Hewitt

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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
File Reference No. 1102-100
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft, *Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95*

Dear Ms. Bielstein:

This letter provides our comments on the Exposure Draft, *Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95*, issued March 30, 2004 (ED).

Hewitt Associates is a global outsourcing and consulting firm delivering a complete range of human capital management services to companies, including Human Resource and Benefits Outsourcing, Human Resource Strategy and Technology, Health Care, Organizational Change, Retirement and Financial Management, and Talent and Reward Strategies, which includes executive compensation. We have been instrumental in developing innovative solutions that have helped our clients become some of the most successful companies in the world.

Hewitt Associates assists companies (both public and private) in developing share-based compensation programs and measuring the value of their share-based payments. A client may engage us to value share-based payments for many reasons: to evaluate the competitiveness of compensation programs or long-term incentive awards, to determine the appropriate sizes of long-term incentive awards, and to derive values for accounting footnote disclosure and proxy disclosure purposes. Our comments incorporate our experience with hundreds of companies and the practical issues and concerns we have regarding the ED and its implementation as proposed.

Fair Value Measurement
Issue 4(a)
Do you believe that the ED provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

- **Post-Vesting Restrictions**—According to paragraph A17, "Restrictions that continue in effect after employees have earned the right to benefit from their instruments, such as the *inability to transfer vested employee share options to third parties* or the *inability to sell vested shares for a period of time*, affect the value of the instruments issued at the vesting date and therefore are reflected in estimating the fair value of the instruments at the grant date." This provision leads one to conclude that precluding transferability of stock options or stock appreciation rights (SARs) after vesting or imposing a post-vesting restriction period, such as a mandatory holding period on shares acquired upon share option exercise by senior executives, should be factored into the fair value determination for the share options. The vast majority of stock options and SARs that are granted are nontransferable during their term (including post-vesting). This would imply that these stock options and SARs should be discounted for nontransferability post-vesting, yet there is no guidance on how that discount should be determined. With respect to attaching holding period requirements to shares received upon option exercise (or lapse of restrictions on restricted stock) this is becoming increasingly common (e.g., a company may require an executive to hold the net shares after payment of the exercise price and taxes for one or two years or perhaps even until retirement).

  However, Footnote 2 in Appendix B states, "...the post-vesting restriction shall be reflected in estimating the grant-date fair value of the shares, but only to the extent that the post-vesting restriction would affect the amount at which the shares being valued would be exchanged. For instance, if the shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged."

  The Final Statement should clarify how paragraph A17's dictate squares with Footnote 2 in Appendix B and whether post-vesting holding requirements for public company stock can or will reduce the grant-date fair value. Additionally, the Final Statement should address how to calculate the discount from the grant-date fair value attributable to the post-vesting nontransferability of employee share options.

- **Market Conditions**—In distinguishing between how a market condition is treated versus a performance or service condition, FASB is adding undue complexity to an already overly complex valuation process, and is artificially creating a bias in favor of performance or service conditions and against market conditions. Companies are disinclined to use a market condition in their performance plans because the market condition is not perceived as being accurately reflected in the fair value and a company may end up recognizing a compensation cost even though the market condition is not achieved. This is counterintuitive (even though the market condition was taken into account in determining the grant-date fair value). From a company's point of view or an executive's point of view, neither the cost to the company nor the value to the executive should be different based on whether the goal is a market condition or a performance condition.

  The Final Statement should not drive a policy that favors the use of one condition over another. Although it is logical that if a market condition is included in the fair value determination, nonachievement should not result in a reversal of a compensation cost. However, this does not mean that a market condition **should** be valued and included in the fair value determination. To increase consistency, the distinction between a market condition and a performance or service condition should be eliminated, with awards with market conditions being treated the same as awards with performance or service conditions, i.e., they do not get factored into the determination of fair value, but compensation cost can be reversed if the market condition is not achieved. This would further FASB's goals of consistent application of the Final Statement and increase comparability of financial statements.

- **Illustration 8, Appendix B**—This Illustration needs to provide a better description of how the Monte Carlo model was applied in determining an estimate of fair value (i.e., what was the fair market value of the shares on the date of grant and if the Monte Carlo model can result in adjusting the number of shares expected to be awarded). As it stands now, it is unclear how these numbers were derived. This Illustration is significant because we expect that many companies may be interested in using a Monte Carlo model (rather than a binomial model). Consequently, it would further the goal of consistent application of the Final Statement if FASB provided the additional information requested. With this information, users will be better able to understand and apply the requirements of the Final Statement.

