June 29, 2004

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

Re: File Reference No. 1102-100
Share-Based Payment: an amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein,

We appreciate the opportunity to provide our comments to the Financial Accounting Standards Board on Exposure Draft No. 1102-100 issued March 31, 2004, “Share-Based Payment: an amendment of FASB Statement No. 123 and 95.”

The JCPenney Company has a long history of offering stock options to a fairly broad group of management associates (our employees are referred to as associates), including store managers, as a tool to recruit, reward and retain the leadership of the Company. The founder of the Company, James Cash Penney, was a strong believer in Company ownership by its associates. In the early years of the Company as a partnership, store managers purchased a stake in the stores they managed, becoming owners of the business. We still believe today that associate ownership is key to a successful operation. Now, more than ever, while we are in the midst of executing a five-year turnaround plan, associate equity ownership is an important factor contributing to our continued sales growth and improved earnings over the past three years.

Information about the Company’s stock option program is provided as an exhibit to this comment letter in the form of the stock option disclosures included in the Company’s 2003 Annual Report. The disclosures included all of the requirements of SFAS No. 123 plus additional voluntary disclosures dealing with the dilutive effect to existing stockholders, which we believe are important for a complete understanding of the total potential impact of a company’s stock option program.

Our views on stock option accounting have not changed from those expressed in prior comment letters to the Board. On a conceptual level we find it difficult to fully accept the compensation aspect of equity based plans that the Board feels so strongly about. We believe that share-based programs have stronger elements of equity transactions than elements of compensation.
Share-based programs provide a link between the owners of an enterprise and the recipients of share-based awards, who upon vesting and subsequent exercise, in the case of stock options, will also share in the ownership of the enterprise.

Share-based programs result in ownership transfers, diluting current shareholders. This is fully understood by stockholders who vote to approve or reject equity based plans. When stockholders approve stock option plans, they do so with the expectation that management, acting as owners, will work even harder to enhance shareholder value. The price stockholders are willing to pay for the expected increase in the value of their holdings is the potential dilution. This dilution is due to an increase in the number of shares, not from charges to the income statement by the compensation cost of these plans, because these charges do not reduce stockholders’ equity at all. Dilution manifests itself through measures such as Stockholders’ Equity per Share, and Earnings per Share, or any other measure involving the number of shares.

The Board’s position is clear that equity-based programs granted to employees for services rendered constitute a form of compensation that should be recognized in a company’s results of operations. When viewed strictly from a compensation point of view, we agree that the cost of equity-based plans should be recognized over the period that an enterprise benefits from its employees rendering services. The critical question we struggle with is how to determine the amount to be recognized in a company’s statement of operations when the ultimate value of a share-based award, and the dilution to existing stockholders, is not known until the value is realized by the employee upon exercise of a stock option or the lapse of restrictions for a restricted stock award. Without the ability to openly trade stock options, we do not believe that current valuation models can accurately measure the fair value of employee stock options.

Accepting the Board’s decision to move forward with expense recognition of share-based payments to employees in companies’ financial statements, the remainder of this comment letter will focus on a few specific areas of concern, outlined below:

- The valuation model
- Awards with graded vesting schedules
- Income taxes
- Ability to reverse compensation expense if market conditions not met
- Level of disclosures too extensive
- The prohibition against restatement of prior year results

The valuation model

If companies are going to be required to record a charge to their income statement for the value of employee stock options at grant date, it is important that the method for measuring that value be fair and reasonable, reflect real economic values and costs, and be comparable across industries. We have concerns regarding the accuracy and reliability of fair values determined by the use of an option-pricing model, such as lattice (binomial) or Black-Scholes. These models assume there is an open market to trade, that options are transferable, that the options have short terms and no restrictions. As a result, traditional option pricing models tend to overstate the value of employee options. Both models appear to produce a very subjective guess regarding the estimated value at the point in time that a company knows the least about the ultimate value of a stock option award.
The Board’s explicit preference for a lattice (binomial) model, in our view, will lead to an increase in cost to implement and will not result in more accurate or comparable valuations. Since both models are just an educated guess, companies should be allowed to keep the calculation as simple and cost-effective as possible. The resulting valuations under any model are only as good as the assumptions that go into the calculations. While the lattice (binomial) model offers the possibility of better estimates of fair value than Black-Scholes, it also opens the door to deliberately minimizing the estimated values through the use of either aggressive or conservative assumptions as the case may be. Further, requiring companies to use specific methods of estimating inputs could potentially prohibit the use of more precise valuation techniques as valuation models continue to evolve.

