

# NASPP

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National Association of  
Stock Plan Professionals

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August 30, 2005

Lawrence Smith  
Director of Technical Application and Implementation Activities and EITF Chair  
FASB  
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PO Box 5116  
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Dear Mr. Smith,

I am writing on behalf of the National Association of Stock Plan Professionals to comment on the position of the FASB staff with respect to the determination of the grant date for share-based payment awards under SFAS 123(R). The National Association of Stock Plan Professionals (NASPP) is a professional association representing over 6,000 members. Our members are directly involved in the design, oversight, and administration of stock compensation programs and include stock plan administrators; Human Resource professionals; corporate secretaries; accountants; securities, tax, and benefits attorneys; and compensation consultants. Our membership includes corporate issuers from all regions of the U.S. and a wide spectrum of industries.

We understand from media reports and various communications from the major U.S. accounting firms that, in response to a request for interpretive guidance, the FASB staff has advised several accounting firms that, for purposes of SFAS 123(R), the grant date of a share-based payment award is not established (and, consequently, the fair value of the award is not fixed) until the key terms and conditions of the award have been communicated to affected employees. We further understand that this position is based on the staff's interpretation of paragraph A77 and the definition of the term "grant date" in Appendix E of SFAS 123(R) as to when an employer and employee have a "mutual understanding" of the key terms and conditions of a share-based payment award. As a result, many companies are now being advised that, once they become subject to SFAS 123(R), their procedures for granting equity compensation will need to be revised to ensure that the communication with employees receiving the awards occurs prior to or on the same date as the awards are approved in order to fix the awards' fair value at the traditional grant date (i.e., the date the award is approved). If they cannot adjust their communication practices in this manner, they will need to revise their accounting

procedures to ensure that the awards' fair value is not fixed until the awards have been properly communicated to the employees receiving the awards.

We are concerned that the FASB staff's position will have far-reaching, undesirable implications for most companies that grant share-based payment awards to their employees. We believe that the adverse impact of this position on existing corporate administrative practices far outweighs any financial reporting benefits to be derived from requiring actual communication of the key terms and conditions of a share-based payment award to an employee to demonstrate the "mutual understanding" necessary to establish the award's grant date.

### **Current Practice**

Under the general corporation laws of most American jurisdictions, a company's board of directors must authorize the issuance of the company's securities, including securities to be issued under share-based payment awards pursuant to an equity or equity-based compensation plan or arrangement. Further, many of these laws include provisions governing the adoption and implementation of equity compensation plans, such as a stock option plan, by the company.

Generally, an equity compensation plan will provide that the board of directors of the company or another designated body (such as the compensation committee of the board) is authorized to administer the plan. This committee is, in turn, empowered to select award recipients (from among eligible plan participants) and to grant awards and determine their terms and conditions, including, among other things, the exercise or purchase price. Typically, the exercise or purchase price of an award will be determined as of the date the committee authorizes the award, which is considered by the company to be the award's grant date.

Except in the case of senior executive officers of a company, the majority of awards are made at the discretion of the committee, pursuant to the company's equity compensation program. The intended recipient does not have the ability to negotiate the terms and conditions of the award, nor to influence the size of the award, its price, or its vesting conditions. In most instances, potential award recipients are recommended to the committee by the company's management. The committee acts upon these recommendations, authorizing the awards and setting the awards' exercise or purchase price. Only after these actions have been taken are the recipients notified of their awards. Occasionally, senior executive officers may be able to negotiate the individual terms and conditions of their awards, but this is by far the exception.

### **Implications of the Staff's Position**

Beyond the administrative concerns expressed earlier, we are concerned that the FASB staff's position will have far-reaching implications for most companies that provide share-based payment awards to their employees. First, if, for financial reporting purposes, an award's grant date is not established until the key terms and conditions of the award have been communicated to the employee receiving the award, any fluctuation in the price of the securities subject to the award between the date the award is approved and the date it is communicated to the employee will affect the amount of compensation cost to be recognized by the company for the award.

