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SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*

SAB Helps Registrants Apply Statement 123(R)

by Jim Kroeker, Herbert Wong, and John Sarno

While FASB Statement No. 123 (revised 2004), *Share-Based Payment*, ends the debate surrounding the expensing of stock options, its requirement to fair value these instruments introduces a number of valuation (and other) challenges. To help companies cope, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, *Share-Based Payment* (SAB 107 or Topic 14). While SAB 107 addresses a wide range of issues, the largest area of focus is valuation methodologies and the selection of assumptions. Notably, the SAB lays out simplified methods for developing certain assumptions.

In addition to providing the SEC staff's interpretive guidance on Statement 123(R), SAB 107 addresses the interaction of Statement 123(R) with existing SEC guidance (e.g., the interaction with the SEC's guidance dealing with non-GAAP disclosures). Its intent is to clarify, not change, any of Statement 123(R)'s guidance. Interested in reading more? The full text of the SAB can be downloaded from the SEC's Web site at www.sec.gov/interps/account/sab107.pdf.

Valuation Methods

Which Model to Use

The SAB reminds registrants that Statement 123(R) does not specify a preference for any particular valuation technique or model (e.g., the Black-Scholes-Merton versus a lattice based model). However, the technique or model a company uses should encompass all the pertinent factors of an award (e.g., market conditions, post-vesting restrictions, etc.).

> **Editor's Note:** Does that mean companies may continue to use the Black-Scholes-Merton model, particularly for awards with less complex terms (e.g., "plain-vanilla" employee stock options)? The short answer to the question is **yes**.

Switching Between Valuation Models

May a company use one valuation technique (e.g., upon adoption of Statement 123(R)) and later change to another? According to the SAB, the SEC staff will not object to such a change nor will the SEC staff require a company to demonstrate preferability when changing its valuation technique. Here are the conditions:

- The new technique meets the measurement objective described in paragraph A8 of Statement 123(R),[1] and
- The same model is used to value similar types of awards.

A word of caution, especially for those who may be interested in arbitraging among various valuation techniques to produce the lowest estimate of compensation cost — the Staff expects that a switch between techniques will be infrequent, especially if there is no significant variation in the types of awards being issued. If a company does change its method of valuing share-based payment awards, then the company needs to disclose the change and the reasons for the change in the notes to the financial statements.

Assumptions Used in Valuation Methods

Regardless of the valuation technique used, Statement 123(R) requires the use of certain inputs (assumptions) into the valuation model. *Expected volatility* and *expected term* have caused the greatest debate. The SAB will help companies develop these two assumptions and even provides several practical methods.

Expected Volatility

To develop an estimate of *expected* volatility, an entity generally starts by considering *historical* volatility; however, it must also consider how historical volatility may differ in the future (e.g., *implied* volatility) requiring the entity to strike a balance between the two. The use of each will be based on a company's specific facts and circumstances. In most cases, the use of implied volatility will depend on the availability of publicly traded options or options embedded in other financial instruments.

The SAB should ease implementation concerns because it provides additional guidance on (1) computing historical volatility (e.g., number and frequency of observations, whether future events were considered, whether and why certain historical periods were excluded) and (2) factors that should be considered if implied volatility is used (e.g., volume of activity, similarity between traded options and employee options). Finally, the SAB describes when the staff would not object to sole reliance on either historical volatility or implied volatility as a reliable estimate. Here's a summary.

Factors Necessary to Rely Solely on:

Historical Volatility	Implied Volatility
• There is no reason to believe that future volatility is likely to differ from its past,	• The company's valuation model is based on a constant volatility assumption (e.g., Black-Scholes-Merton),
• The computation uses a simple average calculation of data points,	• The traded options on which implied volatility is based are actively traded,
• The historical period analyzed should be as long as the expected term assumption, and	• The market prices used are measured on a date close to the grant-date,
• A reasonable amount of price observations are used consistently throughout the historical period.	• The traded options are near the money and have exercise prices similar to the employees' options, and
	• The remaining maturities of the traded options are at least one year.

[1] Paragraph A8 of Statement 123(R) states in part, "a company should select a valuation technique or model that (a) is applied in a manner consistent with the fair value measurement objective and the other requirements of Statement 123(R), (b) is based on established principles of financial economic theory and generally applied in that field, and (c) reflects all substantive characteristics of the instrument."

A Short-Cut for Determining "Expected Term"

In valuing employee stock options, Statement 123(R) requires entities to use the "expected term" of an option rather than the stated contractual term. Why? To incorporate into the valuation the effects of nontransferability by taking into account employees' early exercise behavior. Statement 123(R) indicates the length of the expected term of an award must (1) equal or exceed the vesting period and (2) be no longer than the option's contractual term. With that as a backdrop, the SEC staff believes the expected term of an award will vary among companies, based upon the specific facts and circumstances. To provide a measure of comparability and to ease the initial implementation of Statement 123(R), the SAB provides a "short-cut" to use in making an estimate of expected term.

