

**Title 9—(Amended)**

**PART 97—OVERTIME SERVICES RELATING TO IMPORTS AND EXPORTS**

■ 3. The authority citation for part 97 continues to read as follows:

Authority: 7 U.S.C. 8301–8317; 49 U.S.C. 80503; 7 CFR 2.22, 280, and 371.4.  
 ■ 4. In § 97.2, the table is amended as follows:  
 ■ a. Under Mexico, by revising the entries for Ciudad Acuna, Nuevo Laredo, Ojinaga, Piedras Negras, Reynosa (Pharr International Bridge), and San Jeronimo to read as set forth below.

■ b. Under Texas, by revising the entries for Dallas-Forth Worth International Airport and Houston (including Houston Intercontinental Airport) to read as set forth below.

**§ 97.2 Administrative instructions prescribing commuted traveltime.**

\* \* \* \* \*

**COMMUTED TRAVELTIME ALLOWANCES**  
 [In hours]

Location covered	Served from—	Metropolitan area	
		Within	Outside
* * * * *			
Mexico:			
Ciudad Acuna .....	Del Rio, TX .....		1½
Do .....	Eagle Pass, TX .....		3
Do .....	Laredo, TX .....		6
Do .....	Pleasanton, TX .....		6
* * * * *			
Nuevo Laredo .....	Del Rio, TX .....		4
Do .....	Eagle Pass, TX .....		5
Do .....	Laredo, TX .....		1½
Do .....	Pharr, TX .....		6
Do .....	Pleasanton, TX .....		5
Ojinaga .....	El Paso, TX .....		6
Do .....	Presidio, TX .....		1
Piedras Negras .....	Eagle Pass, TX .....		1
Do .....	Laredo, TX .....		5
Do .....	Pharr, TX .....		10
Do .....	Pleasanton, TX .....		5
Reynosa (Pharr International Bridge) .....	Eagle Pass, TX .....		12
Do .....	Hidalgo, TX .....		1
Do .....	Laredo, TX .....		5
Do .....	Mission, TX .....		1
Do .....	Pharr, TX .....		1
San Jeronimo .....	El Paso, TX .....		2
Do .....	Presidio, TX .....		6
Do .....	Santa Theresa, NM .....		1
* * * * *			
Texas:			
Dallas-Forth Worth International Airport .....	Decatur .....		2
Do .....	Ft. Worth or Dallas .....		2
* * * * *			
Houston (including Houston Intercontinental Airport) ....	.....		2
Do .....	Bellville, TX .....		4
Do .....	Bryan, TX .....		4
Do .....	Georgetown, TX .....		8
Do .....	Pleasanton, TX .....		8
* * * * *			

Done in Washington, DC, this 28th day of March, 2005.

**Elizabeth E. Gaston,**  
 Acting Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 05–6458 Filed 3–31–05; 8:45 am]

BILLING CODE 3410–34–P

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 211**

[Release No. SAB 107]

**Staff Accounting Bulletin No. 107**

AGENCY: Securities and Exchange Commission.

**ACTION:** Publication of staff accounting bulletin.

**SUMMARY:** The interpretations in this staff accounting bulletin (“SAB”) express views of the staff regarding the interaction between Statement of Financial Accounting Standards Statement No. 123 (revised 2004), *Share-Based Payment* (“Statement

123R” or the “Statement”) and certain Securities and Exchange Commission (“SEC”) rules and regulations and provide the staff’s views regarding the valuation of share-based payment arrangements for public companies. In particular, this SAB provides guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of Statement 123R in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of Statement 123R, the modification of employee share options prior to adoption of Statement 123R and disclosures in Management’s Discussion and Analysis (“MD&A”) subsequent to adoption of Statement 123R.

**DATES:** March 29, 2005.

**FOR FURTHER INFORMATION CONTACT:**

Shan L. Benedict, Chad A. Kokenge, or Alison T. Spivey, Office of the Chief Accountant (202) 942-4400 or Craig Olinger, Division of Corporation Finance (202) 942-2960, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549-1103.

**SUPPLEMENTARY INFORMATION:** The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission’s official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Dated: March 29, 2005.

**Margaret H. McFarland,**

*Deputy Secretary.*

**PART 211—[AMENDED]**

■ Accordingly, part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 107 to the table found in subpart B.

[**Note:** The text of SAB 107 will not appear in the Code of Federal Regulations.]

**Staff Accounting Bulletin No. 107**

The staff hereby adds Topic 14 to the staff accounting bulletin series. Topic 14 provides guidance regarding the

application of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*. The staff also hereby amends the following staff accounting bulletins.

1. Topic 4.D.2. is modified to update the references in footnote 4 from APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“Opinion 25”) and FASB Statement No. 123, *Accounting for Stock-Based Compensation* (“Statement 123”) to Statement 123R. Opinion 25 and Statement 123 were superseded by Statement 123R.

2. Topic 4.E. is modified to delete the references and related guidance to compensation and deferred compensation. Statement 123R requires compensation costs to be recognized in the financial statements as services are provided by employees and does not permit those costs to be recognized as deferred compensation on the balance sheet before services are provided.

3. Topic 5.T. is modified to update the references from “AICPA Interpretation 1 to Opinion 25” to “paragraph 11 of Statement 123R.” AICPA Interpretation 1 to Opinion 25 was superseded by Statement 123R.

**Topic 14: Share-Based Payment**

The interpretations in this SAB express views of the staff regarding the interaction between Statement 123R and certain SEC rules and regulations and provide the staff’s views regarding the valuation of share-based payment arrangements for public companies. Statement 123R was issued by the Financial Accounting Standards Board (“FASB”) on December 16, 2004. Statement 123R is based on the underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value.<sup>1</sup> Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information.<sup>2</sup>

Statement 123R addresses a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

Statement 123R replaces Statement 123 and supersedes Opinion 25. Statement 123, as originally issued in 1995, established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

<sup>1</sup> Statement 123R, paragraph 1.

<sup>2</sup> Statement 123R, page iv.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of Statement 123R and enhance the information received by investors and other users of financial statements, thereby assisting them in making investment and other decisions. This SAB includes interpretive guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity<sup>3</sup> status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of Statement 123R in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of Statement 123R, the modification of employee share options prior to adoption of Statement 123R and disclosures in MD&A subsequent to adoption of Statement 123R.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement Statement 123R, and the interpretive guidance provided by this SAB, particularly during the period of the Statement’s initial implementation. Thus, throughout this SAB the use of the terms “reasonable” and “reasonably” is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of Statement 123R and the interpretive guidance provided by this SAB in any given situation. In addition, as discussed in the Interpretive Response to Question 1 of Section C, Valuation Methods, estimates of fair value are not intended to predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made

<sup>3</sup> Defined in Statement 123R, Appendix E.

under Statement 123R. Over time, as issuers and accountants gain more experience in applying Statement 123R and the guidance provided in this SAB, the staff anticipates that particular approaches may begin to emerge as best practices and that the range of reasonable conduct, conclusions and methodologies will likely narrow.

