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SEC Guidance On Stock Option Expensing

Statement of Financial Accounting Standards No. 123 (revised 2004) ("FAS 123R") requires companies that follow U.S. generally accepted accounting principles to recognize compensation expense for the fair value of stock option grants and other stock-based awards. To determine the amount of expense, companies will be required to estimate the fair value of stock-based awards at the time of grant. On March 29, 2005 the staff of the Securities and Exchange Commission issued *Staff Accounting Bulletin No. 107* ("SAB 107") with guidance on the stock option expense rules contained in FAS 123R. The SEC staff has also made publicly available a Memorandum dated March 18, 2005 from its Office of Economic Analysis ("SEC Memo"), which gives an economic perspective on FAS 123R. This Client Alert summarizes SAB 107 and the SEC Memo.

I. BACKGROUND

A. Recent Change to Effective Dates

For larger public companies, FAS 123R was to take effect in the first reporting period after June 15, 2005 (e.g., for calendar year companies the third quarter of 2005). For public companies that are small business issuers and nonpublic companies, FAS 123R was to take effect in the first reporting period after December 15, 2005 (e.g., the first quarter of 2006 for calendar year small business issuers and January 1, 2006 for calendar year nonpublic companies).

On April 15, 2005, the SEC announced an amendment to its rules changing the effective dates of FAS 123R for public companies, but its new rules do not change the accounting required under the standard. The SEC's new rule, contained in Release No. 33-8568, adds subsection 4-01(a)(3) to Regulation S-X and allows public companies that are not small business issuers to implement FAS 123R at the beginning of their next fiscal year instead of their next reporting period that begins after June 15, 2005. The relevant date is December 15, 2005 for small business issuers (i.e., the beginning of their next fiscal year that begins after December 15, 2005). This means that a calendar year public company is not required to follow FAS 123R until January 1, 2006. If, however, a public company has a June 30 year end and is not

a small business issuer, it must comply with FAS 123R beginning July 1, 2005.

In its April 15 release, the SEC expressed its concern that under the prior effective dates, implementation of the new rules in a period other than the first quarter of a fiscal year may make compliance more complicated for public companies and potentially could make comparisons more difficult for investors. In addition, allowing the rules to take effect at the beginning of a fiscal year would relieve public companies from having to change their accounting systems in the middle of a fiscal year and allow them to implement any software programs that facilitate compliance with the new standard in a more orderly fashion. It would also allow auditors to conduct more consistent audit, review and attest procedures in this area.

B. Concept of Fair Value

Because the definition of fair value is based on the concept of an amount at which willing parties would buy and sell an asset or liability, the best evidence of fair value would be the market prices of identical or similar instruments in an active trading market, and where this data is available, it should be used to estimate the value of the award. Where this data is not available, the estimate should be calculated using a valuation technique that meets the requirements of FAS 123R.

C. Pricing Models

FAS 123R recognizes different option-pricing models as meeting its criteria for estimating fair value. It states (in paragraph A13) that a lattice model (such as a binomial model) and a closed-form model (such as the Black-Scholes-Merton formula) are among the techniques that meet the criteria. It also states that a Monte Carlo simulation technique would also meet its criteria. This flexibility allows companies to choose among alternative approaches in obtaining the best estimate in light of the company's circumstances.

D. Valuation Methods and Assumptions

It is widely agreed that the Black-Scholes-Merton model is the simplest to apply, but that the lattice and other models allow for greater flexibility while also being more complex and requiring intensive data gathering. The SEC Memo referenced above comments that the structural advan-

tages of the lattice and related models are likely to become more apparent as companies gain experience with valuation under FAS 123R. In SAB 107 the SEC staff has provided guidance on the use of valuation methods and assumptions.

