



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. It is a pleasure to be here.

As you know, following the FASB's issuance of Statement 123R last December, OCA staff, together with staff in the Division of Corporation Finance, set out to try and address some of the questions about valuation and the interaction of Statement 123R and certain SEC rules and regulations in Staff Accounting Bulletin No. 107 (SAB 107). Shan has already provided insight on several areas discussed in SAB 107, and I plan to focus on certain valuation issues, specifically the expected volatility and expected term assumptions and the use of market instruments.

Before I jump into the detailed valuation discussion, I would like to share a personal observation regarding one part of the process that led to the issuance of SAB 107. Our team worked closely with the Commission's Office of Economic Analysis (OEA) in this effort. For those that are not familiar with OEA, this office serves as the chief advisor to the Commission and its staff on economic issues associated with the SEC's regulatory activities. The economists in this office are highly distinguished professionals, and it has been a privilege to learn from them. Working with OEA on the SAB was like receiving valuation tutorials from well-renowned PhDs in a small group setting. I came away from that experience having not only learned a great deal, but also gained an appreciation of the importance of valuation issues in accounting today.

As the FASB continues to consider issues related to the role of fair value in accounting, questions regarding the relevancy and reliability of fair value measurements will undoubtedly be a focal point of that debate. In order to properly join this debate, I believe that accounting professionals would benefit from trying to increase their awareness and understanding of economic and valuation issues and the various techniques and models available to measure fair value.

Expected Volatility Assumption

Turning to share-based payment valuations, let me first touch on the expected volatility assumption. Statement 123R defines volatility as the measure of the change in a financial variable, such as a company's share price, during a period.¹ Although Statement 123R does not require a specific method to be used, it does provide a list of factors to consider when estimating expected volatility.² The staff has been asked whether exclusive reliance on a particular factor would be acceptable in estimating expected volatility. SAB 107 does include the staff's thoughts on when exclusive reliance on either realized historical volatility or current implied volatility would be appropriate. I would like to give you a few additional thoughts on these two measures of volatility based on questions we have received since the SAB was released.

Implied volatility reflects the market's consensus regarding changes in a company's share price during the term of an option. Since employee options have terms that usually extend for several years or more, we understand that some companies may be hesitant to use an implied volatility measure derived from traded options that typically have terms of 2 years or less. SAB 107 expresses the staff's view that, holding other factors constant, the current implied volatility of a traded option with a term of one-year or more would typically not be significantly different from the implied volatility that would be derived from a traded option with a longer term. In fact, the staff stated in SAB 107 that it will not object to a company exclusively relying on the implied volatility derived from a traded option with a remaining maturity of at least one year, assuming other criteria provided in the SAB are also met. In addition, SAB 107 also notes that implied volatility based on a traded option with a remaining maturity of six months or more could be considered as long as a company also considers other relevant information in estimating expected volatility.

Of course, historical realized volatility is one source of relevant information to consider when developing an estimate of expected volatility. Since companies are more familiar with calculations of historical realized volatility, I am not going to go in to a lot of detail on this topic. However, I do want to mention that we are aware that there are many methods available out there for companies to utilize in computing historical volatility.

When evaluating the alternative methods, we would encourage companies to keep in mind the objective as stated in Statement 123R - to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option.³ The staff expects companies to make good faith efforts to determine an appropriate estimate of expected volatility as one of the key assumptions used in determining a reasonable fair value estimate.

We have become aware of two methods for computing historical volatility that we believe will not meet this expectation. The first method is one that weighs the most recent periods of historical volatility much more heavily than earlier periods. The second method relies solely on using the average value of the daily high and low share prices to compute volatility. While we understand that we may not be aware of all of the methods that currently exist today and that others may be developed in the future, we would like to remind companies to keep in mind the objective in Statement 123R when choosing the appropriate method.

Of course, many companies will likely conclude that exclusive reliance on either historical or implied volatility is inappropriate. In those circumstances, companies would have to consider the information that is available to assist in estimating expected volatility. As you might expect, this consideration would likely be highly subjective. All available information should be carefully evaluated, and there is no "magic formula" for assigning probabilities to that information for an individual company or industry group. Again, I suggest that companies keep in mind the objective of estimating expected volatility stated in Statement 123R, which is to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option.⁴

Expected Term Assumption

I would now like to discuss the expected term assumption that is needed to use a closed-form option pricing model, such as the Black-Scholes-Merton model.⁵ When developing an estimate of expected term for input into a closed-form model, Statement 123R notes that there may be several different sources of information available, such as a company's historical data, industry averages, or academic research.⁶ When the SAB was being developed, the staff understood that there were minimal sources of publicly available information that could assist companies in determining the period of time that an employee share option would remain outstanding. Some companies might have appropriate historical information available to develop this estimate, but others might not have historical data available for the term of the option being valued. Still others might believe that historical information is not representative of future employee exercise patterns due to, for example, an expectation of a more volatile stock price over the term of the employee option.

