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MERCER
Human Resource Consulting

1166 Avenue of the Americas
New York, NY 10036-2708
212 345 7648 Fax 212 345 7414
susan.eichen@mercer.com
www.mercerHR.com

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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

Subject:
Share-Based Payment Exposure Draft (File Ref. No. 1102-100)

Dear Ms. Bielstein:

We appreciate the hard work of the FASB and its staff in crafting the above-referenced Exposure Draft (ED). We recognize the challenge of drafting a standard that covers a large number of issues and practices, balances the interests of several constituencies, and adheres to a principles-based approach while providing adequate implementation guidance.

Please note that our comments are made in the context of Mercer Human Resource Consulting's role as compensation consultants, and do not necessarily reflect the views of either our parent company, Marsh & McLennan Companies, or any specific client.

While we do not agree with all of the ED's proposals, we believe that the proposed Statement goes a long way toward accomplishing the FASB's stated objectives: satisfying user concerns about faithful representation of the economics underlying share-based payment transactions; improving comparability by eliminating alternative methods of accounting for share-based payments; simplifying US GAAP by requiring a single fair-value standard with "modified prospective" transition rules; and converging with international accounting standards. Similarly, under the proposed Statement, the playing field among most kinds of share-based payments is leveled, so compensation plan choices won't be as driven by accounting considerations as they have been.

We recommend that, before the Board issues a final standard, more field testing be done to thoroughly identify and address implementation issues. We also recommend that the effective date be set so as to provide a reasonable time (possibly a year) between issuance of the final standard and the effective date. This will enable companies and their advisors to do what is necessary to comply, and will benefit users and other interested parties in the short and long run.

Comments

Many of our comments concern implementation issues. Although, over time, some of these issues will be resolved simply through experience, accomplishment of the objectives outlined above will be enhanced if some substantive changes and clarifications are made.

Recognition of Compensation Cost (Issues 1 and 2)

We endorse the fair-value accounting principle for share-based compensation and elimination of the "pro forma disclosure only" alternative in Statement 123.

Grant-Date Fair Value Measurement (Issue 3)

We believe that a pure grant-date approach has a number of merits but also appreciate the Board's modified grant-date "compromise." We believe that the modified grant-date approach, assuming it is retained in the final standard, should be applied to all types of awards, including those with market conditions.

The dichotomy in Statement 123 and the ED between allowing a "true-up" for awards with service and performance conditions, but not allowing a "true-up" for awards with market conditions, continues to trouble us, in part because we believe the rationale for the dichotomy is not clear. The rationale appears, in substantial part, to be a "deeming rule" under which service and performance conditions are deemed to affect vesting, and market conditions are deemed to affect exercisability. But this deeming rule does not always comport with reality. In the typical case, employees become vested and acquire the right to exercise at the same time – and, even if not, any one of the three types of conditions can affect either vesting or exercisability.

In addition, the dichotomy perpetuates the APB 25 flaw of disparate outcomes for similar awards, leading, in turn, to accounting-driven plan designs that may be inappropriate when shareholder interests and attraction and retention needs are considered.

We note that the ED can be read as somewhat internally inconsistent with respect to the treatment of forfeitures. For example, expense is trued up for actual pre-vesting forfeitures but not for post-vesting termination behavior. Companies are expected to accurately estimate post-vesting forfeitures to use as assumptions in lattice-based models, including not only the rate at which post-vesting terminations will occur but also the type of termination, given that different exercise provisions apply to different types of terminations.

We also believe the proposed treatment of reload options as new awards, separate from the underlying grants that contain the reload feature, is inconsistent with the FASB's preference for grant-date measurement. This treatment doesn't make practical sense, since reload features can be readily valued and taken into account at the time of grant of the underlying option.

Fair Value Measurement – Issues of Consistency, Reliability, Preferences, Alternatives (Issue 4)

The most common ED-related inquiries from our clients have been: "Tell us how to value our options under the ED. What information do we have to provide? What if we don't have it? How much flexibility do we have in selecting models and assumptions?"