The short-cut? For "plain-vanilla" employee stock options, companies are permitted, but not required, to use the simple average of the vesting period and the contractual term [(vesting period + contractual term) ÷ 2] as a surrogate for the expected term of the award. Don't get too excited, this is a limited time offer. The "short-cut" method is available only until December 31, 2007, at which time all awards need to be based using the company's best estimate of expected term.

Editor's Note: Keep in mind — generally, the longer the expected term of the award, the higher its fair value. Using a refined estimate of expected term, rather than the "short-cut" method, will result in a more precise estimate of compensation cost.

The SAB addresses the issue of grouping a company's employees when analyzing the expected term of an award. If a company elects to use the "short-cut" method, then a company should use only **one** grouping of employees. For example, for the same grant, a company cannot use a more refined measure of expected term for their rank and file employees and use the "short-cut" method for their executives. For those companies electing to apply the "short-cut" method, it should be applied to all "plain-vanilla" options granted (i.e., one employee grouping). For those companies not applying the simplified approach, the staff believes that as few as one or two employee groupings may be used (e.g., executives and non-executives) and still achieve a reasonable fair value estimate.

Management's Discussion and Analysis (MD&A)

SAB 107 also discusses the SEC staff's expectation of registrants' MD&A disclosures related to share-based payment transactions.

Because MD&A should provide information about the quality and potential variability of a company's earnings and cash flow, upon adoption of Statement 123(R), a company's MD&A should discuss factors that affect the comparability of the financial statements. For example, companies should consider describing the following (a complete list can be found in SAB Topic 14.M):

- The transition method selected (e.g., modified prospective or modified retrospective application method).
- Differences in valuation methods or assumptions compared to those used pursuant to Statement 123.
- Changes in the quantity or type of instruments used (e.g., a shift from options to nonvested shares).
- Changes in the terms of share-based payment arrangements (e.g., addition of performance conditions).
- Effects on the financial statements as a result of the adoption of Statement 123(R) (e.g., any cumulative adjustments).

Additionally, the SAB reminds registrants that the SEC expects to see an explanation of whether historical volatility, implied volatility, or a combination of both, was used to estimate expected volatility **and why** its use was appropriate. Companies also should consider describing the information they used to arrive at the expected volatility assumption (e.g., number and frequency of observations for historical volatility, volume of activity for implied volatility, etc.).

Modifications Prior to Adoption of Statement 123(R)

In the SAB, the SEC staff reiterates and expands on earlier comments dealing with pre-adoption accelerated vesting of "out-of-the-money" stock options — a strategy many companies may use to put compensation cost behind them prior to adoption of Statement 123(R)) (see *Heads Up* dated December 13, 2004).

The SEC staff believes an acceptable interpretation of "old" Statement 123 allows a company to recognize any remaining unvested compensation cost as a result of the acceleration of the vesting terms of an award only in the footnotes and not in the income statement, so long as the employee's rights to the award are not predicated on providing any future employee service.[2] Pursuant to paragraph 47 of Statement 123, companies must disclose the terms of significant modifications to existing awards. More specifically, the SEC staff believes registrants should disclose the reasons for accelerated vesting of out-of-the-money stock options.

Non-GAAP Financial Measures

With the requirement to record stock-based compensation cost in the financial statements, some preparers may be considering reporting net income exclusive of stock-based compensation cost in their annual reports and other documents provided to the SEC. SAB 107 clearly states that the disclosure of net income excluding charges for stock-based compensation is a non-GAAP financial measure.

If a company wants to disclose this amount, first it needs to determine whether or not it is a prohibited non-GAAP financial measure pursuant to SEC Regulation S-K, Item 10(e). If a company concludes that this measure is not a prohibited non-GAAP financial measure, then management needs to explain why it believes the presentation of this amount provides meaningful information to investors (along with all other disclosures required pursuant to SEC Regulation S-K, Item 10(e)).

The SAB notes that stock-based compensation cost may fluctuate in different ways and for different reasons than other expenses. Therefore, in order to comply with the SEC's rules on MD&A and non-GAAP financial measures, the SAB suggests that companies should identify the amount of material stock-based compensation cost and describe why it has fluctuated between periods.

In addition, when pro-forma financial statements are required for SEC filings (e.g., when a business acquisition has occurred), the staff will object to pro-forma income statements that remove the effects, if any, of share-based payment transactions from net income.

Classification of Compensation in Income Statement Line Items

The SEC staff believes stock-based compensation cost needs to be included in the same income statement line items(s), as if that compensation had been paid to the same employees in cash. That is, stock-based compensation cost should not be recognized as a separate income statement caption. However, the SAB indicates that a company can provide additional disclosure of the amount of stock-based compensation cost included in specific financial statement line item(s) either (1) as a parenthetical note on the face of the income statement or statement of cash flows, (2) in the footnotes, and/or (3) within MD&A.

Adoption of Statement 123(R) in an Interim Period

The disclosures required by Statement 123(R) for annual financial statements are required in the Form 10-Q for the interim period in which Statement 123(R) is first adopted.

Though not discussed in the SAB, companies that elect to use the modified retrospective application method of adoption normally would not need to amend and re-file prior 10-Ks and 10-Qs. However, in the event of filing a registration statement, certain financial statements may need to be amended and re-filed, depending on which comparative financial statements are included or incorporated by reference.