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#### A. Share-Based Payment Transactions With Nonemployees

*Question:* Are share-based payment transactions with nonemployees included in the scope of Statement 123R?

*Interpretive Response:* Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by Statement 123R. Statement 123R explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments;<sup>4</sup> and
- Requires that an entity record the value of a transaction with a nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued.<sup>5</sup>

Statement 123R does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, Statement 123R does not specify the measurement date for share-based payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued.<sup>6</sup> For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to Emerging Issues Task Force (“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*.

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in Statement 123R would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in Statement 123R by analogy to share-based payment transactions

with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in Statement 123R would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement.<sup>7</sup> For example, the staff believes the guidance in Statement 123R on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

#### B. Transition From Nonpublic to Public Entity Status

*Facts:* Company A is a nonpublic entity<sup>8</sup> that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8.<sup>9</sup> As a nonpublic entity, Company A had been assigning value to its share options<sup>10</sup> under the calculated value method prescribed by Statement 123R<sup>11</sup> and

<sup>7</sup> For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service termination, Statement 123R requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the option’s expected term rather than the contractual term. If these features (*i.e.*, nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.

<sup>8</sup> Defined in Statement 123R, Appendix E.

<sup>9</sup> For the purposes of these illustrations, assume all of Company A’s equity-based awards granted to its employees were granted after the adoption of Statement 123R.

<sup>10</sup> For purposes of this staff accounting bulletin, the phrase “share options” is used to refer to “share options or similar instruments.”

<sup>11</sup> Statement 123R, paragraph 23 requires a nonpublic entity to use the calculated value method when it is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. Statement 123R, paragraph A43 indicates that a nonpublic entity may be able to identify similar public entities for which share or option price information is available and may consider the historical, expected, or implied volatility of those entities’ share prices in estimating expected volatility. The staff would expect an entity that becomes a public entity and had previously measured its share options under the calculated value method to be able to support its previous decision to use calculated value and to provide the disclosures required by paragraph A240(e)(2)(b) of Statement 123R.

had elected to measure its liability awards based on intrinsic value. Company A is considered a public entity on January 2, 20X8 when it makes its initial filing with the SEC in preparation for the sale of its shares in a public market.

*Question 1:* How should Company A account for the share options that were granted to its employees prior to January 2, 20X8 for which the requisite service has not been rendered by January 2, 20X8?

*Interpretive Response:* Prior to becoming a public entity, Company A had been assigning value to its share options under the calculated value method. The staff believes that Company A should continue to follow that approach for those share options that were granted prior to January 2, 20X8, unless those share options are subsequently modified, repurchased or cancelled.<sup>12</sup> If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of Statement 123R. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under Statement 123R, paragraph 51(a), as the fair value of the modified share options over the fair value of the original share options measured immediately before the terms were modified.<sup>13</sup>

*Question 2:* How should Company A account for its liability awards granted to its employees prior to January 2, 20X8 which are fully vested but have not been settled by January 2, 20X8?

*Interpretive Response:* As a nonpublic entity, Company A had elected to measure its liability awards subject to Statement 123R at intrinsic value.<sup>14</sup> When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with Statement 123R.<sup>15</sup> In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under Statement 123R and intrinsic value. For example, assume the intrinsic value in the period ended December 31, 20X7 was \$10 per award. At the end of the first reporting period

<sup>12</sup> This view is consistent with the FASB’s basis for rejecting full retrospective application of Statement 123R as described in Statement 123R, paragraph B251.

<sup>13</sup> Statement 123R, footnote 103. The staff believes that because Company A is a public entity as of the date of the modification, it would be inappropriate to use the calculated value method to measure the original share options immediately before the terms were modified.

<sup>14</sup> Statement 123R, paragraph 38.

<sup>15</sup> Statement 123R, paragraph 37.

<sup>4</sup> Statement 123R, paragraph 7.

<sup>5</sup> *Ibid.*

<sup>6</sup> Statement 123R, paragraph 8.

ending after January 2, 20X8 (when Company A becomes a public entity), assume the intrinsic value of the award is \$12 and the fair value as determined in accordance with Statement 123R is \$15. The measured cost in the first reporting period after December 31, 20X7 would be \$5.<sup>16</sup>

*Question 3:* After becoming a public entity, may Company A retrospectively apply the fair-value-based method to its awards that were granted prior to the date Company A became a public entity?

*Interpretive Response:* No. Before becoming a public entity, Company A did not use the fair-value-based method for either its share options or its liability awards granted to the Company's employees. The staff does not believe it is appropriate for Company A to apply the fair-value-based method on a retrospective basis, because it would require the entity to make estimates of a prior period, which, due to hindsight, may vary significantly from estimates that would have been made contemporaneously in prior periods.<sup>17</sup>

*Question 4:* Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by Statement 123R?<sup>18</sup>

*Interpretive Response:* In the registration statement filed on January 2, 20X8, Company A should clearly describe in MD&A the change in accounting policy that will be required by Statement 123R in subsequent periods and the reasonably likely material future effects.<sup>19</sup> In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition, Company A should consider the applicability of SEC Release No. FR-60<sup>20</sup> and Section V, "Critical Accounting Estimates," in SEC Release No. FR-72<sup>21</sup> regarding critical accounting policies and estimates in MD&A.

<sup>16</sup> \$15 fair value less \$10 intrinsic value equals \$5 of incremental cost.

<sup>17</sup> This view is consistent with the FASB's basis for rejecting full retrospective application of Statement 123R as described in Statement 123R, paragraph B251.

<sup>18</sup> Statement 123R disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242.

<sup>19</sup> See generally SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

<sup>20</sup> SEC Release No. FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

<sup>21</sup> SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

### C. Valuation Methods

Statement 123R, paragraph 16, indicates that the measurement objective for equity instruments awarded to employees is to estimate at the grant date the fair value of the equity instruments the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. The Statement also states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement for equity and liability instruments awarded in a share-based payment transaction with employees.<sup>22</sup> However, if observable market prices of identical or similar equity or liability instruments are not available, the fair value shall be estimated by using a valuation technique or model that complies with the measurement objective, as described in Statement 123R.<sup>23</sup>

*Question 1:* If a valuation technique or model is used to estimate fair value, to what extent will the staff consider a company's estimates of fair value to be materially misleading because the estimates of fair value do not correspond to the value ultimately realized by the employees who received the share options?

*Interpretive Response:* The staff understands that estimates of fair value of employee share options, while derived from expected value calculations, cannot predict actual future events.<sup>24</sup> The estimate of fair value represents the measurement of the cost of the employee services to the company. The estimate of fair value should reflect the assumptions marketplace participants would use in determining how much to pay for an instrument on the date of the measurement (generally the grant date for equity awards). For example, valuation techniques used in estimating the fair value of employee share options may consider information about a large number of possible share price paths, while, of course, only one share price path will ultimately emerge. If a company makes a good faith fair value estimate in accordance with the provisions of Statement 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, then subsequent future events that affect the instrument's value do not provide meaningful information about the quality of the original fair value estimate. As long as the share options were originally so measured, changes in an employee share option's value, no matter how significant, subsequent to its grant date do not call into question the reasonableness of the grant date fair value estimate.