**Recommendation:** We believe that the Board should not indicate that one model (lattice, or binomial) is preferable (or seemingly required) relative to another model. Such flexibility regarding the selection of option-pricing models will allow preparers to assess the costs and benefits of all available models given their unique circumstances. The Board should continue its research efforts regarding valuation techniques to determine if there are other models that could be adapted to address the unique characteristics of employee stock options.

**Awards with graded vesting schedules**

SFAS 123, "Accounting for Stock-Based Compensation", allows companies to consider an award with graded vesting as a single award or as multiple awards. So, for example, under existing guidance, a company that grants options to an employee that vest over a three-year period, can choose to view that grant as a single award and recognize one-third of the related cost in each of the three years. Alternatively, the company can view the award as multiple awards and recognize 61% of the cost in year one, 28% of the cost in year two, and 11% of the cost in year three. The exposure draft proposes to change existing guidance by requiring companies to view awards with graded vesting as multiple awards, resulting in accelerated expense recognition.

We believe that the economics of the manner in which option grants actually vest and are perceived by both employers and employees should be reflected in the accounting for options to promote transparency and understandability. In fiscal 2004, JCPenney granted stock options to its associates that vest over a three-year period. The economics of that grant are that at the end of the first year after grant date, if an associate is still with the Company, they become vested in one-third of the shares under option. If they are employed at the end of the second year after grant date, they would become vested in another one-third of the shares under option, and so forth. If such employee leaves the Company during the second year they would only be vested in one-third of the option shares, not in 61% of the option shares. So the most accurate reflection of the cost of the option grant is to follow the vesting as designed by the Company, and communicated to and understood by the optionee; that is, to treat it as a single award with straight-line expense recognition.

We believe that financial statement users find the single-award method more understandable than the proposed method and the single-award method is more closely aligned with the Company’s intent of granting awards to employees. It seems counter-intuitive to accelerate expense recognition into the early years of an award, while the benefit of employee services is received ratably over the service period. The straight-line method more closely matches the expense with the benefit received.
Recommendation: We recommend that the Board retain the alternative attribution methods currently permitted by SAFS 123.

**Income taxes**

The proposed Statement would require that any excess tax benefits resulting from a tax deduction in excess of compensation cost recognized for financial statement reporting be recorded as additional paid-in capital under the theory that the additional tax savings are the result of an equity transaction. Conversely, if the tax deduction ends up being less than the recorded compensation cost, i.e., a portion of a deferred tax asset is written off, the additional tax payment is to be recognized as an additional charge to the income statement. This treatment appears to be inconsistent with certain aspects of SFAS No. 109, “Accounting for Income Taxes,” and SFAS No. 95, “Statement of Cash Flows.” The whole premise of the proposed Statement is that the Board has established that stock options and other forms of share-based payments to employees are compensation cost, which is a component of a company’s statement of operations. Accordingly, we would support an accounting model whereby all adjustments necessary to account for differences between the tax effect of the recorded compensation cost for financial reporting purposes and the tax benefit of the actual deduction realized upon exercise or settlement of an award are recorded as part of income tax expense in the statement of operations. In addition, since the proposed Statement has defined stock options as compensation cost, which is part of a company’s operations, we believe that both excess tax benefits and related deferred tax write-offs should be part of operating cash flows on the statement of cash flows.

Recommendation: We recommend that the Board treat both excess tax benefits and tax benefit shortfalls consistently through recognition in the income statement, and all related tax activity as operating cash flows on the statement of cash flows.