- **Illustration 22, Appendix B**—In accordance with paragraph A40A, Illustration 22 depicts when certain equity instruments are treated as liabilities in accordance with Statement 150. This Illustration, coupled with Footnote 60 of Appendix B, indicates that when a share-based award is not transferable and an employee could terminate service and receive or retain the fair value of the award for the remaining contractual term, the award will be subject to Statement 150 and treated as a liability. Arguably, this could be applied after a change-in-control event if an employee is given a right to terminate employment and receive or retain the full value of his share options. This also appears to be applicable when share-based awards permit an employee, upon retirement, to be able to exercise vested options through the end of their contractual term.

  It is unclear to us why an award that provides for the exercise of stock options through the end of their contractual term would be a liability (any more than an award that provides for the exercise of stock options for five years or any other period that is less than the contractual term). In either case, the company is obligated to deliver stock if exercise occurs within the post-termination exercise period specified in the contractual agreement entered into between the employer and the employee. There is no obligation on the part of a company to deliver its assets.

  We understand that in Statement 150, an obligation is defined as a duty or responsibility on the part of the issuer either to transfer assets or to issue its equity shares. Apparently, although an issuer's equity shares are not assets to the issuer, they become assets to the new holder of the shares. According to Statement 150, settling an obligation by issuing shares will adversely affect the interests of the other holders of the issuer's equity shares by diluting their interests in the issuer's assets, just as settling an obligation by transferring assets will adversely affect their interests by reducing the issuer's assets. Statement 150 goes on to state that the duty or responsibility to issue shares leaves an entity little or no discretion to avoid taking an action that it might otherwise wish to avoid. Therefore, FASB concluded, for purposes of Statement 150, that a duty or responsibility to issue shares is an obligation and, potentially, a liability. It is our view that there is almost always a duty or obligation to deliver shares upon the exercise of a stock option regardless of when exercise occurs and regardless of the time period for the post-termination exercise period, by virtue of the contractual nature of the arrangement.

  Also, it is very clear that Statement 150 does not apply to obligations under stock-based compensation arrangements if those obligations are accounted for under APB Opinion No. 25, Accounting for Stock Issued to Employees; FASB Statement No. 123, Accounting for Stock-Based Compensation; AICPA Statement of Position (SOP) 93-6, Employers' Accounting for Employee Stock Ownership Plans, or related

guidance. Statement 150 does apply to a freestanding financial instrument that was issued under a stock-based compensation arrangement but is no longer subject to Opinion 25, Statement 123, SOP 93-6, or related guidance (e.g., Statement 150 applies to mandatorily redeemable shares issued upon an employee's exercise of an employee stock option). However, retaining the ability to exercise a stock option for the remaining contractual term is not analogous to this example since no mandatorily redeemable shares are issued upon an employee's exercise of the stock option.

Issue 4(b)
Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options? If not, why not?

- **Preferability of Lattice Models**—We agree with FASB's conclusion that the fair value of employee share options can be measured with sufficient reliability. However, we do not necessarily agree with the conclusion that lattice models are preferable. Although lattice models can reflect the unique characteristics of employee share options, we believe the Black-Scholes-Merton model can also reflect these unique characteristics, albeit in a different way. With the Black-Scholes-Merton model, the unique characteristics of employee stock options (e.g., nontransferability and employee exercise behavior) are imbedded in the expected life assumption. Companies only need to evaluate exercise data to determine **when** employees typically exercise, but they do not need to go through an in-depth and complicated analysis of determining **why** employees exercise (e.g., evaluating the impact of stock price movement or blackout periods on behavior). Although it is perhaps theoretically interesting, in the end, the means to the result does not really matter, only the result does (and that result is **when** employees exercise).

  For most companies, using a lattice model is going to be a difficult and time-consuming process, often for a result that may not be materially different from the result obtained using the Black-Scholes-Merton option pricing model. This is because, under the ED, the input to a lattice model for the term must be the full contractual term, and other factors impacting employee exercise behavior must be input to reduce the value. Once these factors are input, often the result is a value that is close to what was obtained using the Black-Scholes-Merton model and an expected life assumption.

