercised and total intrinsic value of shares vested during the vear
- Total compensation cost for share-based payment arrangements recognized in income and the total compensation cost capitalized as part of the cost of an asset
- Total compensation cost related to nonvested awards not yet recognized and the weightedaverage period over which it is expected to be recognized
- Amount of cash received from exercise of share options
- Amount of cash used to settle equity instruments granted under share-based payment arrangements

We believe the new requirements will be time consuming as some information is not readily available, such as the capitalized amount of stock-based compensation cost, since it is subject to account distribution based on labor and is not individually tracked.

Transition

Issue 13: 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?

We do not agree with the transition provisions of the proposed statement. While we agree with the Board's conclusion that previously estimated grant-date fair values should not be recalculated, we believe it would be inappropriate to recognize expense in accordance with the original provisions of FAS 123 for awards granted prior to the effective date of the amendment, while subsequent awards would be expensed under the amended statement. Instead, we support the use of the prospective method of transition, which would consistently recognize expense in the income statement using the ED recommended lattice model, or as we recommended, a company's choice of models, applied consistently. If the Board retains the modified prospective approach, we believe retroactive restatement should be allowed, using the amounts previously disclosed under FAS 123.

Cash Flows

Issue 16: Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

We do not agree that excess tax benefits should be credited to equity, as discussed in our response to Issue 11. If the Board determines they should be, we do not believe the excess tax benefits should be reflected as financing cash inflows. As noted in paragraph C142 of the ED, the primary purpose of a statement of cash flows is to provide relevant information about cash receipts and cash payments (FASB Statement No. 95, Statement of Cash Flows (FAS 95), paragraph 4). The tax deduction for share-based payment transactions is a reduction of taxes payable, not a cash receipt, and the actual cash payment to a taxing authority is operating in nature. If the Board amends FAS 95 for share-based payment transactions, it may invite further amendments related to other issues, leading to a somewhat arbitrary allocation between operating, investing and financing activities.

Attribution of Compensation Cost

The ED (paragraph 10) would eliminate the alternative allowed under FAS 123 of accruing compensation cost for all instruments subject to a service condition and recognizing forfeitures as they occur. We do not agree that this alternative should be eliminated. The additional complexity of basing the accrual on an estimate of forfeitures is not always justified, when recognizing forfeitures as they occur may not produce a significantly different result, based on materiality. We believe both alternatives should continue to be allowed.

Thank you for the opportunity to comment on this proposal.

Sincerely

Joseph M. Buonaiuto