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Mr. Lawrence W. Smith
Director of Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
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Dear Mr. Smith:

The purpose of this letter is to formally request that the Financial Accounting Standards Board ("FASB") evaluate the FASB staff's recently expressed view on the definition of "grant date" under Statement of Financial Accounting Standards No. 123 (revised 2004), i.e., "FAS 123R". At a minimum, we believe this FASB staff view should only be adopted after the FASB staff follows its articulated procedures for issuing a FASB Staff Position ("FSP") or the issue is brought before the Emerging Issues Task Force ("EITF").

This letter addresses the following:

- Our Understanding of the FASB Staff View on the Definition of Grant Date;
- Implementation Consequences of the FASB Staff View on the Definition of Grant Date;
- Definition of Grant Date under Applicable Accounting Literature;
- Issues with the FASB Staff View on the Definition of Grant Date; and
- Our Point of View

Our Understanding of the FASB Staff View on the Definition of Grant Date. It is our understanding that the FASB staff recently expressed its view on the definition of grant date under FAS 123R to the Big 4 accounting firms. According to the FASB staff, there is no grant date until the terms of an equity award are communicated to those individuals receiving an award. They believe that there cannot be a mutual understanding of the key terms of the award between the employer and the employee until this communication takes place, even if that communication takes place within a "reasonable" period of time after the award is approved (by the compensation committee or the board, whichever is applicable). Apparently, the FASB staff also stated that FAS 123R clarified the definition of grant date and thus, the effective date for this view is the same as the date of adoption of FAS 123R.

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Implementation Consequences of the FASB Staff View on the Definition of Grant Date

Under APB Opinion 25 and Original FAS 123, the accepted practice for determining the grant date has generally been the date of a board's or a compensation committee's approval of the terms of the grant, provided that those terms are communicated to affected individuals within a reasonable period of time following such approval. For most companies, particularly companies with global operations and equity-grant participants all around the world, it is very rare that this communication happens on the actual date of the board or compensation committee meeting.

Since the recent FASB staff view changes the currently accepted practice for determining the grant date, the consequences are such that companies are left with alternatives that are impractical, difficult to implement administratively, and contrary to good corporate governance practices.

Alternatives Available to Companies

The alternatives available to companies include the following:

- Grant Date for Purposes of Determining the Exercise Price is the Date of Communication -- In this case, the date of communication is the grant date for purposes of determining the exercise price. Of course, companies would need to have a process in place for determining and tracking when the communication occurs (which most do not and which is administratively burdensome). Also, most plan documents do not define the grant date as the date of communication. Rather, the grant date is the date of the board/compensation committee approval. Companies would have to amend their plans and these amendments would need to be carefully drafted to ensure there are no unintended consequences (e.g., tax issues). Another significant issue is that every participant could conceivably have a different grant date with a different exercise price, and that is very impractical from an administrative point of view and unacceptable to companies because of the communication challenges to employees and an overarching issue of "fairness"—imagine two people sitting next to each other and one receives the communication when the stock price is \$X and the other receives the communication when the stock price has risen to \$X plus 10 percent.
- Communicate the Terms Prior to the Approval by the Board or Compensation Committee—Under this scenario, all of the key terms of the grant would be communicated on or before the date of the approval by the board or the compensation committee. On the date of board/compensation committee approval, the exercise price is established and this is communicated electronically (web-based or email). There are numerous issues with this approach.

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The first is a governance issue. In many cases, the board/compensation committee approves the specific awards (sizes and terms) for the Section 16 officers and it also approves the aggregate pool for equity awards to participants below the Section 16 officer level (often including ranges for each level or salary grade). In our view, it would not be appropriate to communicate anything until the board/compensation committee actually approves the awards and the aggregate size of the pool. Otherwise, the Company and the board/compensation committee could be accused of simply being a "rubber stamp." This would certainly not be considered a "best practice" from a corporate governance perspective. This approach could also present difficult employee relations issues, where the board/compensation committee did not approve the "expected" awards.

