Reese K. Feuerman Vice President and Controller 750 E. Pratt Street 16th Floor Baltimore, MD 21202



Letter of Comment No: 5810 File Reference: 1102-100

June 30, 2004

Ms. Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: File Reference No. 1102-100

VIA ELECTRONIC MAIL

Dear Ms. Bielstein:

I am writing to provide comments to assist the FASB in its deliberations on the Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (the "ED"). Constellation Energy Group is interested in this issue because we award share-based payments under our long term incentive plans. I have organized our comments in order of the issues identified in the Notification for Recipients section of the ED.

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16-C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

While we agree with the measurement and attribution of compensation cost over the requisite service period based on the grant-date fair value, for option-based grants we believe that there should be a final true-up of expense recognized in the financial statements to actual cost based on the option's ultimate intrinsic value at the time of exercise or expiration. We believe that not to do so is inconsistent with the most basic tenets of accounting. That is, while for many

Ms. Suzanne Q. Bielstein June 30, 2004 Page 2 of 6

transactions it is necessary to record an estimate, in almost in all cases there is an ultimate trueup of the estimate to reflect actual results. The FASB already recognizes in the ED the need for the associated tax benefits to be trued-up, yet it has not provided for the true-up of the underlying transaction giving rise to those tax benefits. While there are differences in timing/recognition of expenses for book vs. tax return purposes, except for certain permanent differences, there is generally an ultimate true-up of the total expense recorded for book and tax purposes to the actual cost. We believe this fundamental principle should be applied to the cost of stock options.

We agree with the FASB that compensation expense for employees' service rendered during the vesting period should be based on grant-date fair value. Once compensation expense has been accrued, the funding of the liability is then exposed to movements in the market price of the company's stock. Rather than being a true-up of compensation expense recorded during the service period, changes in value between the employees' vesting date and ultimate settlement of the option relate to payment of a liability. Recognizing the FASB's movement from intrinsic value accounting to fair value accounting for share-based compensation, we nonetheless believe that this true-up should be recognized in the financial statements. Furthermore, in the case of an option that expires unexercised, we believe that the transaction is essentially the forgiveness of a liability that also needs to be recognized.

We suggest that the FASB may want to consider an approach whereby once an option becomes fully vested, the difference between the intrinsic value of the option and the liability for accrued compensation expense (recognized in earnings based on grant-date fair value) would be recorded in other comprehensive income (OCI) until settlement. These changes would be accumulated in OCI each reporting period until the time of settlement when OCI would be closed-out to earnings to reflect the final true-up and associated financing cost or benefit. We believe such an approach would not only provide for the true-up that is essential to properly reflect the actual economics of the transaction, but also would accommodate symmetrical treatment of the related tax benefits, and obviate the need for many of the disclosures that the ED calls for by giving investors full visibility of the total cost of stock options in the basic financial statements.

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 the FASB should express a preference for one valuation model (a lattice model) over other models or prescribe the use of any specific model. Rather, we believe that the FASB should permit the use of any valid model that meets the objective of determining a reasonable estimate of the fair value of employee share options. Although it is a more flexible model, the binomial model may not be the most efficient or cost effective model for every company. The FASB should allow users flexibility in determining the appropriate valuation model for their company. The calculation of fair value is an estimate requiring experience and judgment. That experience and judgment should also be allowed in determining the appropriate

Ms. Suzanne Q. Bielstein June 30, 2004 Page 3 of 6

valuation model for a company, considering the costs and benefits of available models as well as a company's unique circumstances.

While the ED permits the use of the Black-Scholes model to value share-option grants when a company does not have sufficient data needed to populate a lattice model, we are unsure whether the ED permits companies to use this model indefinitely or whether companies would be required to undertake a reasonable effort to obtain the information needed to apply a lattice model within a certain period of time. We believe the FASB should clarify that in the long run use of a binomial model is not required for all companies.

In the final analysis, every model is an estimate, and the selection of one model over another does not ensure the validity of the result. Use of proper assumptions with a simpler model will provide a better answer than the use of improper assumptions with a more complex model. The FASB should recognize this in the final standard by not being prescriptive in expressing favor for lattice models over other models.

Attribution of Compensation Cost

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?

We agree with the proposed expense recognition pattern for awards with graded vesting schedules and believe that it is the most appropriate method to recognize compensation expense over the requisite service period for awards vesting in this manner. However, we do not agree that it is cost effective to treat each tranche of the same award as a separate award for valuation purposes, and subsequently to have to track the associated deferred taxes for each tranche separately. This requirement adds significant complexity to the accounting and record keeping for these awards, especially given the proposed treatment of deferred taxes, and is not justified by an incremental benefit in the accuracy obtained. Because the ED provides for flexibility and judgment in the selection of certain valuation assumptions, we believe that graded vesting awards can be reasonably valued as a single award.