*Question 2:* In order to meet the fair value measurement objective in Statement 123R, are certain valuation techniques preferred over others?

*Interpretive Response:* Statement 123R, paragraph A14, clarifies that the Statement does not specify a preference for a particular valuation technique or model. As stated in Statement 123R, paragraph A8, in order to meet the fair value measurement objective, a company should select a valuation technique or model that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of Statement 123R, (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.

The chosen valuation technique or model must meet all three of the requirements stated above. In valuing a particular instrument, certain techniques or models may meet the first and second criteria but may not meet the third criterion because the techniques or models are not designed to reflect certain characteristics contained in the instrument. For example, for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton closed-form model would not generally be an appropriate valuation model because, while it meets both the first and second criteria, it is not designed to take into account that type of market condition.<sup>25</sup>

Further, the staff understands that a company may consider multiple techniques or models that meet the fair value measurement objective before making its selection as to the appropriate technique or model. The staff would not object to a company's choice of a technique or model as long as the technique or model meets the fair value measurement objective. For example, a company is not required to use a lattice model simply because that

<sup>22</sup> Statement 123R, paragraph A7.

<sup>23</sup> Statement 123R, paragraph A8.

<sup>24</sup> Statement 123R, paragraph A12, states "The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future."

<sup>25</sup> See Statement 123R, paragraphs A13-17.

model was the most complex of the models the company considered.

*Question 3:* In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?<sup>26</sup>

*Interpretive Response:* As long as the new technique or model meets the fair value measurement objective in Statement 123R as described in Question 2 above, the staff would not object to a company changing its valuation technique or model.<sup>27</sup> A change in the valuation technique or model used to meet the fair value measurement objective would not be considered a change in accounting principle. As such, a company 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.<sup>28</sup> However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. Disclosure in the footnotes of the basis for any change in technique or model would be appropriate.<sup>29</sup>

*Question 4:* Must every company that issues share options or similar instruments hire an outside third party to assist in determining the fair value of the share options?

*Interpretive Response:* No. However, the valuation of a company's share options or similar instruments should be performed by a person with the requisite expertise.

#### D. Certain Assumptions Used in Valuation Methods

Statement 123R's fair value measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary

<sup>26</sup> Statement 123R, paragraph A14 and footnote 49, indicate that an entity may use different valuation techniques or models for instruments with different characteristics.

<sup>27</sup> The staff believes that a company should take into account the reason for the change in technique or model in determining whether the new technique or model meets the fair value measurement objective. For example, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of the Statement.

<sup>28</sup> Statement 123R, paragraph A23.

<sup>29</sup> See generally Statement 123R, paragraph 64c.

to earn the right to benefit from the instruments.<sup>30</sup> In order to meet this fair value measurement objective, management will be required to develop estimates regarding the expected volatility of its company's share price and the exercise behavior of its employees. The staff is providing guidance in the following sections related to the expected volatility and expected term assumptions to assist public entities in applying those requirements.

The staff understands that companies may refine their estimates of expected volatility and expected term as a result of the guidance provided in Statement 123R and in sections (1) and (2) below. Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes.<sup>31</sup>

#### 1. Expected Volatility

Statement 123R, paragraph A31, states, "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 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."

*Facts:* Company B is a public entity whose common shares have been publicly traded for over twenty years. Company B also has multiple options on its shares outstanding that are traded on an exchange ("traded options"). Company B grants share options on January 2, 20X6.

*Question 1:* What should Company B consider when estimating expected volatility for purposes of measuring the fair value of its share options?

*Interpretive Response:* Statement 123R does not specify a particular method of estimating expected volatility. However, the Statement does clarify 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.<sup>32</sup> Statement 123R

<sup>30</sup> Statement 123R, paragraph A2.

<sup>31</sup> Statement 123R, paragraph A240(e).

<sup>32</sup> Statement 123R, paragraph B86.

provides a list of factors entities should consider in estimating expected volatility.<sup>33</sup> Company B may begin its process of estimating expected volatility by considering its historical volatility.<sup>34</sup> However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility.<sup>35</sup> Implied volatility<sup>36</sup> can be useful in estimating expected volatility because it is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility.

The staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility. The staff believes companies that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. The extent of the ultimate reliance on implied volatility will depend on a company's facts and circumstances; however, the staff believes that a company with actively traded options or other financial instruments with embedded options<sup>37</sup> generally could place greater (or even exclusive) reliance on implied volatility. (See the Interpretive Responses to Questions 3 and 4 below.)

The process used to gather and review available information to estimate expected volatility should be applied consistently from period to period. When circumstances indicate the availability of new or different information that would be useful in estimating expected volatility, a

<sup>33</sup> Statement 123R, paragraph A32.

<sup>34</sup> Statement 123R, paragraph A34.

<sup>35</sup> *Ibid.*

<sup>36</sup> Implied volatility is the volatility assumption inherent in the market prices of a company's traded options or other financial instruments that have option-like features. Implied volatility is derived by entering the market price of the traded financial instrument, along with assumptions specific to the financial options being valued, into a model based on a constant volatility estimate (e.g., the Black-Scholes-Merton closed-form model) and solving for the unknown assumption of volatility.

<sup>37</sup> The staff believes implied volatility derived from embedded options can be utilized in determining expected volatility if, in deriving the implied volatility, the company considers all relevant features of the instruments (e.g., value of the host instrument, value of the option, etc.). The staff believes the derivation of implied volatility from other than simple instruments (e.g., a simple convertible bond) can, in some cases, be impracticable due to the complexity of multiple features.

company should incorporate that information.

*Question 2:* What should Company B consider if computing historical volatility?<sup>38</sup>

*Interpretive Response:* The following should be considered in the computation of historical volatility:

1. *Method of Computing Historical Volatility*—The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B's expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term<sup>39</sup> of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B's historical volatility much more heavily than earlier periods.<sup>40</sup> For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history.<sup>41</sup>

2. *Amount of Historical Data*—Statement 123R, paragraph A32(a), indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B 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. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

<sup>38</sup> See Statement 123R, paragraph A32.

<sup>39</sup> For purposes of this staff accounting bulletin, the phrase "expected or contractual term, as applicable" has the same meaning as the phrase "expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of an employee share option."

<sup>40</sup> Statement 123R, paragraph A32(a), states that entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. Accordingly, the staff believes methods that place extreme emphasis on the most recent periods may be inconsistent with this guidance.

<sup>41</sup> Generalized Autoregressive Conditional Heteroskedasticity ("GARCH") is an example of a method that demonstrates this characteristic.