II. CHOICE OF VALUATION METHODS

SAB 107 states that the SEC staff would not object to a company's choice of a technique or model as long as the technique or model (a) is consistent with the fair value measurement objective and other requirements of 123R; (b) is based on established principles of financial economic theory; and (c) reflects all substantive characteristics of the instrument. It further states that if a company makes a good faith fair value esti-

...FAS 123R and SAB 107 clearly require companies to use all information that is available at the time of grant to estimate the relevant parameters for their valuation models.

mate in accordance with the provisions of FAS 123R in a way that is designed to take into account the assumptions that underlie the instrument's value that marketplace participants would reasonably make, changes in value, no matter how significant, subsequent to the grant date would not call into question the reasonableness of the grant date fair value estimate.

The SEC Memo makes the point that FAS 123R and SAB 107 clearly require companies to use all information that is available at the time of grant to estimate the relevant parameters for their valuation models. It can be inferred from this that if information available at the time of the estimate were to be disregarded, this would be an indication that the estimate was not made in good faith. It can also be inferred that if the company uses a valuation model or assumptions applying the model in a way that is not consistent with its own circumstances, this

would also be an indication of the lack of good faith.

III. CHANGE IN VALUATION METHODS

SAB 107 also states that a company may subsequently change the valuation model chosen. Such a change would be a change in estimate for purposes of applying APB Opinion No. 20, *Accounting Changes*, but would not be a change in accounting principle. Accordingly, a company that changes its valuation model would not be required to file a preferability letter from its independent accountants as described in Rule 10-01(b)(6) of Regulation S-X when it changes valuation techniques or models. The SEC staff would not, however, expect a company to frequently switch valuation techniques or models, particularly in circumstances where there was not significant variation in the form of share-based payments being valued. FAS 123R states that a valuation technique should not be changed unless a different valuation technique is expected to produce a better estimate of fair value. Financial statement footnote disclosure would be required to disclose the basis for any change in technique or model. For public companies, we believe that if the option expense is material to the company, and the change is expected to result in a material change in the estimate in the future, disclosure in the Management's Discussion and Analysis section of the company's next Form 10-Q or 10-K would also be required.

IV. ASSUMPTIONS

FAS 123R (paragraph A18) states that a valuation technique or a model must take into account, at a minimum:

- ◆ The exercise price of the option.
- ◆ The expected term of the option, taking into account both the contractual term of the option and the effects of the employees' expected exercise and post-vesting employment termination behavior.
- ◆ The current price of the underlying share.
- ◆ The expected volatility of the price of the underlying share for the expected term of the option.

- ◆ The expected dividends on the underlying share for the expected term of the option.
- ◆ The risk-free interest rate(s) for the expected term of the option.

Several assumptions need to be made in connection with these factors, including risk-free interest rate(s), expected term of the option, expected volatility of the option, expected dividends and other assumptions. The two assumptions that are specifically addressed in SAB 107 are the expected volatility and the expected term.

A. Expected Volatility

SAB 107 cites FAS 123R, paragraph A31:

"Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require an estimate of expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the share[s] can be expected to vary—up or down. Because an option's value is unaffected by expected negative returns on the shares, other things [being] equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility."

SAB 107 further points out that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option. FAS 123R, paragraph A32, provides a list of factors that entities should consider when estimating expected volatility. Those factors are:

- ◆ Volatility of share price over the most recent period that is generally commensurate with the contractual term of the option if a lattice model used, or the

expected term of the option if a closed-form model is used. Changes in volatility should be included. For example, in computing historical volatility, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid.

- ◆ The implied volatility of the share price determined from the market prices of traded options or other traded financial instruments such as outstanding convertible debt, if any.
- ◆ For public companies, the length of time an entity's shares have been publicly traded.
- ◆ Appropriate and regular intervals for price observations. If an entity considers historical volatility in its estimate, it should use intervals that are appropriate. For example, a publicly traded entity would likely use daily price observations while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.
- ◆ Corporate and capital structure. An entity's corporate and capital structure may affect expected volatility; for example, highly leveraged entities tend to have higher volatilities.