In order to address the concern raised that publicly available information does not currently exist and historical data might not, in all cases, provide appropriate information, SAB 107 states that the staff will not object to the use of a "simplified" method for estimating expected term for "plain vanilla" options, as those options are described in the SAB. This alternative is available for all public companies. In addition, the staff would not object if a company applied the simplified method in the financial statements for the pre-IPO years included in the initial registration statement filed with the Commission.

SAB 107 states the staff's belief that more detailed information about employee exercise behavior will, over time, become available. In fact, I have recently become aware of an effort underway to gather and analyze data with the purpose of making the results of this analysis publicly

available. Personally, I am encouraged by these developments and the continuing public dialogue in this area.

Market Instruments

Another subject of recent discussion at the Commission relates to the use of market instruments to value employee share options. Statement 123R states that the best evidence of fair value for employee share options is observable market prices of identical or similar instruments in active markets.⁷

In Statement 123R, the FASB did not attempt to consider the appropriate design of an instrument that might be specifically created for the purpose of obtaining a market-based value of employee share options. Since the issuance of SAB 107, we became aware of efforts underway to design and sell a market instrument for the purpose of providing a value for employee share options. This past September, our former Chief Accountant, Don Nicolaisen, issued a statement expressing his views on the use of market instruments to estimate the grant-date fair value of employee share options. His statement is accompanied by a memo from our Office of Economic Analysis on the economic perspectives of these instruments. Chairman Cox also issued a statement commenting on the use of appropriate market instruments for estimating the fair value of employee share options.

We are not currently aware of any instruments that have been sold in the market for the purpose of valuing employee share options. As a result, the discussions we have had about these types of instruments have been theoretical in nature. As Mr. Nicolaisen stated in his September statement, we believe that it should be possible to design instruments whose transaction prices would be a reasonable estimate of the fair value of underlying employee share options.

Rather than try to discuss all of the views expressed in the September statements, I am going to focus my remarks on two possible approaches to market instruments in order to provide you with some perspectives on what we have been considering. For further information on market instruments beyond what I am about to cover, please visit the Commission's website.

Statement 123R states that the objective of accounting for share-based payment transactions with employees is to record the cost of employee services to the company.⁸ In order to determine the cost to the company, the purchaser of a market instrument would need to step into the shoes of either the employer or the employee.

If the purchaser of a market instrument assumes the role of the employee, then the instrument would be intended to be designed such that the purchaser would pay an amount based on the value that the purchaser would expect an employee to receive from the option. One possible approach would be to design an instrument that would result in a payoff that tracked the payoff of an underlying pool of employee stock options.

Another approach might be to design an instrument that replicates the restrictive terms included in employee share options. However, we do not

believe that the value that a third-party investor would assign to an instrument with the same restrictive terms would represent the fair value of the employee share option consistent with the measurement objective of Statement 123R. That is, it does not seem possible to replicate an employer-employee relationship or the effects of that relationship in a transaction with a third party.

An additional point related to instruments containing restrictive terms is that the investor may be motivated to pay as little as possible for the instrument, while, at the same time, the employer might be motivated to sell the instrument at the lowest possible price in order to obtain a lower value for purposes of recording compensation cost in its financial statements.

On the other hand, if a holder of a market instrument assumes the role of the employer, then that holder would be expected to assume the risks associated with the future exercise of the options by the employees. The holder of the instrument would be free to manage those risks however it deems appropriate, through hedging strategies, transfers to another third party, or some other means. I would expect that an independent third-party that enters into this transaction would strive to maximize the transaction price received from the employer. The counterparty, or the issuer of the stock options, is laying off its obligation to a third party and therefore would likely seek to minimize the transaction price.

Of course, all of the discussion so far has centered on whether the design of an instrument could provide an estimate of fair value for employee share options. The marketing plan for the instrument is an equally important consideration because marketplace participants will need information about the terms of the awards as well as other information that would be useful to appropriately determine a fair value estimate.

Once an instrument has been designed, marketed, and sold for an amount that represents the fair value of an employee share option, the accounting for that instrument under Statement 123R would need to be considered. All of these questions are very interesting, and since September we have continued to gather information and learn more about the potential for market instruments to provide a fair value for employee share options. I am hopeful that the public dialogue on this issue will continue so that the issues can be worked through and we can reach the next stage in the evolution of employee share option valuation.

This concludes my remarks. Thank you for your time today.

Endnotes

- ¹ Statement 123R, paragraph A31.
- ² Statement 123R, paragraph A32.
- ³ Statement 123R, paragraph B86.
- ⁴ Statement 123R, paragraph B86.
- ⁵ Statement 123R, paragraph A18.

6 Statement 123R, paragraph A29.

7 Statement 123R, paragraph A7.

8 Statement 123R, paragraph 9.

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Introduction

Good afternoon. As you know, Staff Accounting Bulletin No. 107, which provides certain staff views regarding Statement 123R¹, 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 period² which is defined as the period during which an employee is required to provide service in exchange for an award.³ 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 28⁴ 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 G⁵ 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 268⁶ 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-98⁷ 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.

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