**Ability to reverse compensation expense if market conditions not met**

Under the proposed Statement, compensation cost would be reversed only for awards granted to employees who do not remain in service for the requisite service period, or who do not achieve a specified operating performance target. If the service period is completed and the target achieved, no compensation cost is reversed. Conversely, an employee’s failure to fulfill either achieving a specified operating performance target or rendering services for a specified period of time, results in expense reversal prior to vesting. If, however, vesting and therefore exercisability is tied to one or more market conditions, for example, the achievement of a specified stock price or return on the stock price, if the market condition is not achieved, compensation expense would not be reversed. We believe that the most transparent representation in this case would be no expense, since the result is that the award never vested and therefore, never became exercisable.

In our view, a market condition should be treated in a similar fashion to performance or service conditions, i.e., the failure to fulfill a market condition tied to vesting should result in expense reversal. If an option award never vests and therefore is not exercisable due to a market condition never being realized, no cost should be reflected in a company’s income statement.
**Recommendation:** We recommend that the Board treat market conditions in a similar fashion to performance and service conditions—i.e., if a stock option award does not vest and therefore is not exercisable due to a market condition not being realized, no compensation cost should be recognized in a company’s income statement, because in effect, just as a performance condition not being achieved results in a stock option not vesting, so does a market condition.

**Level of disclosures too extensive**

The whole premise of the proposed Statement is that share-based awards to employees should be measured at fair value and recognized as compensation expense in the income statement. Intuitively, we would have expected that fewer disclosures would be necessary than was allowed under the disclosure-only option of SFAS 123. The disclosures under SFAS 123 were intended to compensate for the fact that the expensing of stock options was not required under the previous standard.

The focus should be on what the cost of share-based payments is to companies. After fair value has been determined at grant date, the uncertainties regarding the ultimate value of stock options include risks borne by the employees based on when they decide to exercise the options (assuming they become vested), and changes in the composition of options outstanding including forfeitures, cancellations, new grants, etc. Disclosing intrinsic values and expected future compensation expense will be very confusing to readers of financial statements and will cause many constituents to second guess the values recorded on companies’ financial statements.

We believe that more disclosures directed to the dilutive effects of stock option programs should be made to allow investors to assess the full impact of stock option programs on their ownership interests in a company. The ultimate result of stock options granted to employees on a company’s shareholders is to increase the number of owners in the company. Under the proposed rules, the compensation cost component has already been reflected in the company’s income statement at the grant date. The only pending impacts on the company are the ultimate dilution when the stock options are exercised and the employees become stockholders, and the tax deduction the company receives. Once the compensation cost is determined, it is not subsequently adjusted, assuming the vesting conditions are met. Disclosing other values in financial statements between the grant date and the final exercise date does not appear relevant or useful to shareholders or other readers of financial statements.

**Recommendation:** In our opinion, the required disclosures should be limited to those outlined in paragraph 46 of Appendix A. The Minimum Required Disclosures in paragraphs B191-B193 should be deleted.

**The prohibition against restatement of prior year results**

SFAS 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", permitted prospective, modified prospective and retroactive restatement methods of transitioning to the recognition provisions of SFAS 123. For the same reasons articulated in SFAS 148, we believe that companies should be permitted to restate their prior period financial statements by recording the amounts that they previously disclosed in accordance with the requirements of SFAS 123.
This will result in greater consistency when making period-to-period comparisons of a company’s financial statements.

Prohibiting retroactive restatement would result in a portion of compensation cost being recorded in the income statement and a portion being disclosed in the footnotes, which seems inconsistent with one of the Board’s primary reasons for mandating the fair value recognition of share-based compensation in companies’ income statements—i.e., that footnote disclosure is not a substitute for accounting recognition.

**Recommendation:** We recommend that the Board permit companies to adopt the final Statements under either the modified prospective or retroactive methods (utilizing the expense amounts previously disclosed under SFAS 123).

* * * * * *

Management of the J.C. Penney Company appreciates the opportunity to express our views on this proposed Statement and would welcome any additional opportunities to discuss share-based payment accounting with the FASB Staff.