3. *Frequency of Price Observations*—Statement 123R, paragraph A32(d), indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B 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 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.<sup>42</sup> Company B should select a consistent point in time within each interval when selecting data points.<sup>43</sup>

4. *Consideration of Future Events*—The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option.<sup>44</sup> Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then 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.

5. *Exclusion of Periods of Historical Data*—In some instances, due to a company's particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility.<sup>45</sup> In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that

<sup>42</sup> Further, if shares of a company are thinly traded the staff believes the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations. The volatility calculation using daily observations for such shares could be artificially inflated due to a larger spread between the bid and asked quotes and lack of consistent trading in the market.

<sup>43</sup> Statement 123R, paragraph A34, states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, Statement 123R, paragraph A23, indicates that assumptions used to estimate the fair value of instruments granted to employees should be determined in a consistent manner from period to period.

<sup>44</sup> Statement 123R, paragraph B86.

<sup>45</sup> Statement 123R, paragraph A32(a).

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

*Question 3:* What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

*Interpretive Response:* To achieve the objective of estimating expected volatility as stated in paragraph B86 of Statement 123R, the staff believes Company B generally should consider the following in its evaluation: (1) The volume of market activity of the underlying shares and traded options; (2) the ability to synchronize the variables used to derive implied volatility; (3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and (4) the similarity of the length of the term of the traded and employee share options.<sup>46</sup>

1. *Volume of Market Activity*—The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect a marketplace participant's expectations regarding expected volatility.

2. *Synchronization of the Variables*—Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B 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 staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. *Similarity of the Exercise Prices*—The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant.<sup>47</sup> If, however,

<sup>46</sup> See generally *Options, Futures, and Other Derivatives* by John C. Hull (Prentice Hall, 5th Edition, 2003).

<sup>47</sup> Implied volatilities of options differ systematically over the "moneyness" of the option. This pattern of implied volatilities across exercise prices is known as the "volatility smile" or "volatility skew." Studies such as "Implied

it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.<sup>48</sup>

4. *Similarity of Length of Terms*—The 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. However, if there are no traded options with maturities that are similar to the share option's contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater.<sup>49</sup> However, when using traded options with a term of less than one year,<sup>50</sup> the staff would expect the company to also consider other relevant information in estimating expected volatility. 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, as applicable, of the employee share option.

The staff believes Company B's evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the market's expectations of future volatility and thus the extent of reliance

Volatility" by Stewart Mayhew, *Financial Analysts Journal*, July–August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

<sup>48</sup> The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of \$52, but the only traded options available have exercise prices of \$50 and \$55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of \$55 and a 60% weight on the option with an exercise price of \$50.

<sup>49</sup> The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.

<sup>50</sup> The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.

that Company B reasonably places on the implied volatility.

*Question 4:* Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?

*Interpretive Response:* As stated above, Statement 123R does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity's estimate of expected volatility be reasonable and supportable.<sup>51</sup> Many of the factors listed in Statement 123R are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in Statement 123R, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option.<sup>52</sup> The staff believes that a company, after considering the factors listed in Statement 123R, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

The staff would not object to Company B placing exclusive reliance on implied volatility when the following factors are present, as long as the methodology is consistently applied:

- Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options;<sup>53</sup>
- The implied volatility is derived from options that are actively traded;
- The market prices (trades or quotes) 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 employee share options;
- The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options;<sup>54</sup> and

<sup>51</sup> Statement 123R, paragraphs A31–A32.

<sup>52</sup> Statement 123R, paragraph B86.

<sup>53</sup> Statement 123R, paragraphs A15 and A33, discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the option's contractual term should consider the factors listed in Statement 123R, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.

<sup>54</sup> When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.

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

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

- Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past;<sup>55</sup>
- The computation of historical volatility uses a simple average calculation method;
- A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and
- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.<sup>56</sup>

*Question 5:* What disclosures would the staff expect Company B to include in its financial statements and MD&A regarding its assumption of expected volatility?

*Interpretive Response:* Statement 123R, paragraph A240, prescribes the minimum information needed to achieve the Statement's disclosure objectives.<sup>57</sup> Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it.<sup>58</sup> Accordingly, the staff expects that at a minimum Company B would disclose in a footnote to its financial statements how it determined the expected volatility assumption for purposes of determining the fair value of its share options in accordance with Statement 123R. For example, at a minimum, the staff would expect Company B to disclose whether it used only implied volatility, historical volatility, or a combination of both.

In addition, Company B should consider the applicability of SEC Release No. FR-60 and Section V,

<sup>55</sup> See Statement 123R, paragraph B87. A change in a company's business model that results in a material alteration to the company's risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company's business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.

<sup>56</sup> If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.

<sup>57</sup> Statement 123R disclosure requirements are included in paragraphs 64, 65, A240, A241, and A242.

<sup>58</sup> Statement 123R, paragraph A240(e)(2)(b).

“Critical Accounting Estimates,” in SEC Release No. FR-72 regarding critical accounting policies and estimates in MD&A. The staff would expect such disclosures to include an explanation of the method used to estimate the expected volatility of its share price. This explanation generally should include a discussion of the basis for the company’s conclusions regarding the extent to which it used historical volatility, implied volatility or a combination of both. A company could consider summarizing its evaluation of the factors listed in Questions 2 and 3 of this section as part of these disclosures in MD&A.

*Facts:* Company C is a newly public entity with limited historical data on the price of its publicly traded shares and no other traded financial instruments. Company C believes that it does not have sufficient company specific information regarding the volatility of its share price on which to base an estimate of expected volatility.

*Question 6:* What other sources of information should Company C consider in order to estimate the expected volatility of its share price?

*Interpretive Response:* Statement 123R provides guidance on estimating expected volatility for newly public and nonpublic entities that do not have company specific historical or implied volatility information available.<sup>59</sup> Company C 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. In making its determination as to similarity, Company C would likely consider the industry, stage of life cycle, size and financial leverage of such other entities.<sup>60</sup>

The staff would not object to Company C looking to an industry sector index (e.g., NASDAQ Computer Index) that is representative of Company C’s industry, and possibly its size, to identify one or more similar entities.<sup>61</sup> Once Company C has identified similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its share price as an assumption in its valuation model.<sup>62</sup> Because of the effects of diversification that are present

in an industry sector index, Company C should not substitute the volatility of an index for the expected volatility of its share price as an assumption in its valuation model.<sup>63</sup>

After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to Company C. Until Company C has sufficient information available, the staff would not object to Company C basing its estimate of expected volatility on the volatility of similar entities for those periods for which it does not have sufficient information available.<sup>64</sup> Until Company C has either a sufficient amount of historical information regarding the volatility of its share price or other traded financial instruments are available to derive an implied volatility to support an estimate of expected volatility, it should consistently apply a process as described above to estimate expected volatility based on the volatilities of similar entities.<sup>65</sup>

## 2. Expected Term

Statement 123R, paragraph A26, 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.” Accordingly, Statement 123R requires that when valuing an employee share option under the Black-Scholes-Merton

framework the fair value of employee share options be based on the share options’ expected term rather than the contractual term.

