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SEC Staff Guidance on Accounting for Share-Based Payment

The SEC staff confirmed the latitude in Statement 123R's provisions on selecting models for valuing share options and clarified other positions on accounting and disclosure for share-based-payment arrangements.[1] New Staff Accounting Bulletin 107 permits registrants to choose from different valuation models to estimate the fair value of share options, assuming consistent application, and also provides guidance on developing assumptions used in valuing employee share options, on related MD&A disclosures, and on the interaction between Statement 123R and ASR 268 and other SEC literature.[2]

SAB 107 does not modify any of Statement 123R's conclusions or requirements. It does, however, provide additional guidance that will be helpful in implementing Statement 123R, an event now only a quarter away.

Valuation

The SAB's guidance on valuation techniques, expected volatility, and expected term permits flexibility in applying the requirements in Statement 123R. The SAB explicitly acknowledges that the fair value of a share option at the grant date is unlikely to correspond to the amount that is ultimately realized by the option holder upon exercise. Differences between the actual outcomes and the original estimates of fair value, either with respect to the values reported or the assumptions used in developing the fair-value estimates, will not automatically indicate that the original estimate was incorrect or inappropriate when the valuation was performed.

Companies valuing an employee share option need to select an appropriate valuation technique or model. They also need to develop and support the assumptions that will be used in the valuation model. Statement 123R permits the use of valuation models that incorporate, at a minimum, these six assumptions: underlying share price, exercise price of the share option, expected dividend rate, expected volatility on the underlying stock, expected term of the

[1] FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004, available at www.fasb.org.

[2] SEC Staff Accounting Bulletin No. 107, Share-Based Payment, available at www.sec.gov; SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks," Rule 5-02.28 of Regulation S-X; EITF Topic No. D-98, Classification and Measurement of Redeemable Securities.

option, and the risk-free rate during the expected term of the option. Most companies have used a closed-form model, the Black-Scholes-Merton model, when valuing employee share options. The alternative is an open-form model, such as a binomial model.

Valuation Techniques. The SEC staff expressed no preference for any individual valuation technique and will accept any technique that meets the criteria set out in Statement 123R. To satisfy the criteria, the valuation technique or model should be based on established principles of financial economic theory and generally applied in that field, applied in a manner consistent with the fair value measurement objective and other requirements of Statement 123R, and reflect all substantive characteristics of the instrument.

In keeping with that position, SAB 107 states that companies are not required to switch to a lattice model except for instruments that cannot be valued by a traditional Black-Scholes-Merton model, such as share options that contain a market condition. Although a lattice model has greater flexibility and may be better able to value some share options, assuming reliable assumptions, companies have found it difficult to identify reliable model inputs that are needed to apply the model. Companies that are able to develop different valuation models should not base their choice of model on achieving a lower estimated fair value.

The SAB's guidance also permits companies to change from one valuation technique to another without obtaining a preferability letter from the independent accountant, reasoning that it would be a change in estimate that is applied prospectively to grants made after the new model's adoption. However, the SEC staff expects changes in valuation techniques to be infrequent.

Expected Volatility. One of the key assumptions needed in valuing an employee share option is the expected volatility. Volatility is a measure of the movement in the underlying stock price. A stock that makes larger movements, either upward or downward, would have a higher volatility than one with smaller movements. The greater the volatility of the entity's stock, the greater the value of the share option, because there is a higher potential for larger upward movements in the stock resulting in a higher payoff to the option holder. In estimating the expected volatility of the stock, the company might consider the stock's historical volatility, the implied volatility on its actively-traded options, or in certain situations, the volatility of peer companies' stock. The SAB provides guidance on each of these.

The SAB provides additional guidance on how to evaluate the factors in Statement 123R for use in estimating the expected volatility assumptions that are used in the valuation process and maintains that the process used should be applied consistently.

Historical Volatility. Many companies estimating expected volatility have relied heavily or exclusively on historical volatility over a period commensurate with the option's expected term. However, historical volatility can be computed over different periods of years using different frequencies (daily, weekly, or monthly observations). The SAB suggests that the staff will allow some flexibility on evaluations of historical volatility and its trends when estimating expected volatility.