In SAB 107 the SEC staff reiterates the FAS 123R preference that a company with actively traded options or other financial instruments with imbedded options generally could place greater (or even exclusive) reliance on implied volatility over historical volatility. SAB 107 states that companies should make good faith efforts to identify and use sufficient information in determining whether to take historical volatility, implied volatility or a combination of both into account to produce the best estimate of expected volatility. It further states that the process used to gather and review available information to estimate expected volatility should be applied consistently from period to period, and when circumstances indicate the availability of new or different information that would be useful in estimating expected volatility, a company should incorporate that information.

SAB 107 gives guidance regarding the method of computing historical volatility. It states that certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of historical volatility much more heavily than earlier periods. It further indicates that a company could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate.

With respect to the frequency of price observations, SAB 107 states that a company should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The SEC staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate. SAB 107 states that if shares of a company are thinly traded, the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations.

SAB 107 further states that a company should consider those future events that it reasonably concludes a market price participant would also consider in making the estimation. For example, if a company has recently announced a merger that would change its business risk in the future, it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

The staff in SAB 107 further states that in some instances historical volatility data from a certain period may not be relevant in evaluating expected volatility. It cites to the FAS 123R examples of extraordinary volatility because of a failed takeover bid. The staff states, however, that if a company disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that

previous period is not relevant to estimating expected volatility due to one or more discreet and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff expressed its view that these situations would be rare.

The staff also stated that when evaluating reliance on implied volatility from its traded options, a company should consider the following:

- ◆ **Volume of Market Activity.** The volume of trading in the underlying shares should be considered as well as the traded options. The staff gives an example

SAB 107 states that companies should make good faith efforts to identify and use sufficient information in determining whether to take historical volatility, implied volatility or a combination of both into account...

that prices for instruments in actively traded markets are more likely to reflect a marketplace participant's expectations regarding expected volatility.

- ◆ **Synchronization of Variables.** A company should synchronize the variables used. For example, to the extent reasonably practicable, a company should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the SEC staff believes that a company should derive implied volatility as of a point in time as close to the grant of the options as reasonably practicable.
- ◆ **Similarity of Exercise Prices.** The SEC staff believes that when valuing an at-the-money option, the implied volatility derived from at- or near-the-money

traded options generally would be most relevant. If it is not possible to find at-or near-the-money traded options, the company should select multiple traded options with an average exercise price close to the exercise price of the employee share option.

- ◆ **Similarity of Length of Terms.** The SEC staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. If there are no traded options with maturities that are similar to the expected or contractual term, then the staff believes that the company could consider traded options with remaining maturities of six months or greater. When using traded options with a term of less than one year, however, the staff expects the company to also consider other relevant information in its estimate. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term of the granted option.

SAB 107 also expressed the view that a company, after considering the factors listed in FAS 123R described above could, in certain instances, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets the stated objective. SAB 107 states that the staff would not object to a company placing exclusive reliance on implied volatility when the following factors are present, as long as the methodology is consistently applied:

- (i) The company utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options;
- (ii) The implied volatility is derived from options that are actively traded;
- (iii) The market prices (trading prices or quotations) of both the traded options and underlying shares are measured at a

similar point in time to each other and on a date reasonably close to the grant date of the options;

- (iv) The traded options have exercise prices that are both near-the-money and close to the exercise price of the employee share options; and
- (v) The remaining maturities of the traded options on which the estimate is based are at least one year.

The staff would not object to a company placing exclusive reliance on historical volatility when the following factors are present, so long as the methodology is consistently applied:

- (i) The company has no reason to believe that its future volatility over the expected or contractual term is likely to differ from its past;
- (ii) The computation of historical volatility uses a simple average calculation method;
- (iii) A sequential period of historical data at least equal to the expected or contractual term of the share option is used; and
- (iv) A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.

The staff further commented that if the expected or contractual term of the option is less than three years, the staff believes that monthly price observations would not provide a sufficient amount of data.