The ED provides a good basic framework for answering these questions. The standard itself presents overall principles to guide decisions regarding fair value calculation. The Appendices, particularly Appendix B, provide detailed implementation guidance. Preparers and auditors must use their judgment to determine how to apply this guidance to a particular company. We appreciate the challenge here: If too much detail is provided, the standard may become a required "cookbook" approach that does not accurately represent individual company transactions. But without enough specificity, comparability among companies can be impaired.

To facilitate implementation without making the standard too prescriptive, we have several recommendations regarding Appendix B. In general, we suggest that the words used in the standard be chosen carefully. In some cases, the ED states that an approach "may" or "can" be used; in others, that an approach "should" or "must" be used. Some examples:

- Paragraph B23: "aggregation of individual awards [into homogeneous groups] should be performed regardless of whether the lattice or closed-form model is used to estimate the fair value." If the Board intends this to be a requirement, it will not be practical in many cases, particularly for smaller companies: The grouping requirement would apply not just for valuation purposes but also to correctly identify forfeitures, exercises, tax deductions and expirations.
- Paragraph B26: "Lattice models can incorporate a term structure of volatilities [which] is one of the advantages of a lattice model." Some observers have interpreted this as a requirement, not just a suggestion, which leads to a more complex valuation approach.

- Paragraph B13: "A US entity issuing an option on its own shares must use as the risk-free interest rates the implied yields from the US Treasury zero-coupon yield curve over the expected term of the option if the entity is using a lattice model incorporating the option's contractual term." Is this intended to preclude companies from using a fixed interest rate assumption in a lattice model?

We would like to see more clarity regarding preferences in the development of assumptions used in valuation models. Volatility, in particular, can be estimated using a wide variety of techniques. Our sibling company, National Economic Research Associates, offers some specific suggestions and their rationale in its June 28, 2004 comment letter.

We note that many of our clients are finding it difficult to obtain employee exercise history that is adequate for estimating future behavior. There are several reasons for this, some of which are noted in paragraph B11 of the ED. But perhaps the biggest obstacles are that (i) companies either have changed their option features in the past several years, or are planning to do so – for example, shortening the term, changing the vesting schedule, eliminating reload features, making post-vesting provisions more generous for those who retire, become disabled, or die; and (ii) because the requirement to factor in employee exercise history data is new, companies and their advisors have not yet become sophisticated in interpreting that data. This is an area where more guidance and perhaps more flexibility would be useful - covering such areas as when it is appropriate to use the Black-Scholes model and alternatives companies may be able to employ in the first few years the final standard is in effect.

We do not recommend that all companies be required to use a single valuation model or conform to narrow, prescriptive rules. We simply wish to see more guidance on how companies can make and support valuation choices, particularly for the first few years during which the proposed Statement is effective.

Employee Stock Purchase Plans (Issue 6)

Despite our general endorsement of fair value accounting, the final standard should, at a minimum, preserve the Statement 123 exclusion for certain ESPPs. In fact, we would like to see the current 5% discount exclusion for ESPPs in Statement 123 expanded to provide noncompensatory treatment for all broad-based, tax-favored employee stock plans, such as Section 423 plans in the US and Save-As-You-Earn schemes in the UK. Such an exclusion would not compromise accounting principles applicable to other types of plans since it would be

"bright line." And it would encourage companies to provide equity ownership opportunities to rank- and-file employees, without the potential for adverse accounting consequences.

If the exclusion for ESPPs is eliminated, as proposed in the ED, we would like to see the accounting treatment for look-back plans simplified. Certain provisions of FASB Technical Bulletin 97-1 are highly impractical. For example, plan types g and h require a company to calculate the cost of a modification each time an employee changes his or her withholdings. For companies with thousands of participants, this is costly and time-consuming and the result is generally not material. In addition, there are alternative ways to value these plans that FTB 97-1 does not permit.

Requisite Service Periods (Issues 7 and 8)
We support the concept of recognizing compensation cost over a service period. However, we think that the ED's current proposals on estimates and re-estimates of requisite service periods will be among the most complicated and costly compliance issues for companies and their auditors.