However, the SAB both points out that periods for computations of historical volatility should be at least as long as the expected term of the share option and states that undue emphasis on more recent periods may disqualify a method. Companies measuring historical volatility will want to consider the changes in historical volatility for different time intervals commensurate with the expected term of the share option.

Statement 123R states that public companies would likely use daily price movements. However, not all companies have stock that is actively traded in the market. The SEC staff therefore believes that weekly or monthly observations are more appropriate for thinly traded stocks because the wide bid-ask spreads may otherwise upwardly bias the estimates. The frequency of observations selected should be consistently applied.

Some companies have suggested that prior periods with atypically high volatility should be excluded from their estimates of historical volatility on the grounds that they are not expected to recur. The SEC staff believes, however, that specific periods should be excluded from the computation of historical volatility *only* if they relate to discrete, specific historic events that are not expected to recur. The staff expects such situations to be rare.

Implied Volatility. Implied volatility is the volatility implicit in the price of the entity's exchanged-traded options or similar instruments. The SAB provides leeway in incorporating implied volatility, saying that if a company can calculate implied volatility, it should generally be considered and may, in certain situations, be relied on exclusively in estimating expected volatility.

The ability to reliably calculate implied volatility depends on (1) how active the market is for the instrument from which implied volatility will be calculated, (2) synchronizing the variables used to calcu-

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late implied volatility with those in the employee share option (e.g., exercise price, intrinsic value, measurement date), and (3) similarity between the length of the term of the traded option and that of the employee share options.

One of the concerns about the use of implied volatility is the short-term nature of exchange-traded options compared to the long-term nature of employee awards. The SEC staff, however, will accept *exclusive* reliance on implied volatility as long as the methodology is consistently applied and all five of the following conditions are met:

(1) The entity uses a valuation model, such as Black-Scholes-Merton, based on a constant volatility assumption;

(2) Implied volatility is derived from options that are actively traded;

(3) The market prices of both the traded options and the underlying shares are measured at a similar point in time and on a date reasonably close to the grant date of the employee share options;

(4) Traded options have exercise prices that are both near-the-money and close to the exercise price of the employee share options; and

(5) The remaining maturities of the traded options on which the estimate is based are at least one year.

Peer Data. The SAB discusses the use of peer data to estimate volatility only in the context of newly-public companies. According to the SAB, newly-public companies can identify peer companies from among those that make up a market index for a similar industry. Companies should not use the index itself, because diversification reduces the volatility of the index.

The use of peer data is likely to be limited to newly-public companies or nonpublic companies that have no objective measures of historical or implied volatility. However, peer data might also be used by a company without implied volatility measures that changes its business significantly so that historical stock-price movements are not an appropriate basis for estimating expected future volatility.

Expected Term. Both Statement 123R and the SAB point out that the expected term must be at least as long as the vesting period. If sufficient information is available, an entity's expected term should be based on its historical experience. However, the SAB permits companies that believe their historical experience is not representative of expected future exercises or that do not have sufficient data on which to estimate historical experience to use a simplified approach to estimate the expected term. This simplified measure sets the expected term equal to the average of the vesting term and the contractual term. The staff does not expect this simplified measure to be used for grants made after December 31, 2007. The measure may serve as a guide to private entities with very limited exercise history.

The SAB leaves open the possibility of the simplified measure, but it also directs companies to attempt to gather expected-term information "from whatever source." This guidance is consistent with the SEC staff's openness to the use of non-entity sources of data, such as industry information and information from actuaries or valuation professionals.

Statement 123R says that expected term should be calculated for sets of employees grouped by relatively uniform exercise behavior. This led companies to consider evaluating expected-term characteristics for a number of different groups based on demographic data, such as gender, age, organizational level, or location. There has been some concern about how many different groups might need to be considered. According to the SAB, as few as one or two groupings may be acceptable to the SEC staff.

Discounts should not be applied to model-calculated values for lack of transferability or hedgeability. The SEC and FASB both have adopted the view that these factors are considered through the use of expected rather than contractual term and that no further discount for lack of marketability is appropriate. Similarly, forfeiture should not be considered in valuing a share option.