If a company is newly public with limited historical trading data on its shares and no other traded financial instruments, it may not have sufficient company specific information regarding the volatility of its share price on which to base an estimate. SAB 107 states that such a company may base its estimate of expected volatility on the historical, expected or implied volatility of similar entities whose share or option prices are publicly available. The company would likely consider the industry, stage of life cycle,

size and financial leverage of such other entities. The SEC staff would not object to the company looking to an industry sector index in order to identify one or more similar entities. Once the company identifies similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its own share price as an assumption in its valuation



model. Because of the effects of diversification that are present in an industry sector index, a company should not substitute the volatility of an index for the expected volatility of its own share price. Use of an industry sector index would be expected to

produce a lower volatility percentage and therefore a lower valuation. After similar entities have been identified, a company should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to the company.

B. Expected Term

Citing FAS 123R, paragraph A26, SAB 107 states:

“The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to the holder to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable [or tradable] share options in that employees cannot sell (or hedge) their share options—they can only exercise them; because of this, employees generally exercise their options before the end of the options’ contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the option’s value [compared to a transferable option]

because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value."

Therefore, FAS 123R requires that when valuing an employee share option under the Black-Scholes-Merton method, the value must be based on the share option's expected term rather than the contractual term. The staff expressed its view that the estimate of expected term should be based on the facts and circumstances available in each particular case. A company should not consider any additional discount for nonhedgeability and nontransferability. Nonhedgeability and nontransferability factor into the expected term assumption, and no additional reduction in the term assumption or other discount is appropriate for these factors.

The staff further believes that forfeitures or terms that stem from forfeitability should not be factored into the determination of expected term. These pre-investing restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for which employees render the requisite service. Further, the estimate of expected term could never be shorter than the vesting period.

FAS 123R indicates that an entity should aggregate individual awards into relatively homogeneous groups with respect to exercise and post-vesting employment termination behaviors regardless of the valuation technique or model used. The staff stated that it believes an entity may generally make a reasonable fair value estimate with as few as one or two groupings. In footnote 69, it explains that academic research suggests that two such groups might be executives and nonexecutives, since executives and other senior managers have been found to be significantly more patient in their exercise behavior than more junior employees.

SAB 107 explains that where a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the SEC staff will not object to the use of historical exercise experience to estimate expected term. There are a number of reasons, however,

that a company may conclude its historical exercise experience is not a reasonable basis to estimate future experience. The reasons for this could include the life of the company and its relative stage of development, past or expected structural changes in the business, differences in the terms of past option grants versus present or future option grants, or lack of variety of price paths (e.g., if a company has a history of

“... where companies issue ‘plain vanilla’ options..., the SEC staff provides a simplified method for calculating expected term.”

exercises only in periods of rising share prices, this may not be sufficient as the sole basis to form the estimate of expected terms for current grants).

Where historical exercise experience is not a reasonable basis to estimate future experience, the expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research. SAB 107 further states that where companies issue “plain vanilla” options (i.e., at-the-money, conditional only on performing service through vesting, forfeiture upon termination of service prior to vesting, limited time to exercise vested shares after termination of service, nontransferable and nonhedgeable), the SEC staff provides a simplified method for calculating expected term. The calculation given by the staff is as follows: $\text{expected term} = ((\text{vesting term} + \text{original contractual term})/2)$. Assuming a 10-year original contractual term and graded vesting over 4 years (25 percent of the options in each grant vest annually) for “plain vanilla” options, the resultant expected term would be 6.25 years.¹ If the company elects to use the simplified method provided, the method

should be applied consistently to all “plain vanilla” employee options, and the company should disclose the use of this method in the notes to its financial statements.

In addition, data about exercise patterns of employees in similar industries and/or situations as a particular company's might be used. The SEC staff in SAB 107 comments that while such comparative information may not be widely available at the present time, it understands that various parties, including actuaries, valuation professionals and others are gathering such data. The staff further noted that its simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term. It further does not expect that such a simplified method would be used for stock option grants after December 31, 2007, as more detailed information should be widely available by that time.