[2] This also assumes that compensation cost was zero under APB Opinion No. 25, *Accounting for Stock Issued to Employees*.

Mezzanine Classification

Although many share-based payment awards with redemption features (requiring a potential for cash settlement by the employer) will be classified as liabilities pursuant to Statement 123(R), some will be classified as equity. For awards classified as equity in accordance with Statement 123(R), SAB 107 reminds registrants that they should assess whether these types of awards (i.e., those with redemption features) should be classified as temporary equity (i.e., "mezzanine" equity) based on SEC Accounting Series Release No. 268, *Redeemable Preferred Stocks* (ASR 268). Remember, this only applies to share-based payment awards with certain redemption features that require settlement by cash or other assets upon occurrence of events that are outside of the control of the issuer (e.g., redemption at the option of the holder).[3] Therefore, awards without redemption features would not go through this assessment.

Awards classified as temporary equity should be presented at their **redemption amounts** at the end of each reporting period, in proportion to how much of the award has vested. Based on EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities," changes in the redemption amount from the grant-date fair value of the instrument would be recorded through equity. This means that only the grant-date fair value of the award is recorded as compensation expense in the income statement.[4]

Depending on the terms and nature of the award, the redemption amount could either be its fair value or its intrinsic value. The staff provides examples in SAB Topic 14.E. But here's an example to illustrate the basic idea.

Example

On January 1, 2006, a company (that is an SEC registrant) grants 100 nonvested shares that cliff vest at the end of four years (on December 31, 2009) and that qualify for equity classification under Statement 123(R). The fair value of the company's shares on January 1, 2006 (the grant date) was $8 per share. After six months past vesting date, the holder has the option to redeem the shares at their fair value.

As redemption cannot occur within six months of exercise, all things being equal, this award would be classified in equity under Statement 123(R).[5] Because the award includes a redemption feature, the company would have to assess whether it should be classified as temporary equity or permanent equity. Since redemption is at the option of the holder, the Company must classify the award as temporary equity on the balance sheet based on its redemption amount at the end of each period.

Let's say that, on December 31, 2007 and December 31, 2008, the company's share price is $10 and $6 per share, respectively. Here's what would be recorded in the mezzanine equity:

	At December 31, 2007	At December 31, 2008
Temporary (mezzanine) equity	$250 ($10 × 100 × 1/4)	$300 ($6 × 100 × 2/4)

Income Tax Accounting

Statement 123(R) establishes a model of accounting for income taxes that is largely similar to its predecessor (see *Heads Up* dated December 17, 2004). Statement 123(R) requires that a company's APIC pool (excess tax benefits in excess of tax benefit shortfalls) for prior awards must be determined upon adoption so that it is available to offset future tax benefit shortfalls. The process of determining this hypothetical pool requires entities to look back to all awards granted in fiscal periods beginning after December 15, 1994 (the effective date of Statement 123), a difficult exercise for some companies to complete on a timely basis. Again, in order to ease the implementation burden of registrants, the SEC staff has devised a "short-cut" method for the determination of the APIC pool. The SAB indicates that a registrant need only ensure a sufficient APIC pool exists to off-set any current period tax shortfalls because the size of APIC pool is not required to be disclosed in a company's financial statements.

[3] SEC Regulation S-X, Rule 5-02.28 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they 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.

[4] This assumes that compensation cost is not capitalized to items such as inventory or fixed assets.

[5] Per paragraph 31 of Statement 123(R).

Transition From Nonpublic to Public Entity Status

When an entity files its initial registration statement, it becomes a public entity for the purposes of Statement 123(R). SAB 107 provides guidance by describing how different types of awards, which were accounted for under nonpublic entity rules pursuant to Statement 123(R), should be accounted for after the company becomes public. Examples that are included in SAB 107 are:

- How should unvested options at the time of going public be accounted for?
- How should fully vested liability awards at the time of going public be accounted for subsequently?
- After becoming a public entity, may a company retrospectively apply the fair-value based method to its awards that were granted prior to it becoming public?[6]

Transactions With Nonemployees

SAB 107 reiterates that only certain aspects of Statement 123(R) apply to nonemployee transactions (e.g., fair value is the measurement objective) and that certain aspects of nonemployee awards are not addressed in Statement 123(R). For example, companies should refer to 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," when determining the measurement date of an award granted to a nonemployee.

When authoritative literature does not address nonemployee transactions, Statement 123(R) generally should be applied by analogy. SAB 107 encourages registrants that have additional questions related to nonemployee share-based payment transactions to share them with the staff.

Other Topics Discussed

The SAB also discusses:

- The mechanics of capitalizing stock-based compensation cost (e.g., with inventory-costing systems) and its interaction with internal control reporting, and
- That GAAP differences would not be expected to result from **valuing** share-based payment awards under Statement 123(R) and International Financial Reporting Standard 2, *Share-based Payment* (although other differences do exist).

[6] See SAB Topic 14.B for the full text of the staff's Q&As on accounting for awards upon transition from nonpublic to public entity status.

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