EATON

June 30, 2004

Director of Major Projects
Financial Accounting Standards Board

Letter of Comment No: 6448
File Reference: 1102-100

Subject: File Reference No. 1102-100

Dear Director:

Eaton Corporation appreciates the opportunity to respond to the Financial Accounting Standards Board's (the Board) Exposure Draft on *Share-Based Payment* (ED). Eaton Corporation is a global company with over 50,000 employees on six continents serving the industrial, commercial, construction, automotive, government and consumer sectors of the economy.

While we recognize the ongoing diligence of the Board in its goal of continuous improvement of the quality of financial reporting in our ever-changing business environment, we do not believe that current accounting standards surrounding employee stock options need to be revised. We believe that investors needs for information related to stock options is best met by comprehensive pro forma financial information related to stock options as is currently provided by public companies. This pro forma information allows investors to make their own determination about the impact of stock options on a company's financial performance.

If the Board ultimately decides to issue a new standard, we recommend the Board delay the effective date of any final rule by at least one year to 2006. The earliest time the Board could issue a final rule would be in fourth quarter 2004, which is very close to year-end for calendar year companies. Companies are currently devoting substantial attention to Section 404 requirements of the Sarbanes-Oxley Act and accelerated SEC filing deadlines, along with making their normal preparations for year-end. The combined effect of this substantial increased workload, coupled with the new complex provisions in the ED, and the changes the ED will require to systems, data collection, modeling, education, plan design and communication, would make implementation in first quarter 2005 challenging and prone to change or error.

Our primary concerns with the proposed ED are summarized as follows:

- Employee stock options do not represent expense to the company that should be recorded in the income statement. The true cost related to employee stock options is the dilution the entire common shareholder group suffers when options are exercised. We believe this cost is most appropriately, and already, reflected in the financial statements through the increase in dilutive shares outstanding used to calculate earnings per share and the resultant reduced earnings per share.

- Employee stock options do not have a readily determinable value on date of grant and, therefore, their value is speculative. Current stock option pricing models do not accurately value employee stock options. These models assume that options trade in an open market, are transferable, are without restrictions and are short-term. In most situations, those assumptions are not applicable to employee stock options and therefore, the models do not generate values for employee stock options that are fair, reasonable, reflect economic reality and are comparable across various industries. Further, inputs into the models will vary widely from company to company, adding to the notion that the values are unreliable. We believe the use of current option pricing models and their inherent wide range of inputs will be of questionable value and will erode the confidence of users in financial reporting.

- No provision is included in the ED to reverse previously recorded expense for options that expire unexercised. This is inconsistent and asymmetrical and should be changed.

- Companies should continue to be allowed to expense stock options by the straight-line method. For employee stock options that vest according to a graded schedule, the new requirement in the ED to front-load expense introduces a large amount of additional complexity into calculations with no significant accompanying benefit, particularly for companies with monthly or daily vesting. In order to meet this requirement, companies will have to spend time and money in order to set-up complex tracking systems necessary to collect the required data which will be of questionable value.

- The FASB should retain the current provision to write-off excess deferred income tax assets directly to equity, against accumulated excess income tax benefits recorded previously in equity from the exercise of options. The requirement in the ED to recognize excess income tax benefits from the exercise of employee stock options as a direct increase to shareholders equity, but in the reverse situation to recognize the difference as a charge in the income statement is inconsistent and asymmetrical. Further, this requirement will require companies to spend time and money in order to set-up complex tracking systems necessary to collect the required data which will be of questionable value.

- The current requirement to reflect in cash flow from operations all income tax benefits related to employee stock options should be retained. The new requirement in the ED to recognize excess income tax benefits from the exercise of employee stock options as a financing activity, but in the reverse situation to recognize the difference as a charge against cash flow from operations is inconsistent and asymmetrical and should be changed.

We appreciate the Board's consideration of these important matters and welcome the opportunity to discuss any and all issues with the Board at its convenience. Comments requested by the Board on selected issues contained in the Exposure Draft are included below. If you have questions regarding this letter, please call me at (216) 523-4175.

Sincerely,

/s/ Billie K. Rawot

Billie K. Rawot
Vice President & Controller
Eaton Corporation

Eaton Corporation's comments on selected issues of the Board's proposed Statement (paraphrased in italics) are as follows:

Recognition of Compensation Cost

<u>Issue 1:</u> Do you agree with the Board's conclusion that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations and as such should be recognized in the financial statements?

We agree that expense should be recognized for employee services received in exchange for equity instruments when the equity instruments have a readily determinable market value on date of grant (e.g., restricted stock).

Employee stock options do not represent a cost to the company that should be recorded in the income statement since they do not have a readily determinable value on date of grant and, therefore, their value is speculative. The only cost related to employee stock options is the dilution the entire common shareholder group suffers when options are exercised. We believe this cost is most appropriately, and already, reflected in the financial statements through the increase in dilutive shares outstanding used to calculate earnings per share and the resultant reduced earnings per share.

<u>Issue 2:</u> Do you agree with the Board's conclusion that pro forma disclosures as if the fair-value-based method of accounting had been applied are not an appropriate substitute for recognition of compensation cost in the financial statements?

We believe the pro forma disclosures that are currently required provide sufficient information for financial statement users to evaluate the impact of employee stock options and other share-based compensation.

Measurement Attribute and Measurement Date

<u>Issue 3:</u> Do you agree with the requirement 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?

We agree that expense should be recognized for employee services received in exchange for equity instruments when the equity instruments have a readily determinable market value on date of grant (e.g., restricted stock). However, employee stock options do not represent a cost to the company that should be recorded in the income statement since they do not have a readily determinable value on date of grant and, therefore, their value is speculative.