Statement 123R and Redeemable Financial Instruments

Statement 123R provides guidance on classifying instruments issued in share-based-payment arrangements as either liabilities or equity in the balance sheet. ASR 268 and EITF Topic D-98 specify that equity-classified financial instruments with redemption features that are outside the control of the issuing entity should be classified outside of permanent equity in the entity's balance sheet and measured at the amount the company can be required to pay. Such instruments are typically displayed in "temporary equity." The SAB provides guidance on equity-classified instruments that should be classified as temporary equity:

- Evaluate the terms of equity-classified instruments in light of ASR 268 to determine whether they should be classified outside permanent equity.
- If an equity-classified share-based-payment award contains features that require it to be classified outside permanent equity under the SEC rules, the amount classified as temporary equity should be based on the redemption amount of the instrument multiplied by the portion of service rendered under the award (i.e., the proportion of the award which is vested). The redemption amount of the instrument may differ from its original fair value.

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For example, assume that a company granted 100,000 shares of nonvested stock to employees. The shares vest over a four-year service period. Six months after vesting, the employees can put the shares back to the company at the fair value of the shares on the date the put is exercised. On the grant date, the shares have a market value of $10 per share. At the end of two years, the shares have a market value of $13 per share. The entity would recognize compensation cost of $250,000 per year (100,000 shares x $10 / 4 years). However, because the shares are puttable at fair value, at the end of two years, the company would report temporary equity of $650,000 (100,000 shares x $13 x 2 years / 4 years). It would also adjust equity by $150,000 because the cumulative compensation cost recognized to date is $500,000 ($250,000 per year x 2 years).

Related Income-Tax Benefits

If the tax benefit from an employee's exercise of a share option is less than the previously-recognized deferred tax asset, the shortfall should first be offset in additional paid-in capital to the extent that previous credits would have been recorded in additional paid-in capital under the Statement-123 approach since it was implemented in 1995.[3] Any remaining shortfall would be recognized in tax expense.

To determine whether there would have been sufficient additional paid-in capital to absorb any shortfall, the company must recreate the pool of available excess tax benefits as if it had been using Statement 123 to measure and recognize compensation cost (rather than for pro forma purposes). SAB 107 says that companies do not necessarily need to calculate available excess tax benefits from prior awards at the time Statement 123R is adopted. The information is required only when an employee's exercise creates a shortfall. However, companies that use the modified retrospective method of transition might have to calculate the available additional paid-in capital amounts immediately, particularly if they have out-of-the-money options that will be expiring soon for which the related deferred tax assets will be written off.

Prior Modifications of Employee Share Options

A company that accelerates the vesting of out-of-the-money options prior to the adoption of Statement 123R should reflect the related compensation cost in the Statement 123 pro forma disclosures, provided that the awards would not have been exercisable without the modification, according to the SEC staff. If the awards are out-of-the-money at the time of the modification, no compensation cost would be recognized under APB 25 for "fixed" share options.[4]

The staff also expects companies that accelerate the vesting of out-of-the-money awards to disclose the modifications and the reasons for them. Statement 123R requires that all significant modifications to awards be disclosed for each period for which financial-statement information is presented.

Classification of Compensation Expense

Statement 123R requires companies to recognize compensation cost related to share-based-payment arrangements, but does not specify how and where that information should be reported in the financial statements. Companies will therefore need to determine where to classify the related cost, which may affect the period in which it is included in the income statement. For some companies, a portion of the compensation cost may be includable in inventory, in property, plant, and equipment, or in some other asset, and would be recognized in income in the period that the asset is sold (inventory) or depreciated or used (property, plant, and equipment).

SAB 107 says that companies should present the expenses related to share-based-payment arrangements in the same line items within the income statement as cash compensation paid to employees. However, the SAB permits companies to disclose the amount of each line item that is attributable to share-based-payment arrangements. This information can be provided parenthetically on the face of the income statement, elsewhere in the financial statements, or within MD&A.