Respectfully,

*Robert B. Cavanaugh*

Robert B. Cavanaugh
Executive Vice President and Chief Financial Officer
J.C. Penney Company, Inc.
ACCOUNTING FOR STOCK OPTIONS

The Company has a stock option program for approximately 1,500 executives and senior management. Over the past several years, the Company's annual net stock option grants (stock options granted during the year, less any forfeitures or terminations) under this program have averaged about 15% of outstanding shares, including the common stock equivalent of preferred shares. On January 31, 2004, options to purchase 24.5 million shares of common stock, representing 8.6% of total shares, were outstanding, of which 17.6 million were exercisable. Of the exercisable options, about 56% were "in-the-money" or had an exercise price below the closing end-of-year stock price of $26.18. See Note 13 for more details about the Company's stock option program.

The Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB 25) which
Management's Discussion and Analysis of Financial Condition and Results of Operations

does not require expense recognition for stock options granted when the exercise price of the option equals, or exceeds, the fair market value of the common stock on the date of grant. See Note 1 on page 28 for further information about the Company's stock option accounting policy.

The FASB is currently reviewing the accounting for stock options, and may require the use of the fair value method prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation." In addition, on February 19, 2004, the International Accounting Standards Board issued accounting rules that require the expensing of stock options, and the FASB is working to align U.S. accounting with international standards. As required by SFAS No. 123 for companies retaining APB 25 accounting, the Company discloses the estimated impact of fair value accounting for stock options issued. See Note 1 on page 28.
Notes to the Consolidated Financial Statements

13 STOCK-BASED COMPENSATION

In May 2001, the Company’s stockholders approved a new 2001 Equity Compensation Plan (2001 Plan), which initially reserved 16 million shares of common stock for issuance plus 12 million shares reserved but not subject to awards under the Company’s 1997 and 2000 equity plans. The 2001 Plan provides for grants to associates of options to purchase the Company’s common stock, stock awards or stock appreciation rights. No future grants will be made under the 1997 and 2000 plans. At January 31, 2004, 8.7 million shares of stock were available for future grants. Stock options and awards typically vest over performance periods ranging from one to five years. The number of option shares is fixed at the grant date, and the exercise price of stock options is generally set at the market price on the date of the grant. The 2001 Plan does not permit stock options below grant date market value. Options have a maximum term of 10 years. Over the past several years, the Company’s net stock option grants (stock options granted during the year, less any forfeitures or terminations) have averaged about 15% of total outstanding stock.

Stock Options

At January 31, 2004, options to purchase 24.5 million shares of common stock were outstanding. If all options were exercised, common shares outstanding (including common equivalents of outstanding preferred stock) would increase by 8.6%. At the end of 2003, 176 million, or 72% of the 245 million outstanding options, were exercisable. Of those, 56% were “in-the-money” or had an exercise price below the closing price of $26.18 on January 31, 2004, as shown in the following schedule:

(Shares in thousands, price is weighted average exercise price)

<table>
<thead>
<tr>
<th>Shares</th>
<th>Price</th>
<th>Exercisable</th>
<th>Shares</th>
<th>Price</th>
<th>Unexercisable</th>
<th>Shares</th>
<th>Price</th>
<th>Total</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In-the-money</td>
<td>9,530</td>
<td>66%</td>
<td>$17.44</td>
<td>6,785</td>
<td>99%</td>
<td>$18.80</td>
<td>16,715</td>
<td>66%</td>
<td>$17.99</td>
</tr>
<tr>
<td>Out-of-the-money</td>
<td>7,712</td>
<td>44%</td>
<td>45.27</td>
<td>50</td>
<td>1%</td>
<td>32.21</td>
<td>7,762</td>
<td>32%</td>
<td>45.16</td>
</tr>
<tr>
<td>Total outstanding</td>
<td>17,642</td>
<td>100%</td>
<td>$29.59</td>
<td>6,835</td>
<td>100%</td>
<td>$18.93</td>
<td>24,477</td>
<td>100%</td>
<td>$26.61</td>
</tr>
</tbody>
</table>

(1) Out-of-the-money options are those with an exercise price equal to or above the closing price of $26.18 at the end of 2003.