The staff believes the estimate of expected term should be based on the facts and circumstances available in each particular case. Consistent with our guidance regarding reasonableness immediately preceding Topic 14.A, the fact that other possible estimates are later determined to have more accurately reflected the term does not necessarily mean that the particular choice was unreasonable. The staff reminds registrants of the expected term disclosure requirements described in Statement 123R, paragraph A240(e)(2)(a).

*Facts:* Company D utilizes the Black-Scholes-Merton closed-form model to value its share options for the purposes of determining the fair value of the options under Statement 123R. Company D recently granted share options to its employees. Based on its review of various factors, Company D determines that the expected term of the options is six years, which is less than the contractual term of ten years.

*Question 1:* When determining the fair value of the share options in accordance with Statement 123R, should Company D consider an additional discount for nonhedgability and nontransferability?

*Interpretive Response:* No. Statement 123R, paragraphs A26 and B82, indicates that nonhedgability and nontransferability have the effect of increasing the likelihood that an employee share option will be exercised before the end of its contractual term. Nonhedgability and nontransferability therefore factor into the expected term assumption (in this case reducing the term assumption from ten years to six years), and the expected term reasonably adjusts for the effect of these factors. Accordingly, the staff believes that no additional reduction in the term assumption or other discount to the estimated fair value is appropriate for these particular factors.<sup>66</sup>

*Question 2:* Should forfeitures or terms that stem from forfeitability be

<sup>63</sup> Statement 123R, paragraph A22.

<sup>64</sup> Statement 123R, paragraph A32(c). The staff believes that at least two years of daily or weekly historical data could provide a reasonable basis on which to base an estimate of expected volatility if a company has no reason to believe that its future volatility will differ materially during the expected or contractual term, as applicable, from the volatility calculated from this past information. If the expected or contractual term, as applicable, of a share option is shorter than two years, the staff believes a company should use daily or weekly historical data for at least the length of that applicable term.

<sup>65</sup> Statement 123R, paragraph A34.

<sup>59</sup> Statement 123R, paragraphs A22 and A43.

<sup>60</sup> Statement 123R, paragraph A22.

<sup>61</sup> If a company operates in a number of different industries, it could look to several industry indices. However, when considering the volatilities of multiple companies, each operating only in a single industry, the staff believes a company should take into account its own leverage, the leverages of each of the entities, and the correlation of the entities’ stock returns.

<sup>62</sup> Statement 123R, paragraph A45.

<sup>66</sup> The staff notes the existence of academic literature that supports the assertion that the Black-Scholes-Merton closed-form model, with expected term as an input, can produce reasonable estimates of fair value. Such literature includes J. Carpenter, “The exercise and valuation of executive stock options,” *Journal of Financial Economics*, May 1998, pp.127–158; C. Marquardt, “The Cost of Employee Stock Option Grants: An Empirical Analysis,” *Journal of Accounting Research*, September 2002, p. 1191–1217; and J. Bettis, J. Bizjak and M. Lemmon, “Exercise behavior, valuation, and the incentive effect of employee stock options,” *Journal of Financial Economics*, forthcoming, 2005.



factored into the determination of expected term?

*Interpretive Response:* No. Statement 123R indicates that the expected term that is utilized as an assumption in a closed-form option-pricing model or a resulting output of a lattice option pricing model when determining the fair value of the share options should not incorporate restrictions or other terms that stem from the pre-vesting forfeitability of the instruments. Under Statement 123R, these pre-vesting restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for which employees render the requisite service.<sup>67</sup>

*Question 3:* Can a company's estimate of expected term ever be shorter than the vesting period?

*Interpretive Response:* No. The vesting period forms the lower bound of the estimate of expected term.<sup>68</sup>

*Question 4:* Statement 123R, paragraph A30, indicates that an entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term, regardless of the valuation technique or model used to estimate the fair value. How many groupings are typically considered sufficient?

*Interpretive Response:* As it relates to employee groupings, the staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.<sup>69</sup>

*Question 5:* What approaches could a company use to estimate the expected term of its employee share options?

*Interpretive Response:* A company should use an approach that is reasonable and supportable under Statement 123R's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in

determining an exchange price for the share options.<sup>70</sup> If, in developing its estimate of expected term, a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the staff will not object to the use of the historical share option exercise experience to estimate expected term.<sup>71</sup>

A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants,<sup>72</sup> or a lack of variety of price paths that the company may have experienced.<sup>73</sup>

Statement 123R describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model.<sup>74</sup> In addition, Statement 123R, paragraph A29, states " \* \* \* 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." For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative information may not be widely available at present, the staff understands that various parties, including actuaries,

valuation professionals and others are gathering such data.

*Facts:* Company E grants equity share options to its employees that have the following basic characteristics:<sup>75</sup>

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;<sup>76</sup>
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
- The share options are nontransferable and nonhedgeable.

Company E utilizes the Black-Scholes-Merton closed-form model for valuing its employee share options.

*Question 6:* As share options with these "plain-vanilla" characteristics have been granted in significant quantities by many companies in the past, is the staff aware of any "simple" methodologies that can be used to estimate expected term?

*Interpretive Response:* As noted above, the staff understands that an entity that chooses not to rely on its historical exercise data may find that certain alternative information, such as exercise data relating to employees of other companies, is not easily obtainable. As such, in the short term, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, the staff will accept the following "simplified" method for "plain vanilla" options consistent with those in the fact set above:  $\text{expected term} = ((\text{vesting term} + \text{original contractual term}) / 2)$ . Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years.<sup>77</sup>

Academic research on the exercise of options issued to executives provides some general support for outcomes that would be produced by the application of this method.<sup>78</sup> If a company elects to

<sup>67</sup> Statement 123R, paragraph 18.

<sup>68</sup> Statement 123R, paragraph A28a.

<sup>69</sup> The staff believes the focus should be on groups of employees with significantly different expected exercise behavior. Academic research suggests two such groups might be executives and non-executives. A study by S. Huddart found executives and other senior managers to be significantly more patient in their exercise behavior than more junior employees. (Employee rank was proxied for by the number of options issued to that employee.) See S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., *Executive Compensation and Shareholder Value: Theory and Evidence* (Kluwer, Boston, MA, 1999), pp. 115–142. See also S. Huddart and M. Lang, "Employee stock option exercises: An empirical analysis," *Journal of Accounting and Economics*, 1996, pp. 5–43.

<sup>70</sup> Statement 123R, paragraph A10.

<sup>71</sup> Historical share option exercise experience encompasses data related to share option exercise, post-vesting termination, and share option contractual term expiration.

<sup>72</sup> For example, if a company had historically granted share options that were always in-the-money, and will grant at-the-money options prospectively, the exercise behavior related to the in-the-money options may not be sufficient as the sole basis to form the estimate of expected term for the at-the-money grants.