As we discuss below, there are a number of practical considerations that might delay the communication of grants to employees, in some cases for up to several weeks. To mitigate the impact of stock price fluctuations after grants have been approved, we expect that companies will need to implement duplicative communication procedures. For example, companies might need to provide an initial communication announcing the key terms of the awards, a follow-up communication once the awards have been approved, and a final communication with the actual award agreement. Currently, most companies provide just a single communication that includes all of this information to employees. Where companies are not able to implement the necessary additional communications, they may need to modify their grant procedures so that the exercise price is not established until the grant is communicated to employees. In addition, companies will need to develop systems for tracking when the grant communication is received by employees; currently few companies, if any, have this capability. We believe that these procedures will impose an unnecessary burden on companies without providing a significant enhancement in the quality of financial reporting under SFAS 123(R).

Second, in some situations the staff's position may lead to unintended, and adverse, collateral consequences. Take, for example, the situation where the price of a share-based payment award is set as of the date the committee approves the award and, as often happens, the value of the company's securities increases between that date and the date the award is actually communicated to the employee receiving the award. If the share-based payment award is an employee stock option, the subsequent increase in the price of the company's securities may result in the option being considered a discount stock option for federal income tax purposes. Under new Section 409A of the Internal Revenue Code, a discount stock option is considered to involve a deferral of compensation, which could trigger immediate taxation as well as an additional 20% income tax penalty.<sup>1</sup>

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<sup>1</sup> While this result may be avoided if the grant date of the stock option is considered to be the date the committee approves the award, it is not clear what benefit is achieved by having different grant dates for federal income tax and financial reporting purposes.

Because these are significant issues that companies must immediately address before they become subject to SFAS 123(R), we respectfully request that the FASB staff reconsider its position for the following reasons:

1. Mutual Understanding of the Key Terms and Conditions of an Award Can Be Inferred from Surrounding Facts and Circumstances

Paragraph A77 of SFAS 123(R) appears to require that three conditions be satisfied to establish the grant date for a share-based payment award:

- The employer and employee have a mutual understanding of the key terms and conditions of the award;
- The employer be contingently obligated to issue equity instruments or transfer assets to an employee who renders the requisite services; and
- The employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares.

Of these conditions, it appears that the "mutual understanding" of the key terms and conditions of the award is the most important. While we readily acknowledge that evidence of such an understanding may be critical where the parties are negotiating the terms and conditions of an individual award, it would seem that, for most share-based payment awards, this understanding can be inferred from the surrounding facts and circumstances:

- As set forth in Paragraph A77, a mutual understanding of the key terms and conditions of an award "may be established through a formal written agreement; an informal, oral arrangement; *or established by an entity's past practice.*" [Emphasis added.] We would observe that for most, if not all, of our members, awards generally are granted in accordance with a pre-defined policy, subject to committee approval, so they would seem to be understood through the company's past practice.
- Another factor in setting the grant date is when the "employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares." This would generally be the date the award is approved. For example, the exercise price of an employee stock option is typically based on the price of the company's stock at the date of formal approval (most plans set the exercise price as the closing or average price on the day of, or the day preceding approval). And in all cases covered by SFAS 123(R), the employee must remain in service from the date the committee approves the award until the communication date in order to have the opportunity to benefit from the award.

- Awards “subject to shareholder approval are not deemed to be granted until that approval is obtained *unless approval is essentially a formality (or perfunctory).*” [Emphasis added.] In the most rudimentary sense, the shareholders, as owners of the company, are the employer. If the grant date is not delayed when their approval is perfunctory, it seems odd that the same would not be true of the employees’ “approval” of the award, which is also perfunctory. After all, the communication of an award is merely a clerical matter that does not impact the substance of the award, nor is an award subject to any negotiation on the part of employees (with the possible exception, as previously noted, of awards granted to senior executive officers). According to a 2004 survey of our members, 30% do not even require employees to acknowledge the awards they have received. For those of our members that do require acknowledgement, their employees routinely accept the awards made to them without question.

In our experience, it is extremely unusual (and, in fact, highly unlikely) that an award would be retracted after it has been approved by the committee. The occasions when an award does not become final in accordance with its terms are so rare as to be inconsequential. A possible FASB staff position that would accommodate these rare exceptions, while providing a workable approach for the vast majority of transactions, would focus on the normal expectation of a company at the time of grant that the award will be accepted in accordance with its terms and conditions. We expect that most, if not all, of our members would consider the company obligated to issue the award once it has been approved. We feel that this also speaks to the ministerial nature of the communication to employees.

