



## U.S. Securities and Exchange Commission

### **Statement by SEC Staff: Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments**

*by*

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#### **Introduction**

Good afternoon. As you know, Staff Accounting Bulletin No. 107, which provides certain staff views regarding Statement 123R<sup>1</sup>, was issued in March. I'd like to spend my time today discussing some of the topics that were addressed in that SAB, and also to let you know of certain questions we have been asked since the SAB was issued.

Before I jump into the specific topics, I would like to comment generally on the requirements of Statement 123R. In the SAB, the SEC staff acknowledged that the implementation of Statement 123R will require companies to use their judgment in determining many estimates and valuations. We expect companies to use reasonable judgment and make good faith estimates; however, we do realize that estimates of fair value are not a forecast of actual future events. Therefore, to the extent that a company utilizes good faith estimates in the application of the provisions of Statement 123R, the staff believes that subsequent changes in an award's value after its grant date do not call into question the reasonableness of the grant date fair value estimate.

#### **Appropriate Accounting for Nonsubstantive Vesting Conditions**

The first specific topic I would like to discuss is the appropriate accounting for nonsubstantive vesting conditions. Statement 123R requires that the compensation cost attributable to a share-based payment award be recognized over the requisite service period<sup>2</sup> which is defined as the period during which an employee is required to provide service in exchange for an award.<sup>3</sup> For example, assume Company A issues an award with a fair value of \$100 to its employee. The terms state that the award will vest at the end of four years if the employee is still working for the company at the end of those four years. Assuming this basic fact pattern, the requisite service period would be four years and, thus, the \$100 would be recognized ratably over the four year period.

We understand that certain share-based payment award plans contain provisions that allow an employee to continue vesting in an award in accordance with the stated vesting terms even though the employee has retired from the company and therefore is no longer providing service to the company in return for the award. Following the principles that I just outlined, if an award under a plan with these provisions was granted to a retirement eligible employee, all of the compensation cost attributable to that award should be recognized on the grant date because the employee may retire from the company at any point and retain the award. Once the employee is eligible to leave employment without losing the award, by definition, there is no longer a requisite service period. Continuing with our example, if the employee of Company A is eligible to retire on the date the award is granted, the entire \$100 should be recognized at that grant date.

It has recently come to our attention that in the past, some companies were not applying such principles and were continuing to recognize the related compensation cost over the stated vesting period either in their income statement or their pro forma footnotes. We have been asked whether this accounting should now be considered an error, since the principles underlying previous accounting standards were the same in this area as those underlying Statement 123R.

We have not, however, asked registrants to consider this to be an error requiring restatement. Rather, we believe that companies that followed this stated vesting period approach in the past should continue following that approach for awards granted prior to the adoption of Statement 123R. Upon adoption of Statement 123R, companies should apply the requisite service period guidance included in the new standard for new or modified awards. We also believe that companies in this position should disclose the impact of this change in policy so that investors can compare results of operations pre and post adoption of Statement 123R.

### **The Effect of Non-Compete Agreements on the Requisite Service Period for Share-Based Payment Awards**

Another question related to the requisite service period is what effect, if any, a non-compete agreement could have on the determination of the requisite

service period. Appendix A to Statement 123R includes two examples where a non-compete agreement is included in the provisions of a share-based payment award – specifically Illustrations 15 and 16. The Board reached different conclusions on the two illustrations based on the different facts and circumstances. In Illustration 15, the Board determined that the non-compete agreement would not effect the determination of the requisite service period and the award should be accounted for as a share award with a clawback feature. In contrast, the Board determined in Illustration 16 that the effect of the non-compete agreement, in concert with other factors, was to create an in-substance requisite service period, even though there is no explicit requirement for the employee to continue providing service in order to vest in the award. According to the language in the illustration and related footnote, this conclusion was reached based on the particular facts and circumstances. Specifically, the facts considered, among others, were the legal enforceability of the agreement and the company's intent in enforcing the agreement, the employee's rights to the awards, the magnitude of the award's value in relation to the employee's other compensation, and the severity of the effect of the non-compete agreement provisions on the ability of the employee to gain employment elsewhere.

I would like to take a step back and focus on the FASB's conclusion reached in Illustration 16 -that a non-compete agreement, when coupled with other factors, could create an in-substance requisite service period. In order to reach this determination the Board concluded that based on all of the facts and circumstances related to the company, the employee and the non-compete arrangement, the employee was essentially in the same position as if a stated substantive vesting period existed. I would like to point out that we do not believe that the sole fact that substantive non-compete provisions are included in the terms of a share-based payment award would lead to the determination that an in-substance requisite service period must exist. Nor do we believe that such a conclusion will be a common occurrence. However, if you believe that your specific fact pattern results in such a conclusion, we would encourage you to come talk to us

In order to make an assessment of whether the inclusion of a non-compete agreement results in an in-substance requisite service period, companies will need to evaluate the facts and circumstances of the arrangement. In particular, companies will need to evaluate the specific terms of the share-based payment award, the terms of the related non-compete arrangements, the company's past practice in relation to the enforcement of non-competes, and, to the extent applicable to the current assessment, past employees' actions in regard to the terms of the non-compete arrangements and perhaps even the individual circumstances of the employees in question.