If communication of an award prior to the board/compensation committee approval is not viable, this means the date of communication would need to happen on the same date the awards are communicated to participants. Theoretically, this could be done via emails or the web, but for most companies, they would need to modify their systems in order to communicate award information on the same date (and this could take time given all of the modifications companies have been required to implement in order to comply with Sarbanes-Oxley). This is also not an ideal form of communication since many companies believe that communication should be more personal/tailored and many companies have implemented procedures to comply with Sarbanes-Oxley audit requirements that require advance notification of an award to an individual's manager prior to notification to the employee. Also, for companies that grant awards outside the U.S., it may actually be illegal in some countries to communicate an award until certain governmental approvals are achieved.

• Board or Compensation Committee Approves the Terms and Fixes the Exercise Price in the Future When the Awards Can be Communicated—This alternative addresses the corporate governance concern expressed above with respect to seeking approval after the awards have been communicated. However, it still can be problematic from a corporate governance perspective if there are significant changes in the stock price from the date of the board/committee approval to the date when the price becomes fixed. For example, the compensation committee may decide that the exercise price will be fixed one month subsequent to the date of the compensation committee meeting, thinking that one month is a sufficient time period to allow for the communication of the award. In that interim month, the stock price could change dramatically, and if the Committee had known, they may have adjusted the size of the awards.

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The other issue with this approach is that the grant date is potentially subject to manipulation. For example, a company could conceivably communicate all of the terms of the award and then wait to set the price when it believes it is most advantageous.

- Schedule an Additional Board/Committee Meeting to Approve the Price Once the Other Terms of the Grant have been Communicated—From a corporate governance perspective, this is probably the best solution. The board/compensation committee would meet to approve the award sizes and key terms, except exercise price. Subsequent to this meeting, the awards are communicated to employees. The board/compensation committee meets again after all communications have been made and sets the exercise price. This is communicated electronically on the date of the board/compensation committee meeting. Obviously, one significant disadvantage to this approach is the need to schedule an additional board/compensation committee meeting, simply to approve the grant date stock price. Another disadvantage is that companies will still need to modify their systems in order to communicate the exercise price on the date of the board/compensation committee approval.
- Fix All Terms at the Date of the Board/Compensation Committee Meeting and if Date of Grant Stock Price is Different, Result is a Premium or Discounted Stock Option Grant—With this approach, the board/compensation committee establishes all of the terms of the awards, including the exercise price at the board/compensation meeting. The awards are communicated subsequent to the board/compensation committee approval. Since the grant date is the date of the communication, if the stock price changes from the date of grant, a stock option grant may be a premium stock option or a discounted stock option.

This is not an attractive approach either for a number of reasons. Companies must determine the fair value cost of all of the awards and even if the exercise price is the same, the stock price on the date of grant may be different for every award. It is cumbersome and costly to determine the fair values of multiple awards that were intended to be identical (i.e., only one fair value calculation). The other issues are that this may have contractual and tax consequences. Under most plan documents, the grant date is the date of the board/committee approval and most plans preclude the granting of discounted stock options (which would occur if the stock price increased after the exercise price had been established by the board/compensation committee). Also, if the date of communication is considered the date of grant for tax purposes, this may also result in the grant of a discounted stock option which would have onerous consequences under Sections 162(m) and 409A of the Internal Revenue Code. One of the requirements to qualify compensation as performance-based under

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Section 162(m) is that the exercise price cannot be less than the fair market value on the date of grant.

Definition of Grant Date under Applicable Accounting Literature

Under APB Opinion 25, the measurement date for an equity award is the first date the price to be paid, if any, and the number of shares to be awarded to an individual is known. For fixed awards, this date is the grant date (i.e., the date of the board/compensation committee approval). In paragraph 395 of FAS 123, the grant date is defined as "the date at which an employer and an employee have a mutual understanding of the terms of a stock-based compensation award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to employees who fulfill vesting requirements." FAS 123 did not expand any further on the definition of grant date, but accepted practice was to establish the grant date on the date of the board/compensation committee approval because this was the date the employer becomes contingently obligated to issue equity instruments or transfer assets to employee who fulfill vesting requirements.