As anticipated, as a result of the issuance of the ED, many companies have been developing and marketing more sophisticated lattice models, although many of them still do not incorporate the full flexibility contemplated by the ED. However, obtaining the model is not the difficulty. What is difficult and overly complicated is the analysis of historical employee data. The question really is "How fine tuned do the assumptions need to be?" and in answering that question, FASB needs to consider the additional costs companies are going to incur to derive a value that has not been proven to provide significantly more accurate results. It has been our experience that the vast majority of companies do not have the expertise or the resources to analyze this information in-house. Thus, many will be forced to outsource this analysis. The companies that can afford to pay more will seek greater levels of analysis in a "race to the bottom." Other companies will simply not be able to afford this luxury. In the end, there will be little consistency among companies because there is simply too much flexibility.

- **Use of Closed-Form Valuation Model**

  — ***Creation of a Safe Harbor***—Because of the issues with lattice models as described above, the Final Statement should specifically permit public companies to continue to use a closed-form valuation model such as the Black-Scholes-Merton formula. If FASB feels strongly that lattice models are preferable, the ability to use the Black-Scholes-Merton model should be allowed to be used until there has been adequate testing of lattice models and a cost/benefit analysis has been performed.

  If a safe harbor is not provided to permit companies to specifically continue to use a Black-Scholes-Merton model (even if a company has employee exercise behavior data), companies will likely face significant issues in complying with the Final Statement. We have heard that some auditors might require companies that have employee exercise behavior data to utilize a lattice model, even if the lattice model available does not have the flexibility contemplated by FASB in the ED. Without commercially available lattice models that have been tested, it is likely that companies will be unable to truly measure the fair value of their share-based payments with the precision contemplated by the ED. This could result in companies being forced to recognize more expense using an inflexible lattice model than they otherwise would have to recognize using the Black-Scholes-Merton model which is currently capable of incorporating employee exercise behavior, at least in an indirect manner through a modification of the inputs to the model.

— ***Definition of "Lattice Models"***—The Final Statement should emphasize that the term "lattice model" encompasses more than just the binomial model. For example, while certain illustrations in the ED make use of the Monte Carlo model, the ED's definition of "lattice model" references only the binomial model. We suggest that the definition of "lattice model" in Appendix G be expanded to include references to other lattice models, e.g., Monte Carlo, etc., both those currently in existence as well as any that may be developed later.

Employee Stock Purchase Plans
Issue 6
Do you agree with the principle that employee stock purchase plans (ESPPs) are 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? If not, why not?

The assumption that appears to underlie the decision to treat ESPPs in this manner is that if employees are given an opportunity to purchase stock on terms better than those offered to shareholders generally, that it is a result of their employment relationship with the company and, accordingly, should be treated as compensatory. At a minimum, the Final Statement should keep current Original Statement 123's accounting guidance as to ESPPs. Preferably, however, ESPPs that are tax qualified should not be considered compensatory arrangements. The rationale for doing so is that ESPPs are not provided by the employer for the purpose of providing compensation. Rather, these are broad-based plans that are designed to create greater employee loyalty and an interest in increasing shareholder value. This is similar to the discounts that retailers offer to their employees.

If this argument is disregarded, at a minimum, there should be no compensation cost associated with a discount offered to employees that is comparable to the stock issuance costs avoided by issuing the stock to employees rather than to the public. The purchase discount is an inducement for employees to participate in the plans or as a cost of raising capital. The modest 5 percent discount permitted by Original Statement 123 can be viewed as being in lieu of the fees that a company would otherwise have to pay to an underwriter in order to sell shares to the public market. By selling its shares directly to its employees, the company avoids such costs, and it would therefore be appropriate to view the discount offered to employees as noncompensatory if it does not exceed 5 percent.

Attribution of Compensation Cost
Issue 9
An award with graded vesting is in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. Do you agree with that accounting treatment? If not, why not?