### **Required Disclosures – Pre and Post Adoption of Statement 123R**

Turning now to some disclosure issues - in Section M of SAB 107 the staff acknowledged that the adoption of Statement 123R may result in significant differences in the financial statements for periods before and after the adoption. In these circumstances, companies should pay particular attention to their disclosures to ensure that investors and other users of their financial

statements are able to understand the transition the company has gone through and the financial statement impact of these differences in the past, present and in the future. We understand that there may be differences between the amount of compensation cost recognized or disclosed in accordance with Statement 123 and the amount that will be recognized under Statement 123R. These differences may arise from many things including: 1) companies refining their estimates of assumptions used; and/or 2) companies modifying their plans or individual outstanding awards.

In SAB 107 the staff recognized that in adopting the provisions of Statement 123R companies may, based on their specific facts and circumstances, decide that it is appropriate to change certain assumptions. This may be based in part on a more in-depth review of the information underlying the assumption. While we believe such changes may indeed be appropriate, it is also appropriate for companies to disclose the effects of such changes and explain the reasons for them.

It is also important for users of financial statements to understand any modifications companies make to their plans or specific awards. Last year at this conference, Chad Kokenge discussed disclosures of modifications to share-based payment arrangements. The staff also addressed this point in Section K of SAB 107. Since Chad's speech last year and the issuance of the SAB, many companies have modified the terms of their share-based payment awards – some including the useful disclosure that Chad discussed in his speech and others choosing not to include it. Let me remind you again of those disclosures.

Following the requirements of paragraph 47 of Statement 123, for each year an income statement is provided, the terms of significant modifications of outstanding awards shall be disclosed. Therefore, specific disclosure of any modifications in anticipation of adopting the new accounting standard is necessary. We also believe that this disclosure should include the reasons the award terms were modified.

Continuing on with the disclosure theme - the language in Section H of SAB 107 reiterates the long standing Commission practice of asking companies to include all annual period disclosures of a newly adopted accounting standard in the first interim period in which it is adopted. This practice is based on guidance provided in APB 28<sup>4</sup> and Article 10 of Regulation S-X. The guidance provides that interim period financial statements may be prepared in less detail than annual financial statements due to the fact that in most cases users can reference the annual financial statements for the more in-depth disclosures. However, when a standard is first adopted in an interim period – even the first interim period of a fiscal year -- there are no annual periods to look back to that include similar accounting. Thus, in the interim period where a standard is adopted, companies should include the required annual disclosures in the financial statements.

### **Disclosure of Non-GAAP Financial Measures in Relation to Share-based Payment Expense Recognized**

Another topic that seems to have received a lot of attention in the press lately relates to non-GAAP financial measures. In Section G of SAB 107, the SEC staff noted that a measure such as "Net Income Before Share-Based Payment Charge" or something equivalent would meet the definition of a non-GAAP financial measure in Regulation G<sup>5</sup> and Item 10(e) of Regulation S-K. In addressing the appropriateness of such a measure being publicly disclosed, the staff pointed to the FAQ on the use of non-GAAP financial measures that was prepared by the staff of the Division of Corporation Finance. Question 8 clarified the views on the appropriateness of eliminating or smoothing an item that is identified as recurring. Specifically, the staff stated in the FAQ that while there is no per se prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items.

In order to overcome this burden, we would expect a company to be able to demonstrate that it utilizes the non-GAAP financial measure to internally evaluate performance. Stating that others evaluate the performance of the company using this measure would not meet this standard. If the hurdle is overcome, and as long as the measure does not violate any of the other prohibitions, the company should provide the disclosure outlined in FAQ 8.

### **Application of ASR 268<sup>6</sup> to Share-Based Payment Arrangements**

Now turning to the application of ASR 268 on temporary equity classification to share-based payment arrangements - the short answer, contrary to past popular belief, is yes - ASR 268 does apply to share-based payment arrangements. However we do acknowledge that in the past, ASR 268 was not consistently applied to all share-based payment arrangements.

To provide a little background, ASR 268 and the further interpretations and clarifications provided in EITF Topic D-98<sup>7</sup> require classification outside of permanent equity for equity instruments that are redeemable (1) at a fixed or determinable price on a fixed or determinable date (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. Based on the guidance regarding classification provided in Statement 123R, most awards with redemption features that are outside of the control of the issuer are required to be classified as liabilities. However for those that are not, Section E of SAB 107 clarifies that registrants should evaluate whether the terms of the award result in the need to classify an amount outside of permanent equity in accordance with ASR 268. This classification and measurement guidance is applicable to an award whether it is vested or unvested.

At the September EITF meeting, we updated EITF Topic D-98 for this along with some other comments. We clarified that awards previously classified as permanent equity that are now required to be reclassified should be reclassified at the amount required to be presented outside of permanent equity when Statement 123R is adopted.

Now, I know you are probably thinking how many items are there in that SAB that I can reference in one speech. I would like to encourage you - if you have not already, to take a look at the SAB. We do believe, in addition to the guidance provided in Statement 123R, that the SAB provides helpful information to companies implementing the Standard. Since its issuance we have received many questions and we continue to encourage you to contact us with questions on the guidance provided. Thank you for your time this afternoon.

## Endnotes

- [1](#) Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*.
- [2](#) Statement 123R, paragraph 39.
- [3](#) *Ibid.*
- [4](#) APB Opinion No. 28, *Interim Financial Reporting*.
- [5](#) 17 CFR 229.10(e)
- [6](#) SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks*.
- [7](#) EITF Abstracts Topic No. D-98, Classification and Measurement of Redeemable Securities.

<http://www.sec.gov/news/speech/spch120505sb.htm>