V. ACCELERATION OF VESTING PRIOR TO ADOPTION OF FAS 123R

SAB 107 also gives guidance regarding the acceleration of share options that are “out-of-the-money.” Where a company has granted at-the-money options where the exercisability of the options is conditioned only upon performing service through the vesting date, and the share price has fallen such that the options are out-of-the-money, it might consider accelerating those options prior to the effectiveness of FAS 123R. SAB 107 states that a company with such options who determines that a modification of the options to accelerate vesting will not require recognition of compensation cost in its financial statements in the period of the modification, the staff would not object to the company reflecting the remaining compensation cost related to those share options in the fair value pro forma disclosures required under FASB Statement No. 123 (the Statement that was revised by FAS 123R) (“Statement 123”), as a result of the acceleration.

The staff stated that so long as the acceleration of vesting permits employees to exercise the share options in a circumstance

when they would not otherwise have been able to do so absent the modification, an acceptable interpretation of Statement 123 is that the modification to accelerate the vesting would result in the recognition of the remaining amount of compensation cost in the period in which the modification is made. Accordingly, a company that accelerates the vesting of out-of-the-money options prior to the effectiveness of FAS 123R may reflect the related compensation cost in the footnote disclosures per Statement 123 in the period in which the

... public entities should specifically disclose any modifications to accelerate the vesting of out-of-the-money share options in anticipation of adopting FAS 123R, including the reasons for modifying the option terms.

acceleration occurs. The staff reminds public entities that Statement 123, paragraph 47, indicates that for each year an income statement is provided, the terms of significant modifications of outstanding awards shall be disclosed. In order to inform investors about modification transactions and management's reasons for entering into those transactions, the staff believes that public entities should specifically disclose any modifications to accelerate the vesting of out-of-the-money share options in anticipation of adopting FAS 123R, including the reasons for modifying the option terms.

VI. MANAGEMENT'S DISCUSSION AND ANALYSIS

The SEC staff suggests that in filings prior to the effectiveness of the new expense rules, companies should clearly describe in their MD&A section the change in accounting policy that will be required in FAS 123R and the reasonably likely material future effects. It references SAB Topic 11M, *Disclosure of the Impact that Recently Issued*

Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period.

In the SEC filing for the interim period when 123R is first adopted, the company should make the disclosures required by paragraphs 64-65, 84 and A240-242 of FAS 123R. The staff points out that where a company implements the expensing rules prospectively, it should disclose the fact that the financial statements for the company's prior interim periods and fiscal years will not reflect any restated amounts. Where a company implements the expensing rules during the middle of a fiscal year retrospectively to the prior interim periods of its current fiscal year and records an adjustment upon adoption of 123R to reflect the cumulative effect of reclassifying share-based payments as liabilities, it would not be required to apply the cumulative effect adjustment to the beginning of the fiscal year. Such adjustments should be recorded as of the date of adoption.

The SEC staff reiterates that the principal objectives of MD&A are to give readers a view of a company through the eyes of management, to provide the context within which financial information should be analyzed and to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. The adoption of FAS 123R may result in significant differences between the financial statements of periods before and after the adoption, especially for companies with significant share-based compensation programs who have not used a fair value method in their footnote disclosure in the past or that adopted the new rules prospectively. Furthermore, companies can be expected to refine their estimates of assumptions in the future. Each of these situations may affect the comparability of financial statements. Accordingly, the staff believes that companies should consider including in their MD&A material qualitative and quantitative information about any of the following, as well as other information that could affect comparability of financial statements from period to period:

- (i) The transition method selected (e.g., prospective or retrospective) and the resulting impact in current and future periods;
- (ii) Method used to account for share-based payments in prior periods and the impact, or lack thereof, on the prior period financial statements;
- (iii) Modifications made to outstanding share options prior to the adoption of 123R and the reasons for the modification;
- (iv) Differences in valuation methodologies or assumptions compared to those that were used in estimating the fair value of share options under Statement 123;
- (v) Changes in the quantity or type of instruments used in share-based payment programs, such as a shift from options to restricted shares;
- (vi) Changes in the terms of awards, such as the addition of performance conditions;
- (vii) A discussion of the one-time effect, if any, of the adoption of 123R, such as any cumulative adjustments recorded in the financial statements; and
- (viii) Total compensation cost related to non-vested awards not yet recognized and the weighted average period over which it is expected to be recognized.

