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Certified in Financial Management Program

Mr. Robert H. Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856 May 13, 2005

Dear Bob:

Letter of Comment No: 5
File Reference: 1102-SCU

The Financial Reporting Committee ("FRC") of the Institute of Management Accountants would like to bring to your attention a significant implementation issue as it relates to Statement of Financial Accounting Standards ("Statement") No. 123 - Revised 2004, Share Based Payment ("FAS 123R"). The issue relates to accounting for provisions of equity award plans that provide for acceleration of vesting upon early retirement of an employee.

By way of background, pursuant to existing equity award plans, many companies provide retirement eligible employees (i.e., employees with requisite age and service requirements) with accelerated vesting of equity awards upon retirement. As an example, Company A's existing equity award plan provides for options granted to employees to vest ratably over a four-year period but upon retirement, all unvested equity awards vest immediately. These retirement provisions were designed to prevent the loss of unvested equity awards upon the retirement of an employee. Pursuant to the provisions of FAS 123R, equity awards granted to early retirement eligible employees would be required to be expensed immediately irrespective of the employees intention to continue working for the Company. For example, an employee may become early retirement eligible at the age of 50 and fully expect to work until the normal retirement age of 65. However, because the employee is early retirement age eligible, the full fair value of an equity award would be immediately expensed. Such awards would be expensed even though the equity awards can not be exercised until the awards vest pursuant to the contractual terms of the award or the employee elects to early retire.

In recognizing the costs for equity awards with these provisions, most companies have historically recognized such costs over the contractual vesting period of the award as this represented the best estimate of the expected service period over which the services would be performed to earn the awards. In support of this accounting, we note the following:

• An employee would rarely choose to retire early as there is a strong economic disincentive preventing early retirement. Specifically, to retire early and trigger an accelerated vesting of their equity awards, the employees

typically must accept a substantially reduced retirement benefit (not only in terms of fewer service years but also in terms of an early-retirement discount on the benefit computed using their actual service years).

- This treatment is consistent with the guidance in Emerging Issues Task Force ("EITF") Issue No. 00-18, Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other than Employees ("EITF 00-18"). Specifically, EITF 00-18 addresses the accounting for fully vested, non-forfeitable equity instruments that are issued on the date a grantor and grantee enter into an agreement for future goods and services. Although EITF 00-18 focuses on the grant of a fully vested equity instrument to a non-employee, it would appear that a similar accounting treatment should be applied to a fully vested equity instrument granted to an employee. While there was no final consensus on EITF 00-18, the SEC Observer noted "that all facts and circumstances must be considered in determining the period(s) and manner in which the measured cost of the transaction should be recognized." That is, the SEC Observer recognized that even though the equity instruments were fully vested they could represent compensation for future goods and services.
- In accounting for pension costs, actuaries calculate pension cost pursuant to FASB Statement No. 87, Employers' Accounting for Pensions, based on the expected period of retirement and not the actual date an employee is eligible to early retire. In addition, EITF Issue No. 88-1 Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan ("EITF 88-1") addressed the accounting for vested benefit obligations that are greater than an accumulated benefit obligation. Specifically, the vested benefit obligation is the actuarial present value of the vested benefits to which the employee is entitled to if the employee separates immediately as compared to the accumulated benefit obligation which is the actuarial present value of the benefits the employee is entitled to based on the employee's expected date of retirement. In EITF 88-1, the EITF concluded that recording the benefit costs based on the vested benefit obligation or the accumulated benefit obligation was a policy decision and permitted accounting for such costs based on an estimate of the expected date of retirement.
- Companies that have used stock options extensively in the past and that have pension programs with early
  retirement provisions also have extensive historical experience that enables them to estimate the actual incidence
  of accelerated vesting with at least as much reliability as they can estimate stock option forfeitures.
- An equity award to an employee who is eligible to retire early but would sacrifice other retirement benefits to do so has economic attributes similar to a fully vested equity award with a market price condition. For fully vested awards with a market price condition, Statement 123R requires use of a derived service period rather than the award's explicit service period. For example, consider an award of 1,000 options with an exercise price of \$10 per share. If the employee elects to retire early, the present value of pension benefits would be \$8,000 lower than if the employee waits to retire at the normal retirement age. Effectively, the exercise price of the options if the employee retires immediately is \$18 per share (\$10,000 exercise price plus \$8,000 forgone pension benefit divided by 1,000 shares), not \$10.

The FRC would like to bring to your attention several concerns it has with the accounting for awards granted to early retirement eligible employees that receive reduced benefits. First, we do not believe that immediately recognizing compensation expense for the full fair value of an equity award to employees who are eligible for early retirement aligns with the expected period of service because there often are significant economic disincentives

dissuading an employee from electing to early retire. Specifically, upon reaching early retirement eligibility an employee may be many years away from the "normal" retirement age - as much as 15 years or more - and in order to exercise their early retirement options the employees typically must accept a substantially reduced retirement benefit (not only in terms of fewer service years but also in terms of an early-retirement discount on the benefit computed using their actual service years). In addition, the awards typically are expected to vest and do vest over their stated vesting periods (as opposed to the accelerated periods). Therefore, we suggest that the FASB reconsider this aspect of FAS 123R. We believe that FAS 123R should be amended to require that an employer should estimate the service period for an early retirement eligible employee based on an assessment of the employee's total package of retirement benefits.

Our second concern is that we do not believe that these provisions and their impact are widely understood by many companies that will be required to implement FAS 123R. Specifically, these provisions were not included in the exposure draft of FAS 123R and, therefore, we do not believe that such provisions were addressed in a manner that allowed for due process in deliberating the significant accounting implications. We understand that the Securities and Exchange Commission ("SEC") and certain accounting firms discussed transition provisions related to expensing options for early retirement eligible employees. However, we are concerned that the discussion by the SEC might not be known to the general public. Therefore, if the Board doesn't reconsider this aspect of FAS 123R, we believe that transition guidance from the FASB is needed.

Third, we believe that there are implementation issues and additional complexities that need to be addressed. For example, over what period should expense be recognized if an option with a four-year vesting period is granted to an employee who is two years away from being eligible for early retirement with significantly reduced benefits? If the vesting period on the date of grant should be adjusted to consider the employee becoming early retiree eligible during the original vesting term, we believe that many companies would have to develop systems to track employees that are not eligible for early retirement at the grant date but may become eligible during the award's term.

We would welcome an opportunity to personally discuss these and other issues with you. If you have any questions, please do not hesitate to call me.

Sincerely,

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Chair, Financial Reporting Committee Institute of Management Accountants

cc:

Mr. Donald T Nicoliason, Chief Accountant Securities & Exchange Commission