The following table summarizes stock options outstanding at January 31, 2004:

(Shares in thousands, price is weighted average)

<table>
<thead>
<tr>
<th>Exercise price range</th>
<th>Shares</th>
<th>Price</th>
<th>Remaining (term years)</th>
<th>Shares</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>$9.32-$16.00</td>
<td>3,755</td>
<td>$15.01</td>
<td>6.4</td>
<td>3,681</td>
<td>$15.04</td>
</tr>
<tr>
<td>$16.06-$19.80</td>
<td>8,696</td>
<td>18.10</td>
<td>8.1</td>
<td>2,374</td>
<td>16.39</td>
</tr>
<tr>
<td>$20.01-$24.80</td>
<td>4,223</td>
<td>20.35</td>
<td>8.2</td>
<td>3,844</td>
<td>20.31</td>
</tr>
<tr>
<td>$25.31-$28.57</td>
<td>303</td>
<td>27.36</td>
<td>7.2</td>
<td>243</td>
<td>27.17</td>
</tr>
<tr>
<td>$32.05-$40.84</td>
<td>3,784</td>
<td>36.17</td>
<td>4.5</td>
<td>3,784</td>
<td>36.17</td>
</tr>
<tr>
<td>$43.00-$44.31</td>
<td>680</td>
<td>43.40</td>
<td>2.4</td>
<td>680</td>
<td>43.40</td>
</tr>
<tr>
<td>$47.69-$50.91</td>
<td>1,423</td>
<td>48.11</td>
<td>2.2</td>
<td>1,423</td>
<td>48.11</td>
</tr>
<tr>
<td>$55.31-$71.28</td>
<td>1,613</td>
<td>67.25</td>
<td>2.6</td>
<td>1,613</td>
<td>67.25</td>
</tr>
<tr>
<td>Total</td>
<td>24,477</td>
<td>$26.61</td>
<td>6.4</td>
<td>17,642</td>
<td>$29.59</td>
</tr>
</tbody>
</table>

A summary of stock option activity follows:

(Shares in thousands, price is weighted average exercise price)

<table>
<thead>
<tr>
<th>January 27, 2001</th>
<th>Shares</th>
<th>Price</th>
<th>Exercisable</th>
<th>Shares</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Granted</td>
<td>3,402</td>
<td>16</td>
<td>17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercised</td>
<td>9,530</td>
<td>56</td>
<td>6,785</td>
<td>99</td>
<td>18.80</td>
</tr>
<tr>
<td>Canceled/orfeited</td>
<td>7,712</td>
<td>44</td>
<td>45.27</td>
<td>50</td>
<td>1</td>
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<tr>
<td>Total outstanding</td>
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<td>100</td>
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<td>$29.59</td>
</tr>
</tbody>
</table>
The Company follows the intrinsic value expense recognition provisions of APB 25 as permitted by SFAS No. 123. As a result, no compensation expense is recognized for stock options. As required by SFAS No. 123, the Company estimates the pro forma effect of recording the estimated Black-Scholes fair value of stock options as expense over the vesting period. See Note 1.

Stock Awards
The Company awarded approximately 364,000, 727,000, and 133,000 shares of stock to employees with weighted-average grant-date fair values per share of $19.43, $20.09 and $15.94, respectively, in 2003, 2002 and 2001, respectively. Total expense recorded for stock-based employee compensation awards was $8.2 million, $5.1 million and $7.5 million in 2003, 2002 and 2001, respectively.

The 2001 Plan also provides for grants of restricted stock awards and stock options to outside members of the Board of Directors. Restricted stock awards acquired by such directors are not transferable until a director terminates service. The Company granted shares of common stock totaling 36,682, 21,266 and 16,608 to outside members of the Board of Directors in 2003, 2002 and 2001, respectively. Total expense recorded for these directors' awards was $0.7 million, $0.5 million and $0.4 million in 2003, 2002 and 2001, respectively.