VII. OTHER GUIDANCE

A. Redeemable Awards

Sometimes financial instruments with redemption features are awarded in conjunction with share-based awards. An example of that is the grant of shares or options to an employee that fully vests at the end of four years (i.e., cliff vest), where the award is redeemable for cash at fair value at the holder's option after six months from the date of share issuance. Though these awards might be classified as equity instruments under the guidance of FAS 123R, the SEC staff believes that a company who issues this type of award must evaluate whether the terms of instruments granted in connection with share-based arrangements with employees that are not classified as liabilities under FAS 123R result in the need to present certain amounts outside of permanent equity in accordance with other accounting guidance. The staff further stated that when an instru-

ment ceases to be subject to FAS 123R (generally, when the rights conveyed under the instrument are no longer dependent on the holder being an employee) and thus becomes subject to the recognition and measurement requirements of other applicable GAAP, the company should reassess the classification of the instrument as a liability or equity at that time.

B. Classification of Compensation Expense Associated With Share-Based Payment Arrangements

The SEC staff stated its view that a company should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. It indicated that a company could consider disclosing the amount of expense related to share-based payment arrangements in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

C. Non-GAAP Financial Measures

The SEC staff made clear that before a company uses a measure such as “Net Income Before Share-Based Payment Charge” or an equivalent measure, it needs to make a determination that it is not a prohibited non-GAAP measure pursuant to Item 10(e) of Regulation S-K, which generally states that a company may not present a non-GAAP performance measure that removes an expense from net income by identifying that expense as non-recurring, infrequent or unusual if it is reasonably likely that the expense will recur within two years or if the company had a similar expense within the prior two years. It further pointed out that companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items. The staff further stated, however, that this type of measure may be relevant for disclosure to investors. Therefore, if a company determines that the non-GAAP financial measure “Net Income Before Share-Based Payment Charge” does not violate any of the prohibitions in Item 10(e), its management would be required to also disclose, among other items, the reasons that

management believes that presentation of the non-GAAP measure provides useful information to investors regarding the company’s financial condition and results of operations, and to the extent material, the additional purposes, if any, for which the company’s management uses the non-GAAP financial measure that are not otherwise disclosed. Further, the staff points out that use of a non-GAAP measure may be misleading absent the following types of disclosures:

- (i) The manner in which management uses the non-GAAP measure to conduct or evaluate its business;
- (ii) The economic substance behind management’s decision to use such a measure;
- (iii) The material limitations associated with the use of the non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure;
- (iv) The manner in which management compensates for such limitations; and
- (v) The substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.

The staff indicated that it would object to the inclusion of a pro forma income statement in its SEC filings that removes from net income the effects of option expensing, because such a disclosure would not meet the conditions under the accounting rules of Regulation S-X for presentation of pro forma financial information. Further, a company may not present non-GAAP financial measures on the face of its financial statements prepared in accordance with GAAP or in the accompanying notes.

D. Capitalization of Compensation Cost Related to Options

Where a company determines that the cost of an option grant is an inventoriable cost, it should be initially capitalized as part of the cost of inventory; the company should later recognize the cost in its income

statement when the inventory is consumed, as cost of goods sold. SAB 107 clarifies that if a company elects to adjust its period end inventory balance for the allocable amount of the share-option cost through a period end adjustment to its financial statements, instead of incorporating the share-option cost through its inventory costing system, this would not be considered a deficiency in internal controls. The staff points out that FAS 123R does not prescribe the mechanism to be used to incorporate a portion of share-option costs in an inventory-costing system. The staff believes that a company may accomplish this through a period end adjustment to its financial statements, and should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment.