Fair Value Measurement

<u>Issue 4(a):</u> Do you believe that the proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency?

The ED provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency, given its inherent measurement subjectivity. Specific company experience should be factored into the valuation calculation to be a meaningful indication of appropriate valuation.

<u>Issue 4(b):</u> Do you agree with the Board's conclusion that that the fair value of employee share options can be measured with sufficient reliability? Do you agree that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options?

We do not believe that fixed, employee stock options lend themselves to reliable measurement. We believe that both the lattice and Black-Scholes-Merton models are market-based and inaccurate tools for valuing employee stock options that are reflected in the income statement. At the time of grant, the options have no value because they are not transferable, they are subject to contingencies, and their future value is speculative. The assignment of a value before any of the economic realities affecting the value are known will cause further distortion. Additionally, the input assumptions can be manipulated to drive a broad range of outcomes.

Regarding the lattice model, we are greatly concerned that companies will have to spend time and money in order to set-up complex tracking systems necessary to collect the required data related to exercises and forfeitures of stock options that will be of questionable incremental value.

Issue 4(c): *Do you believe that the Board should require a specific method of estimating expected volatility?*

We believe the Board should allow companies to use their best judgment based on their business environment while considering the various factors discussed in the ED. However, with so many factors outside of a company's control, it is speculative to think that one can accurately predict stock price volatility and the impact on option transactions.

Issue 4(d): *Do you agree that the methods for estimating fair value in the proposed Statement give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value?*

We are concerned with the ED's attempt to estimate the fair value of options using option-pricing models that were never intended to value employee stock options. As discussed in Issue 4(b), we do not believe that fixed stock options lend themselves well to reliable measurement.

Issue 5: *Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value?*

Any recognition of value to a company and option holder is only appropriate at grant date of option. The intrinsic value method with remeasurement through the settlement date is not an appropriate alternative accounting treatment. Therefore, employee stock options do not represent a cost to the company that should be recorded in the income statement since they do not have a readily determinable value on date of grant and, therefore, their value is speculative.

Employee Stock Purchase Plans

Issue 6: *Do you agree that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of shares?*

We agree with this principle and do not believe these plans are intended to be compensation to employees and should not be accounted for as such.

Attribution of Compensation Cost

Issue 7: Do you believe that the requisite service period is the appropriate basis for attribution?

Companies should continue to be allowed to expense stock options by the straight-line method over the requisite service period. For employee stock options that vest according to a graded schedule, the new requirement in the ED to front-load expense is inappropriate and not reflective of the service requirements for the grant in totality. Additionally, it introduces a large amount of additional complexity into calculations with no significant accompanying benefit, particularly for companies with monthly or daily vesting. In order to meet this requirement, companies will have to spend considerable time and money in order to set-up complex tracking systems necessary to collect the required data which is of questionable value.

Issue 8: Do you believe that the proposed Statement provides sufficient guidance about estimating the requisite service period?

We believe the ED provides adequate guidance about estimating the requisite service period.

Issue 9: Do you agree with the proposed accounting treatment that would require a single method of accruing compensation cost for awards with a graded vesting schedule?

As discussed in Issue 7, companies should continue to be allowed to expense stock options by the straight-line method. To require front-loaded accruals for all new grants is inappropriate and increases the complexity and calculations, particularly for companies with monthly or daily vesting.

Modifications and Settlements

Issue 10: Do you believe the proposed principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments are appropriate?

The ED does not allow a company to adjust compensation expense related to unexercised options that expire unexercised. Various factors impact actual option exercises. Option-pricing models attempt to replicate exercise patterns based on historical information, but some events are unpredictable at the grant date. We believe an adjustment to compensation expense should be allowed when these factors have the affect of rendering the options worthless.

Income Taxes

Issue 11: Do you agree with the method of accounting for income taxes established by this proposed Statement?

We do not agree with the requirement that excess tax benefits be recognized in equity, while shortfalls in tax benefits be included in earnings. We believe any difference between the initial deferred tax asset recognized during the vesting period and the eventual tax benefit should be recorded in equity, regardless of whether the difference is excess or a shortfall.

Disclosures

Issue 12: Do you believe that the disclosure objectives in this proposed Statement are appropriate and complete? Do you believe the minimum required disclosures are sufficient to meet those disclosure objectives?

In general, we believe that the proposed disclosures are adequate. However, those related to the number and weighted-average exercise prices as discussed in paragraph B191(b) should be disclosed for each year that an income stated is presented, which is consistent with current requirements, instead of just the most recent year.

Transition

<u>Issue 13:</u> *Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement?*

We believe companies should be allowed to restate results of prior periods to ensure comparability using similar pro forma disclosures currently required under SFAS 123.

Cash Flows

<u>Issue 16:</u> *Do you agree with reflecting the excess tax benefits as financing cash inflows rather than as a reduction of taxes paid?*

We believe that requiring only cash tax benefits in excess of deferred taxes to be classified as a financing cash flow implies that part of a company's motivation for issuing options is to raise capital, which is not typically the case. We believe all income tax cash flows related to stock options should remain in operating cash flows.

Understandability of This Proposed Statement

<u>Issue 18:</u> *The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the standard, and a willingness to study the standard with reasonable diligence. Do you believe that the proposed Statement, taken as a whole, achieves that objective?*

Given the technical nature of employee stock option calculations, we believe the additional requirements proposed in this ED greatly increase the complexity and provide little incremental value to users of financial statements. FASB accounting regulations are becoming increasingly more complex, even for those with reasonable levels of accounting and business knowledge, which lends itself to more varied interpretation and less comparability, which seems to undermine the ultimate objective of improving financial reporting.