<sup>73</sup> For example, if a company had a history of previous equity-based share option grants and exercises only in periods in which the company's share price was rising, the exercise behavior related to those options may not be sufficient as the sole basis to form the estimate of expected term for current option grants.

<sup>74</sup> Statement 123R, paragraph A27.

<sup>75</sup> Employee share options with these features are sometimes referred to as "plain-vanilla" options.

<sup>76</sup> In this fact pattern the requisite service period equals the vesting period.

<sup>77</sup> Calculated as  $(((1 \text{ year vesting term (for the first 25\% vested)} + 2 \text{ year vesting term (for the second 25\% vested)} + 3 \text{ year vesting term (for the third 25\% vested)} + 4 \text{ year vesting term (for the last 25\% vested)}) / 4 \text{ total years of vesting}) + 10 \text{ year contractual life}) / 2$ ; that is,  $((1+2+3+4)/4) + 10) / 2 = 6.25$  years.

<sup>78</sup> J.N. Carpenter, "The exercise and valuation of executive stock options," *Journal of Financial*

use this method, it should be applied consistently to all "plain vanilla" employee share options, and the company should disclose the use of the method in the notes to its financial statements. Companies that have the information (from whatever source) to make more refined estimates of expected term may choose not to apply this simplified method. In addition, this simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

Also, as noted above, the staff believes that more detailed information about exercise behavior will, over time, become readily available to companies. As such, the staff does not expect that such a simplified method would be used for share option grants after December 31, 2007, as more detailed information should be widely available by then.

#### *E. Statement 123R and Certain Redeemable Financial Instruments*

Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer.<sup>79</sup> Statement 123R provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as

*Economics*, 1998, pp.127–158 studies a sample of 40 NYSE and AMEX firms over the period 1979–1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The "mean time to exercise" is shorter than expected term since the study's sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bizjak; and Michael L. Lemmon, "Exercise behavior, valuation, and the incentive effects of employee stock options," forthcoming in the *Journal of Financial Economics*. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., *Executive Compensation and Shareholder Value: Theory and Evidence* (Kluwer, Boston, MA, 1999), pp. 115–142.

<sup>79</sup> The terminology "outside the control of the issuer" is used to refer to any of the three redemption conditions described in Rule 5–02.28 of Regulation S–X that would require classification outside permanent equity. That rule 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.

liabilities; however, some redeemable instruments will qualify for equity classification.<sup>80</sup> SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks,"*<sup>81</sup> ("ASR 268") and related guidance<sup>82</sup> address the classification and measurement of certain redeemable equity instruments.

*Facts:* Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest).

The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder's option, but only after six months from the date of share issuance (as defined in Statement 123R). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of Statement 123R. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e.g., redemption at the option of the holder) that are outside the control of the issuer.

*Question 1:* While the instruments are subject to Statement 123R,<sup>83</sup> is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under Statements 123R?

*Interpretive Response:* Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under Statement 123R result in the need to present certain amounts outside of permanent equity (also referred to as being presented in "temporary equity") in accordance with ASR 268 and related guidance.<sup>84</sup>

<sup>80</sup> Statement 123R, paragraphs 28–35 and A225–A232.

<sup>81</sup> ASR 268, July 27, 1979, Rule 5–02.28 of Regulation S–X.

<sup>82</sup> Related guidance includes EITF Abstracts Topic No. D–98, *Classification and Measurement of Redeemable Securities* ("Topic D–98").

<sup>83</sup> Statement 123R, paragraph A231, states that an instrument ceases to be subject to Statement 123R when "the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service)."

<sup>84</sup> Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which paragraphs 14–18 of EITF

When an instrument ceases to be subject to Statement 123R and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

*Question 2:* How should Company F apply ASR 268 and related guidance to the shares (or share options) granted under the share-based payment arrangements with employees that may be unvested at the date of grant?

*Interpretive Response:* Under Statement 123R, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital<sup>85</sup> is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuer's control but are classified as equity instruments under Statement 123R.

The staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under Statement 123R is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable

Issue 00–19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, would otherwise require the assumption of net cash settlement. See Statement 123R, footnote 152 to paragraph B121, which states, in part: "\* \* \* Issue 00–19 specifies that events or actions necessary to deliver registered shares are not controlled by a company and, therefore, except under limited circumstances, such provisions would require a company to assume that the contract would be net-cash settled. \* \* \* Thus, employee share options might be classified as substantive liabilities if they were subject to Issue 00–19; however, for purposes of this Statement, the Board does not believe that employee share options should be classified as liabilities based solely on that notion." See also Statement 123R, footnote 20.

<sup>85</sup> Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

stock that qualifies for equity classification under Statement 123R is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic<sup>86</sup> value of the option should be presented as temporary equity at that date.

**Question 3:** Would the methodology described for employee awards in the Interpretive Response to Question 2 above apply to nonemployee awards to be issued in exchange for goods or services with similar terms to those described above?

**Interpretive Response:** See Topic 14.A for a discussion of the application of the principles in Statement 123R to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

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

**Facts:** Company G utilizes both cash and share-based payment arrangements to compensate its employees and nonemployee service providers. Company G would like to emphasize in its income statement the amount of its compensation that did not involve a cash outlay.

**Question:** How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?

**Interpretive Response:** The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees.<sup>87</sup> The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements. Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to

<sup>86</sup> The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

<sup>87</sup> Statement 123R does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

the financial statements, or within MD&A.

#### G. Non-GAAP Financial Measures

**Facts:** Company H, a calendar year company, adopts Statement 123R as of July 1, 2005. Company H has issued share options to its employees each year since issuing publicly traded stock twenty years ago. In the MD&A section of its 2005 Form 10-K, Company H believes it would be useful to investors to disclose what net income would be before considering the effect of accounting for share-based payment transactions in accordance with Statement 123R.

**Question 1:** Does the resulting measure, "Net Income Before Share-Based Payment Charge," or an equivalent measure, meet the definition of a non-GAAP measure in Regulation G and Item 10(e) of Regulation S-K?<sup>88</sup>

**Interpretive Response:** Yes. Because the financial measure Company H is considering excludes an amount (share-based payment expense) that is included in the most directly comparable measure calculated and presented in accordance with GAAP (net income), it would be considered a non-GAAP financial measure pursuant to the provisions of Regulation G and Item 10(e) of Regulation S-K.

**Question 2:** Is the measure "Net Income Before Share-Based Payment Charge," or an equivalent measure, a prohibited non-GAAP measure pursuant to Item 10(e) of Regulation S-K?