... a company need only calculate the additional paid-in capital available for offset if and when it faces a situation in which deductions reported on its tax return are less than the relevant deferred tax asset.

E. Paid-in Capital Calculation Required Only as Needed if and When a Tax Deficiency Occurs

In accordance with FAS 123R, reporting entities will need to determine whether deductions reported on tax returns for share-based payment awards exceed or are less than the cumulative compensation cost recognized for financial reporting. If deductions exceed the cumulative compensation cost, the company should generally record any resulting excess tax benefits as additional paid-in capital. If deductions are less than the cumulative compensation cost, the entity should record the write-off of the deferred tax asset, net of the related valuation allowance, against any remaining additional paid-in capital from previous awards accounted for in accordance with the fair value method of Statement 123 or FAS 123R as applicable. The remaining balance,

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if any, of the write-off of the deferred tax asset shall be recognized in the income statement. The staff clarifies in SAB 107 that while it is important that appropriate detailed information be available when needed for consideration, a company need only calculate the additional paid-in capital available for offset if and when it faces a situation in which deductions reported on its tax return are less than the relevant deferred tax asset. In addition, a company need only perform the calculations periodically to the extent necessary to conclude that sufficient paid-in capital is available for the offset of the deduction shortfall.

F. Non-Employee Stock Options

SAB 107 states that 123R does not supersede any authoritative literature that specifically addresses accounting for stock options granted to non-employees. With respect to questions regarding non-employee arrangements that are not specifically addressed in other authoritative literature, the staff believes that it would be generally appropriate for entities to apply FAS 123R guidance by analogy to stock options granted to non-employees unless more authoritative accounting literature is more clearly applicable or FAS 123R would be inconsistent with the terms of the instrument.

G. Outside Experts Not Required

SAB 107 states that as long as the valuation of the options or similar instruments is performed by a person with the requisite expertise there is no requirement to hire an outside consultant to make the determination.

H. Transition to Public Company Status

When a company transitions from nonpublic to public company status, stock options valued under the "calculated value" method (using share price volatility information of similar public entities) prior to becoming public should continue to be valued under that method after becoming public unless the stock options are subsequently modified, repurchased or cancelled. If the options are modified, repurchased or cancelled, the event should be assessed under FAS 123R. Where, however, a nonpublic company had elected to measure its liability awards at intrinsic value, it should measure the liability awards at fair value under FAS 123R when it becomes a public entity.

I. Application of The Measurement Provisions of FAS 123R to Foreign Private Issuers

The staff stated its general belief that application of the guidance for share-based payment arrangements with employees under International Accounting Standards Board International Financial Reporting Standard 2, Shared-Based Payment (IFRS 2) would generally result in a fair value measurement that is consistent with the fair value objective stated in FAS 123R. The staff generally believes therefore that application of FAS 123R's measurement guidance would not generally result in a reconciling item required under Item 17 or 18 of Form 20-F for a foreign private issuer that has complied with the provisions of IFRS 2 for a share-based payment transactions with employees. However, the staff does remind foreign private issuers that there are certain differences between the guidance in IFRS 2 and FAS 123R that may result in reconciling items.

End Note

- 1 Calculated as: 1 year vesting term (for the first 25 percent vested) plus 2 year vesting term (for the second 25 percent vested) plus 3 year vesting term (for the third 25 percent vested) plus 4 year vesting term (for the last 25 percent vested), divided by 4 total years of vesting, plus 10 year contractual life, divided by 2, or $((1+2+3+4)/4) + 10 / 2 = 6.25$ years.

ABOUT THE AUTHORS

Partners Douglas Faucette, Larry Hansen, Janet Love, and Associate Tim Farber are experienced in representing publicly and privately held clients in a range of industries, including thrifts and other depository institutions, insurance companies, manufacturers, distributors, service industries, and others.