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 disagree with the ED's proposed accounting for income taxes. We do not believe it is appropriate that tax benefit excesses and deficiencies be accounted for differently, with excesses

Ms. Suzanne Q. Bielstein June 30, 2004 Page 4 of 6

being credited to equity and deficiencies being charged to earnings. This treatment is inappropriately asymmetric and punitive to earnings, especially in the case where an option expires unexercised and the deferred tax asset must be reversed and charged to the income statement, yet the book compensation expense cannot be reversed. It is inconsistent to adjust the deferred tax asset through income tax expense when the compensation expense that gives rise to the income tax benefit is not re-measured.

As we previously suggested, we believe there should be a true-up of cost at settlement of the option. If the FASB agrees and determines that it is appropriate to true-up book expense at settlement of the option, then all tax true-ups should also be recorded to the income statement in the same period. However, if the FASB concludes that there should be no true-up of book expense, then all tax true-ups should be recorded to equity. The FASB concluded in the ED that fair value changes between the measurement date and the date an award is exercised are attributable to an equity transaction. The proposed treatment of tax shortfalls is not consistent with that conclusion. We believe that treatment for tax shortfalls should be recognized in a manner consistent with the related transaction. Since the FASB concludes that the permanent tax differences are attributable to an equity transaction (and not a compensation transaction), the appropriate treatment of these differences, whether they are excesses or deficiencies, is to record them in equity.

The proposed tax treatment will also lead to significant complexities in record keeping as companies will have to track these permanent differences by individual grant and by tranche for awards with graded vesting features. We do not believe that this treatment is cost beneficial for companies and strongly urge the FASB to reconsider the proposed rules related to tax shortfalls.

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). 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.

As a general comment, we believe that the ED is too prescriptive in requiring specific, extensive disclosures. First and foremost, we believe that the FASB should provide companies the latitude to make the appropriate level of disclosure based on the materiality of share based awards to their overall financial results. As written, the ED's disclosure provisions could require many companies to make a disproportionate level of rote disclosure for programs that are relatively immaterial to their operating results and overall financial condition.

Ms. Suzanne Q. Bielstein June 30, 2004 Page 5 of 6

Second, given that the ED will require recognition and measurement of the cost of stock options in the financial statements, we believe it is inconsistent for the ED to significantly expand disclosure requirements. We question whether some of the additional disclosures provide more meaningful, value-added information. Specifically, we question the necessity of the following disclosures as we do not believe they will provide useful information to financial statement users:

- Total intrinsic value of options exercised and shares vested during the year for each year an income statement is provided (B191-c);
- Aggregate intrinsic value of outstanding options and options currently exercisable as of the latest balance sheet date (B191-d);
- The amount of cash received from exercise of options and similar instruments granted under share-based payment arrangements and the excess tax benefits recognized in equity (B191-i);
- The amount of cash used to settle equity instruments granted under share-based payment arrangements (B191-j); and
- A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares. If as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose the expected amount of shares to be repurchased during that period (B191-k).

Many of the above disclosures focus on the intrinsic value of options and we are unsure of their relevance or intended use, particularly considering the ED's focus on accounting based on fair value. Further, disclosures focused on cash transactions are unnecessary in that such transactions will be reported as a financing activity in the statement of cash flow as part of proceeds from common stock issued. We recommend that the FASB consider whether all of the disclosures illustrated in paragraphs B191 to B193 will still be relevant to financial statement users after companies begin to recognize compensation cost for the fair value of stock options.

Cash Flows

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?

We disagree with the presentation of excess tax benefits as a financing activity in the statement of cash flow. This treatment contradicts the fundamental principles of SFAS 95 which clearly indicates that the focus of the statement of cash flow should be on actual cash flow. Under the proposed rules, the cash effect of excess tax benefits would be based on the nature of the related capital transaction (acquisition of shares upon exercise), rather than on the actual cash flow (a reduction of taxes paid to a governmental entity). The payment of taxes is fundamentally an operating activity. Additionally, the requirement to classify these excess tax benefits as a financing cash flow seems to imply that part of a company's incentive for awarding options is to

Ms. Suzanne Q. Bielstein June 30, 2004 Page 6 of 6

raise capital, which is not in alignment with the FASB's rationale for expensing options on the basis that they represent employee compensation.

The proposed cash flow treatment is without precedent as there are no other transactions requiring a segregation of taxes between operating and financing activities in the statement of cash flow. It is inconsistent to treat the compensation component of the option as an operating activity and the related tax effect as a financing activity. This asymmetrical treatment also results in a punitive effect by reducing operating cash flow in the case of tax shortfalls, yet disallowing increases to operating cash flow in the case of excess tax benefits.

We believe that the statement of cash flow is clear and informative under existing GAAP and urge the FASB to reconsider this issue and retain the current provisions of SFAS 95.

* * * * * *

We appreciate the opportunity to provide our views on these important matters.

Very truly yours,

/s/ Reese K. Feuerman
Vice President and Controller
Constellation Energy Group, Inc.