First-Time Adoption in an Interim Period

If a company adopts Statement 123R in an interim period, the Form 10-Q for the period of adoption should contain all the disclosures required by Statement 123R for annual periods. Companies that use the modified retrospective method of adoption to the beginning of the year should disclose the effects of adopting Statement 123R on previously-reported interim periods in the year of adoption. In periods prior to the adoption of Statement 123R, entities are required to provide SAB-74 disclosures about the future effect of accounting standards not yet adopted.[5]

Some companies will be recognizing a cumulative effect from the adoption of Statement 123R. For example, when a company has liability-classified awards that it previously measured using intrinsic value, it will need to adjust the carrying amount of

[3] FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995.
[4] APB Opinion No. 25, Accounting for Stock Issued to Employees, October 1972.
[5] SAB Topic 11-M, Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period, available at www.sec.gov.

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that liability to fair value upon adoption of Statement 123R and report a cumulative effect from the adoption of the Statement. SAB 107 makes clear that the cumulative effect of adoption is reported in the interim period of adoption (third quarter for a calendar-year company that adopts on July 1), rather than in the first interim period of the year, even when it uses the modified retrospective method of adoption.

MD&A Disclosures

Because some companies may revisit their valuation methodologies or assumptions and others may change their share-based-payment arrangements, the SAB outlines several MD&A disclosures that companies may need to provide to describe differences in pre- and post-Statement 123R accounting:

- Transition method selected and financial-statement effect,
- Valuation method used before adopting Statement 123R,
- Modifications made to outstanding share options prior to adopting Statement 123R and the reasons for the modifications,
- Changes in valuation methodologies or assumptions from those used for compliance with Statement 123,
- Changes in the quantity or type of instruments used in share-based-payment programs,
- Changes in the terms of instruments issued under share-based-payment programs,
- Discussion of the one-time effect of adoption (e.g., any cumulative-effect adjustments recognized in the period of adoption), and
- Total compensation costs related to non-vested awards not yet recognized and the weighted-average period over which the entity expects to recognize that cost.

Non-GAAP Financial Measures. A measure of income that excludes the effect of share-based-payment arrangements is a non-GAAP measure.[6] The SAB does not prohibit disclosing such measures. Instead it reiterates management's responsibility to support that the measures are used internally to monitor performance and how those disclosures may be relevant for investors and requires management to make disclosures about the non-GAAP measure in accordance with existing SEC staff guidance.[7]

The SAB also reminds companies to consider the need for disclosing in MD&A the effect of share-based-payment arrangements on their financial performance and how key financial-statement elements are affected. The SAB makes it clear that Regulation S-X prohibits companies from including in SEC filings a "pro-forma income statement" that removes the effect of share-based-payment arrangements.[8]

Internal Control Over Capitalizing Compensation Cost

Some companies have questioned whether the SEC's rules related to Section 404 of the Sarbanes-Oxley Act imposed additional system and control requirements for capturing share-based-payment cost in inventory, in property, plant, and equipment, or in other asset categories.[9] The SAB clarifies that if a company chooses to adjust period-end inventory balances for the capitalization of share-based-payment costs using a period-end adjustment, rather than incorporating the costs in its inventory costing system, the process would not, in and of itself, constitute a deficiency in internal controls over financial reporting. Companies should establish controls for any such period-end adjustments. It seems reasonable to conclude that this guidance would also apply to the process that a company uses to capitalize share-based-payment costs within property, plant, and equipment or within other assets.

Transition to Public-Company Status

For purposes of applying Statement 123R, an entity becomes a public company when it files an S-1 with the SEC. Nonpublic companies are permitted, in limited circumstances, to use calculated value rather than fair value when measuring equity-classified share-based-payment awards issued to employees. Calculated value uses the volatility of an industry index rather than an estimate of the entity's expected volatility. Nonpublic companies are also permitted to use intrinsic value rather than fair value in measuring their liability-classified share-based payment awards issued to employees.

SAB 107 provides guidance on valuation by a previously-nonpublic entity that becomes a public company. Unvested equity-classified awards that were measured using the calculated-value method should continue to be measured the same way after the entity becomes public. However, nonpublic entities that used intrinsic value to measure liability-classified awards must remeasure those awards to fair value at the time they become public companies. The difference between fair and intrinsic value should be recognized as compensation cost in the period the entity becomes public.