Finally, Paragraph B49 states that “[t]he definition of grant date in this Statement is essentially the same as in Statement 123, which in turn was essentially the same as the notion of grant date used in practice under Opinion 25. Common to all of those definitions is the notion of the grant date as the date an agreement or mutual understanding is reached.” Since these definitions are purportedly substantively the same, it is not clear why SFAS 123(R) should now require companies to demonstrate the existence of this “mutual understanding” between an employer and employee differently than has been required under prior standards.

## 2. Compliance Alternatives are Unnecessarily Burdensome

Many of our members have indicated to us that the alternatives available to them for complying with the FASB staff’s position will be very costly and burdensome. It is not unusual for awards to a large number of employees to be communicated over a period of weeks. Awards are often communicated to employees by their managers, which clearly presents a number of obstacles to tracking when the communication actually occurred.

Having managers communicate awards to their direct reports is considered a best practice; it provides an important opportunity for discussion of the employee's contributions to the company and the company's future expectations of the employee. In order to attain the accounting efficiency and cost-effectiveness of a single grant date, companies would have to eliminate this beneficial practice, with no apparent enhancement to the quality of their financial reporting. Further, when awards are granted to overseas employees, local laws (such as requirements to translate the communication into local language or complete filings with local authorities prior to the communication to employees) and even local customs or holidays can impact the timing of the communication.

Very few of our members currently have procedures in place or mechanisms by which they can track when each award is communicated. Companies with fiscal years beginning July 1, 2005 are the first required adopters of SFAS 123(R), and, in many cases, those companies have already made their annual employee stock option grants on the presumption that the grant date definition was generally unchanged from prior practice (based in part on the language in paragraph B49 in the Basis for Conclusions).

While we understand that accounting principles cannot be driven by administrative considerations, we believe that a cost/benefit assessment should at least be part of the decision-making process. Since the communication to employees does not impact the substance of the award in any way, we believe there is little benefit to be gained from the staff's position for companies or for the users of their financial statements.

3. Position Should be Subject to Due Process Considerations

Universal practice under APB 25 and SFAS 123 has been to treat the approval date as the grant date for financial reporting purposes (indeed, much of the stock option accounting controversy has been predicated on the assumption that, as of the option grant date – that is, the date the option was approved by the appropriate committee – the intrinsic value of the option failed to reflect its true worth). Thus, we believe that the staff's position represents a significant departure from prior practice that is unduly narrow and restrictive, without apparent consideration of cost/benefit implications, nor the perfunctory nature of the employees' acceptance.

We are concerned that this position was arrived at through private discussions between the FASB staff and the major US accounting firms, rather than in a public forum, and without the opportunity for full consideration of all aspects of the issue. Because of its potential implications for companies and the departure it represents from current practice, we believe that companies should have an opportunity to comment on this matter.

## **Our Perspective**

We believe that there are legitimate and supportable reasons for continuing to treat the grant date for a share-based payment award as the date the board of directors, board compensation committee, or other plan administrator approves the award (unless it is subject to shareholder approval or there is a reasonable likelihood that the award will not be accepted in accordance with its terms and conditions), provided that the company makes a good faith, reasonable effort to communicate the key terms and conditions of the award to the affected employee within a reasonable period of time.<sup>2</sup> We believe that this approach would accommodate those rare situations where an award might be rejected, such as individually negotiated arrangements that remain unsettled at the time of grant or is being made to an employee in a jurisdiction that imposes tax immediately upon grant. This approach would reflect the normal assumption that awards will be accepted following communication, but leave room for a different result when this assumption is not warranted.

We would welcome the opportunity to meet with members of the FASB staff to discuss this matter further, respond to questions, and provide additional information. We are willing to come to Norwalk to meet with you on this matter at the staff's convenience. Thank you for your time and consideration. If you have any questions regarding this letter, please do not hesitate to contact me at (510) 608-6098 or [bbaksa@naspp.com](mailto:bbaksa@naspp.com).

Sincerely,



Barbara A. Baksa, CEP  
Executive Director

cc: Robert Herz, Chairman, FASB  
Michael Crooch, Board Member, FASB  
Donald Nicolaisen, Office of Chief Accountant, SEC  
Allen Beller, Director, Division of Corporate Finance, SEC  
Carol Stacey, Chief Accountant, Division of Corporate Finance, SEC

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<sup>2</sup> We believe that the determination of what is a reasonable period of time should be based on all of the relevant facts and circumstances. In our experience, what is a reasonable period for employees in one locality may not be reasonable for another, due to local laws and customs.