This is especially true for companies that include multiple conditions (i.e., service, performance, market) and those that vary the conditions, depending on area of employment or level of employment. For example, companies may grant awards with performance-accelerated vesting provisions, but with performance goals that vary by business unit and reporting level.

Accordingly, we urge the Board to consider simplifications to the requisite service period proposals.

Graded Vesting (Issue 9)
Requiring a separate valuation for each segment of an award with graded vesting significantly increases the effort needed to value such awards, as well as the administration required to track each segment separately (vesting, forfeitures, etc.). This is particularly true for smaller companies, even though the additional work may not have a significant impact on the overall cost of the award.

An amortization schedule that treats separately each vesting segment of an award with graded vesting provides a better matching of service period with cost. However, it adds another degree of complexity that may not be warranted.

We recommend that companies be permitted to choose between a single valuation and multiple valuations for awards with graded vesting schedules, and also to choose between front-loaded and straight-line amortization schedules.

Modifications (Issue 10)
In general, the modification principles of the ED seem logical although, as in the case of the requisite service period proposals, various simplifications to mitigate complexity and cost might be considered.

There is at least one anomaly that we believe deserves attention: eliminating a reload feature on an outstanding option. Presumably all would agree that eliminating this feature makes an award *less* valuable. But eliminating it will encourage option-holders to wait longer before exercising (because the incentive to exercise early to obtain the reload option is removed), resulting in a longer expected life assumption. This means, under the ED, that for accounting purposes, the new award is considered *more* valuable than the original one – a distortion of reality. (If the reload feature is incorporated into the initial grant-date value, as suggested above, this anomaly would not occur.) We expect this to be a fairly significant issue, as many companies that currently grant options with reload features will seek to control accounting costs by eliminating those features from outstanding awards.

Income Taxes (Issue 11)
We believe that the lack of symmetry in the ED's approach – recognizing tax deficiencies in the income statement and excess tax benefits in equity - is troublesome. Among other things, it leads to the somewhat perverse situation where a company must recognize additional expense when it reverses the deferred tax asset for an option that expires unexercised.

Treatment of Retained Stock Options as Liabilities
We would like more clarification of the guidance concerning when an equity instrument becomes subject to Statement 150. Paragraph B184 suggests that allowing employees to retain stock options for more than 60 to 90 days after termination of employment would convert the options to liabilities. It is quite common to allow retirees, disabled employees and, sometimes, employees who are involuntarily terminated without cause to retain their options for a few years following termination. Does this paragraph suggest that those options would be subject to variable accounting as liabilities as of the employee's termination date? If so, we think this treatment is illogical and should be changed.

Transition Provisions/Retrospective Application (Issue 13)
In general, we agree with the "modified prospective" transition approach of the proposed transition rules. For example, revaluing outstanding awards using a lattice model and under other aspects of the new Statement would be impractical and costly in most cases.

But companies should be permitted to use retrospective application to enhance the consistency of their financial statements, if they choose to. Retrospective application also would help eliminate inconsistencies that currently exist because some companies account under APB 25 and some under Statement 123 and, in the latter case, have chosen among three alternative transition rules.

Postponement of Effective Date; Additional Testing
As noted at the outset of this letter, we urge the Board to consider postponing the effective date, possibly to a year after issuance of the final standard, to allow companies and their advisors additional time to study the standard, collect the historical employee exercise data necessary to comply, determine the most appropriate valuation model, and develop assumptions that are well-reasoned and supportable. We also recommend that the Board provide companies more leeway to continue using a closed-form model like Black-Scholes while they become accustomed to a lattice model. Finally, we recommend more field testing of the ED's provisions before a final standard is issued. We believe these various actions will benefit users of financial statements and other interested parties in the short and long run.

We appreciate the opportunity to comment on the ED. If there are issues that you would like to discuss, please contact me at susan.eichen@mercer.com, or 212-345-7648.

Sincerely,
Susan Eichen