When determining whether they are unable to determine fair value and should use calculated value to measure share-based-payment

[6] SEC Regulation G and Item 10(e) of Regulation S-K.

[7] Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures, June 13, 2003 available at www.sec.gov.

[8] Regulation S-X Item 10(e)(ii)(D).

[9] SEC Release No. 33-8238, Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports, June 5, 2003.

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awards, nonpublic entities should consider the likelihood that they will become public and the potential timing. The SAB states that a newly-public company that previously measured share-based-payment awards using calculated value would be expected to be able to support its assertion that the company was "not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the volatility of its share price."

Foreign Private Issuers

The SEC staff believes that the differences between the measurement provisions of Statement 123R and those of IFRS 2 will "generally" not result in reconciling items in a GAAP reconciliation provided under Item 17 or Item 18 of Form 20-F.[10] However, the staff acknowledges there may be situations in which such differences occur. Foreign private issuers cannot simply assume that no reconciling items are needed for their share-based-payment arrangements.

Transactions with Nonemployees

The staff believes it would "generally be appropriate" for registrants to apply Statement 123R's provisions to share-based-payment transactions with nonemployees that are not explicitly within the scope of Statement 123R or other authoritative literature. Transactions with related parties or other economic interest holders also can generally be accounted for by applying Statement 123R's provisions.

Classifying Share-Based-Payment Arrangements that Do Not Depend on Employee Service

A proposed FASB Staff Position would say that a requirement to deliver registered shares in a share-based-payment arrangement originally within the scope of Statement 123R does not necessarily result in the related award becoming liability-classified if the instrument becomes subject to other accounting literature because the rights of the instrument no longer depend on the holder being an employee.*

Under Statement 123R, when the rights conferred under a share-based-payment award cease to depend on the holder being an employee of the entity, that is, no longer depend on providing service, the award should be classified by reference to other GAAP. This situation may arise, for example, when an employee retires and, upon retirement, is permitted to retain vested share options for their remaining contractual term. Statement 123R notes that other GAAP that could apply to the classification of such an award includes the consensus reached in EITF 00-19.**

However, according to the proposed Staff Position, instruments originally issued as employee compensation that can be settled only by delivering registered shares are not assumed to require cash settlement when applying EITF 00-19. Instead, the proposed Staff Position directs entities to consider the guidance of paragraph 34 of Statement 123R in order to evaluate "the substantive terms of an instrument that can be settled only by delivering registered shares to determine whether it qualifies as a liability."

Comments on the proposed Staff Position are due April 15, 2005. We expect some respondents will request additional clarifications.

* Proposed FASB Staff Position No. EITF 00-19-a, Application of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," to Freestanding Financial Instruments Originally Issued as Employee Compensation.

** EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In, a Company's Own Stock.

Among the differences between accounting for share-based-payment transactions with nonemployees and accounting for those with employees is the date used to measure fair value. The fair value of an equity-classified employee share option is measured at the grant date. The fair value of an equity-classified nonemployee share option is measured at the earlier of the date the nonemployee's performance is complete or the date the nonemployee commits to the performance that will earn payment (performance commitment).[11] Share options to nonemployees are usually measured with the contractual term as an input to the valuation model. Employee share options, in contrast, are measured using the expected term as an input to the Black-Scholes-Merton valuation model. A

[10] International Financial Reporting Standard No. 2, Share-based Payment.

[11] EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

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nonemployee receives a share option upon completing performance, and the share option may become subject to the provisions of Statement 133, whereas an employee share option generally would be accounted for according to Statement 123R as long as the holder remains an employee.[12]

The descriptive and summary statements above are not intended to substitute for the text of Staff Accounting Bulletin 107, Statement 123R, the proposed FSP, or any of the other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for share-based-payment arrangements and complying with SEC filing requirements should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

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[12] FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998. FASB DIG Issue C3, Scope Exceptions: Exception Related to Share-Based Payment Arrangements, both available at www.fasb.org.