We do not believe that mandating a single compensation cost attribution method, along the lines of the FIN 28 accelerated compensation cost recognition method, will improve financial accounting for employee share awards sufficiently to justify the substantial administrative burden this would place on companies, especially those that have historically offered vesting for their awards more frequently than on an annual basis, e.g., awards with quarterly, monthly, or weekly vesting. Instead, we think the Final Statement should continue to offer companies the same choice of cost attribution methods as are available in Original Statement 123, e.g., a choice between straight-line and tranche-specific/accelerated cost recognition methods. By offering this choice, companies will be able to select the most cost-effective manner for reporting the compensation cost related to their share-based awards. We know of several companies who think the straight-line cost attribution method would be preferable, even though it might cause the company to incur a higher noncash, compensation expense. This is because even though the tranche-specific method likely would lower the noncash compensation expense to be recognized, the company would have to incur additional cash-costs (administrative expenses, salaries, and service fees) to determine the tranche-specific fair value expense.

Modifications and Settlements
Issue 10
The ED established several principles that guide the accounting for modifications and settlements, including cancellations of awards. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

- **Conversion of Share-Based Awards in an Equity Restructuring**—Given how the ED is drafted, if a company modifies its outstanding awards as a result of an equity restructuring (e.g., a spin-off), the recognition of an incremental accounting expense can be avoided if the awards are adjusted by equating the fair value of the awards immediately before the transaction to the fair value of the awards immediately after the transaction. This is different than what companies do in the case of an equity restructuring under FIN 44 (maintaining the aggregate intrinsic value and the ratio of exercise price to market price) to avoid an additional accounting expense. It is also

inconsistent with the general requirements for the tax-free conversion of incentive stock options in a merger or acquisition context. When employee awards are adjusted as a result of an equity restructuring, the FIN 44 methodology is well accepted by employees and is also generally consistent with how shareholders' shares are adjusted. Introducing the fair value concept in this context only adds undue complexity and misunderstanding, and results in nonalignment with shareholders. Consequently, why not simply establish a safe harbor that would permit modifications that meet the FIN 44 criteria of maintaining the aggregate intrinsic value and the ratio of exercise price to market price to also result in no additional compensation expense under the Final Statement?

Disclosures

Issue 12

Do you believe that the disclosure objectives set forth in this ED are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosure objectives are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

- **Expected Volatility**—Paragraph B191.f.(2)(b) indicates that if a company uses a method for determining fair value that employs different volatilities during the contractual term, it must disclose the range of volatilities used and the weighted average expected volatility. We believe that simply providing the range of volatilities is sufficient disclosure and the administrative burden to calculate the weighted average volatility far exceeds the benefit, if any. However, if FASB continues to require companies to report a weighted average volatility when they utilize a method of determining fair value that uses different volatilities, then we suggest guidance be included as to how the weighted average volatility is to be determined.

- **Policy for Issuing Shares Upon Share Option Exercise**—Paragraph B191.k. indicates that if, as a result of a policy for issuing shares upon share option exercise, a company expects to repurchase shares in the following annual period, it must disclose the expected amount of shares to be repurchased during that period. Unlike other provisions, this disclosure requirement is directed to the next annual period following the one covered by a company's financial statements. It would likely prove difficult if not impossible for some companies to determine the reasons a share repurchase was undertaken and many more will be reluctant to try and estimate the extent of any future action. Consequently, we suggest moving this requirement to Paragraph B193 where it would be voluntarily disclosable as supplemental information.

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Transition
Issue 13
Do you agree with the transition provisions of the ED? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of the ED? If so, why?

The ED only permits the modified prospective transition method for public companies. However, if FASB wants to encourage comparability of financial statements and their utility to users, it should permit companies to allow the retroactive restatement transition method, as currently permitted by Statement 148. By allowing companies to retroactively restate prior years' financial statements using the provisions of Original Statement 123, it would increase the comparability of companies' financial statements on both a relative and absolute basis. We suggest that retroactive restatement should be applied using Original Statement 123 and not the Final Statement, because companies have already performed these calculations for purposes of the footnote disclosure requirement under Original Statement 123. Also, companies that have voluntarily adopted using the retroactive restatement method will have prior years' costs reflected in their income statements using Original Statement 123. Allowing retroactive restatement will not give early adoptees that adopted using the retroactive restatement method an unfair disclosure advantage over companies which chose to wait until a new Final Statement is implemented.

We appreciate the opportunity to comment on the ED. If you have questions, we would be happy to discuss these comments further.

Sincerely,

Hewitt Associates LLC

Roberta D. Fox

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