FAS 123R expands on the definition of grant date. Specifically, grant date is defined in Appendix E as:

"The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until approval is obtained unless approval is perfunctory, for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares."

In Appendix B of FAS 123R, Basis for Conclusions, paragraph B49 seems to be very clear regarding the definition of grant date. It states that the definition of grant date is essentially the same as in Statement 123, which in turn is essentially the same as the notion of grant date used in practice under APB Opinion 25. The FASB acknowledged in paragraph B49 that because it sometimes may be difficult to determine when a mutual understanding of the key terms and conditions has been reached, the Board decided to clarify the concepts underlying the definition of grant date by adding the following sentence to the definition in Appendix E, "the grant date

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for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares."

Reasons Why the FASB Staff View on the Definition of Grant Date Should be Evaluated

First, we believe that paragraph B49, as discussed above, already clarified the definition of grant date to be the date that the employee benefits from or is adversely affected by the stock price. Clearly, the Board recognized that it may be difficult to determine the date of mutual understanding and felt it was necessary to add that clarification. Also, the statement that the grant date is essentially the same as under APB Opinion 25 and FAS 123 appears to be a clear intent by the Board to continue the current practice.

Besides the significant implementation consequences discussed above, we believe there are other issues with the FASB staff's position. The FASB staff has stated that the grant date cannot occur until there is a "mutual" understanding of the key terms of the award and this cannot occur until the award is communicated. For most equity awards, we would question whether there is ever a "mutual" understanding of the terms. It is unusual for many companies to actually require acceptance of an award (unless there is a noncompete or clawback provision, or there are local country tax laws that require acceptance in order to establish a grant date for tax purposes). For many companies, the communication is "one-way" because there is nothing that an employee needs to agree to in order to receive the award. In fact, the acceptance of an award is often perfunctory.

In its definition of grant date, FASB incorporates the concept of "perfunctory approval" with respect to awards that are granted contingent on subsequent shareholder approval. Specifically, the grant date for accounting purposes cannot occur until shareholder approval is received, unless the approval is essentially a formality (or perfunctory). It seems to us that with the majority of equity awards, this concept could be extended to the requirement of a mutual understanding. In essence, the mutual understanding is a formality or perfunctory.

Another reason concerns the manner in which the change in practice was communicated. We are troubled that this position was not at least stated in an FSP, which would allow constituents an opportunity to comment.

Our Point of View

We believe the grant date should be the date the employee begins to benefit from or be adversely affected by the stock price. We do not believe that communication of an award is critical since it is usually after the date the individual is affected by stock price changes, can be difficult to determine (which FASB seemed to acknowledge), does not

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represent a "mutual" understanding because the communication is often "one-way," and is generally only a formality because the individual would not decline the award anyway (unless there is a noncompete or clawback, or acceptance is necessary for tax purposes). We also do not believe it is necessary to establish a "bright line" test for when communications need to occur. Obviously, the communication should be within a reasonable period of time after the board/compensation committee approval of an equity-based award in order to ensure employees understand what they will receive in exchange for their service to the company over the requisite service period. Good faith communication efforts by companies granting equity awards should be sufficient. We urge the FASB to rescind the guidance the FASB staff communicated to the Big 4 accounting firms and clarify that the definition of grant date is the date the participant begins to benefit from or is adversely affected by changes in the stock price, provided that the communication of the key terms of the award are made within a reasonable period of time, which is determined based on facts and circumstances.

If you have any questions regarding this letter, please contact me.

Sincerely,

Hewitt Associates LLC

Roberta D. Fox

RDF:jh

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Exchange Commission

cc: Mr. Robert H. Herz, Chairman Financial Accounting Standards Board
Mr. Donald T. Nicolaisen, Office of the Chief Accountant, Securities and Exchange
Commission
Mr. Allen L. Beller, Director, Division of Corporation Finance, Securities and