**Interpretive Response:** Item 10(e) prohibits the inclusion of certain non-GAAP financial measures and also mandates specific disclosures for registrants that include permitted non-GAAP financial measures in filings. Generally, under Item 10(e) of Regulation S-K, 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. The staff issued Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003. Question 8 discusses whether it is appropriate to eliminate or smooth an item that is identified as recurring. The staff answered the question in part by stating "Companies should never use a non-GAAP financial measure in an

<sup>88</sup> 17 CFR 229.10(e). All references to Item 10(e) of Regulation S-K also includes corresponding provisions of Item 10(h) of Regulation S-B with respect to small business issuers as well as U.S. GAAP information of foreign private issuers under General Instruction C(e) of Form 20-F.

attempt to smooth earnings. Further, 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, especially if the non-GAAP financial measure is used to evaluate performance."

The staff believes that a measure used by the management of Company H that excludes share-based payments internally to evaluate performance may be relevant disclosure for investors. In these cases, if Company H determines that the non-GAAP financial measure "Net Income Before Share-Based Payment Charge" does not violate any of the prohibitions from inclusion in filings with the Commission outlined in Item 10(e) of Regulation S-K, Company H's management would be required to disclose, among other items, the following:

- The reasons that the company's management believes that presentation of the non-GAAP financial 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.<sup>89</sup>

In addition, the staff's response to Question 8 included in Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003 notes that the inclusion of a non-GAAP financial measure may be misleading absent the following disclosures:

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

**Question 3:** How could Company H demonstrate the effect of accounting for share-based payment transactions in accordance with Statement 123R and Regulation G and Item 10(e) of Regulation S-K in its Form 10-K?

<sup>89</sup> 17 CFR 229.10(e)(1).

*Interpretive Response:* The staff believes that including a discussion in MD&A addressing significant trends and variability of a company's earnings and changes in the significant components of certain line items is important to assist an investor in understanding the company's performance. The staff also understands that expenses from share-based payments might vary in different ways and for different reasons than would other expenses. In particular, the staff believes Company H's investors would be well served by disclosure in MD&A that explains the components of the company's expenses, including, if material, identification of the amount of expense associated with share-based payment transactions and discussion of the reasons why such amounts have fluctuated from period to period.

*Question 4:* Would the staff object to Company H including a pro-forma income statement in its SEC filings that removes from net income the effects of accounting for share-based payment arrangements in accordance with Statement 123R?

*Interpretive Response:* Yes. Removal of the effects of accounting for share-based payment arrangements in accordance with Statement 123R would not meet any of the conditions in Rule 11-01(a) of Regulation S-X for presentation of pro forma financial information. Further, the removal of the effects of accounting for share-based payment arrangements in accordance with Statement 123R would not meet any of the conditions in Rule 11-02(b)(6) of Regulation S-X to be reflected as a pro forma adjustment in circumstances where pro forma financial information is required under Rule 11-01(a) of Regulation S-X for other transactions such as recent or probable business combinations.

In addition, Item 10(e) of Regulation S-X prohibits presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X. Further, a company may not present non-GAAP financial measures on the face of the company's financial statements prepared in accordance with GAAP or in the accompanying notes.

#### H. First Time Adoption of Statement 123R in an Interim Period

*Facts:* Company I's fiscal year begins on January 1, 2005. Company I plans to adopt Statement 123R on July 1, 2005, which is the beginning of its first interim period following the effective date. Company I previously recognized share-based payment compensation in accordance with Opinion 25.

*Question 1:* What disclosures are required in Company I's Form 10-Q for the third quarter of 2005?

*Interpretive Response:* The disclosures required by paragraphs 64-65, 84, and A240-242 of Statement 123R should be included in the Form 10-Q for the interim period when Statement 123R is first adopted. If Company I applies the modified retrospective method<sup>90</sup> in other than the first interim period of a fiscal year, the staff believes that the Form 10-Q for the period of adoption should include disclosure of the effects of the adoption of Statement 123R on previously reported interim periods.<sup>91</sup> If Company I applies the modified prospective method,<sup>92</sup> the financial statements for Company I's prior interim periods and fiscal years will not reflect any restated amounts. The staff believes that Company I should disclose this fact. Regardless of the transition method chosen, Company I should also provide the disclosures required by 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 interim and annual financial statements preceding the adoption of Statement 123R.

*Facts:* Company J plans to adopt Statement 123R by applying the modified retrospective method only to the preceding interim periods of its current fiscal year. Company J anticipates recording an adjustment upon the adoption of Statement 123R to reflect the cumulative effect of reclassifying certain share-based payment arrangements as liabilities.

*Question 2:* Would Company J be required to apply the cumulative effect adjustment to the beginning of the fiscal year and to reflect the change in classification from liabilities to equity to its interim periods preceding adoption in accordance with Statement 3,<sup>93</sup> paragraph 10?

*Interpretive Response:* No. Statement 123R, paragraph 76, limits retrospective application to recording compensation cost for unvested awards based on the amounts previously determined under Statement 123 for pro forma footnote disclosure. Any adjustments to be recorded as a cumulative effect of a change in accounting principle should be recorded as of the date of adoption of Statement 123R, which may occur

<sup>90</sup> Statement 123R, paragraph 76.

<sup>91</sup> See Statement 123R, paragraph 77.

<sup>92</sup> Statement 123R, paragraph 74.

<sup>93</sup> Statement of Financial Accounting Standards No. 3, *Reporting Accounting Changes in Interim Financial Statements* ("Statement 3").

after the beginning of the fiscal year. Therefore, based on the guidance in Statement 123R, paragraphs 79-82, registrants are not required to apply the provisions of Statement 3, paragraph 10.

#### I. Capitalization of Compensation Cost Related to Share-Based Payment Arrangements

*Facts:* Company K is a manufacturing company that grants share options to its production employees. Company K has determined that the cost of the production employees' service is an inventoriable cost. As such, Company K is required to initially capitalize the cost of the share option grants to these production employees as inventory and later recognize the cost in the income statement when the inventory is consumed.<sup>94</sup>

*Question:* If Company K elects to adjust its period end inventory balance for the allocable amount of share-option cost through a period end adjustment to its financial statements, instead of incorporating the share-option cost through its inventory costing system, would this be considered a deficiency in internal controls?

*Interpretive Response:* No. Statement 123R does not prescribe the mechanism a company should use to incorporate a portion of share-option costs in an inventory-costing system. The staff believes Company K may accomplish this through a period end adjustment to its financial statements. Company K should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment. The fact that the entry is recorded as a period end adjustment, by itself, should not impact management's ability to determine that the internal control over financial reporting, as defined by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002,<sup>95</sup> is effective.

#### J. Accounting for Income Tax Effects of Share-Based Payment Arrangements Upon Adoption of Statement 123R

*Facts:* In accordance with Statement 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 the deductions exceed the cumulative compensation cost recognized for

<sup>94</sup> Statement 123R, paragraph 5.

<sup>95</sup> Release No. 34-47986, June 5, 2003.

*Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.*

financial reporting, the entity generally should record any resulting excess tax benefits as additional paid-in capital. If deductions are less than the cumulative compensation cost recognized for financial reporting, 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 Statement 123R, as applicable. The remaining balance, if any, of the write-off of the deferred tax asset shall be recognized in the income statement.<sup>96</sup>

Company L is an entity that previously recognized employee share-based payment costs under the intrinsic value method of Opinion 25. In this situation, Statement 123R states that Company L “shall calculate the amount available for offset [in additional paid-in capital] as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123’s original effective date and transition method.”<sup>97</sup>

*Question:* When is Company L required to calculate the additional paid-in capital from previous share-based payment awards that is available for offset against the write-off of a deferred tax asset?

*Interpretive Response:* Statement 123R will necessitate the tracking of tax attributes relating to share-based payment transactions with employees for a number of reasons, including the requirements related to any required write-off of excess deferred tax assets upon settlement of a share option. While it is important that appropriate detailed information be available when needed for consideration, the timing as to when such information actually affects financial reporting will vary from company to company. In preparation for the adoption of Statement 123R, Company L should evaluate the level of detail which may be required considering its particular facts and circumstances.

Statement 123R is silent as to when the additional paid-in capital available for offset should be calculated. However, the staff notes that Company L would not be required to calculate the additional paid-in capital available for offset by the date it adopts Statement 123R. In addition, the staff notes that Statement 123R does not require disclosure of the additional paid-in

capital available for offset.<sup>98</sup> The staff believes that Company L need only calculate the additional paid-in capital available for offset if and when Company L faces a situation in which deductions reported on its tax return are less than the relevant deferred tax asset. In addition, Company L 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.

#### *K. Modification of Employee Share Options Prior to Adoption of Statement 123R*

*Facts:* Company M is a public entity that historically applied the recognition provisions of Opinion 25 and intends to transition to Statement 123R under the modified prospective method of application.<sup>99</sup> In prior periods, Company M granted at-the-money share options to its employees in which the exercisability of the options is conditional only on performing service through the vesting date.<sup>100</sup> Since the time of grant, Company M’s share price has fallen such that the share options are out-of-the-money. Prior to adoption of Statement 123R the share options are still unvested, and Company M intends to modify these unvested share options to accelerate the vesting. Company M has determined that the modification to accelerate vesting will not require recognition of compensation cost in its financial statements in the period of the modification under the provisions of Opinion 25.<sup>101</sup> However, Company M intends to reflect the compensation cost related to the modification in its fair value pro forma disclosures under Statement 123,<sup>102</sup> in the period the modification is made.

*Question:* Would the staff object to Company M reflecting the remaining compensation cost related to these share options in the fair value pro forma disclosures required under Statement 123 as a result of the modification in the

period in which the modification was enacted?

*Interpretive Response:* No. The staff believes that an acceptable interpretation of Statement 123 is that the modification to accelerate the vesting of such share options would result in the recognition of the remaining amount of compensation cost in the period the modification is made, 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. The staff notes that the service period definition in Statement 123<sup>103</sup> indicates, “If the service period is not defined as an earlier or shorter period, it shall be presumed to be the vesting period.” After the modification, Company M’s share options will be vested pursuant to the awards’ terms. Accordingly, under this interpretation, there is no remaining service period and any remaining unrecognized service cost for those share options should be recognized at the date of the modification. The staff believes that since the remaining unrecognized compensation cost is accelerated and recognized at the date of modification, no compensation cost would be recognized for these modified share options in the income statement in the periods after adoption of Statement 123R, absent any further modifications.

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 Statement 123R, including the reasons for modifying the option terms.

#### *L. Application of the Measurement Provisions of Statement 123R to Foreign Private Issuers<sup>104</sup>*

*Question:* Does the staff believe there are differences in the measurement provisions for share-based payment arrangements with employees under International Accounting Standards Board International Financial Reporting Standard 2, *Share-based Payment* (“IFRS 2”) and Statement 123R that would result in a reconciling item under Item 17 or 18 of Form 20-F?

<sup>98</sup> Statement 123R’s disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242.

<sup>99</sup> Statement 123R, paragraph 74.

<sup>100</sup> The terms of these share options do not define the service period as being other than the vesting period.

<sup>101</sup> See FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, paragraph 36, which requires the recognition of compensation expense under Opinion 25 due to a modification of a share-based payment award only if, absent the acceleration of vesting, the award would have otherwise been forfeited during the vesting period pursuant to its original terms.

<sup>102</sup> Statement 123, paragraph 45, as amended by Statement 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (“Statement 148”).

<sup>103</sup> Statement 123, Appendix E.

<sup>104</sup> As defined in Regulation C § 230.405.

<sup>96</sup> Statement 123R, paragraph 63.

<sup>97</sup> *Ibid.*

Interpretive Response: The staff believes that application of the guidance provided by IFRS 2 regarding the measurement of employee share options would generally result in a fair value measurement that is consistent with the fair value objective stated in Statement 123R.<sup>105</sup> Accordingly, the staff believes that application of Statement 123R's measurement guidance would not generally result in a reconciling item required to be reported under Item 17 or 18 of Form 20-F for a foreign private issuer that has complied with the provisions of IFRS 2 for share-based payment transactions with employees. However, the staff reminds foreign private issuers that there are certain differences between the guidance in IFRS 2 and Statement 123R that may result in reconciling items.<sup>106</sup>

M. Disclosures in MD&A Subsequent to Adoption of Statement 123R

Question: What disclosures should companies consider including in MD&A to highlight the effects of (1) Differences between the accounting for share-based payment arrangements before and after the adoption of Statement 123R and (2) changes to share-based payment arrangements?

Interpretive Response: As stated in SEC Release FR-72, 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 Statement 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 that have followed the recognition provisions of Opinion 25 or that adopted the fair-value-based method for financial statement recognition in accordance with Statement 123 using the prospective method permitted by Statement 148. Furthermore, the staff understands that companies may refine their estimates of assumptions as a result of implementing Statement 123R and the interpretive guidance provided in this SAB. In addition, the staff understands that many companies are

evaluating their share-based payment arrangements and making changes to those arrangements.

Each of these situations may affect the comparability of financial statements. Accordingly, to assist investors and other users of financial statements in understanding the financial results of a company that has adopted Statement 123R, the staff believes that companies should consider including in 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:

- Transition method selected (e.g., modified prospective application or modified retrospective application) and the resulting financial statement impact in current and future reporting periods;
- Method utilized by the company to account for share-based payment arrangements in periods prior to the adoption of Statement 123R and the impact, or lack thereof, on the prior period financial statements;
- Modifications made to outstanding share options prior to the adoption of Statement 123R and the reason(s) for the modification;
- Differences in valuation methodologies or assumptions compared to those that were used in estimating the fair value of share options under Statement 123;
- Changes in the quantity or type of instruments used in share-based payment programs, such as a shift from share options to restricted shares;
- Changes in the terms of share-based payment arrangements, such as the addition of performance conditions;
- A discussion of the one-time effect, if any, of the adoption of Statement 123R, such as any cumulative adjustments recorded in the financial statements; and
- Total compensation cost related to nonvested awards not yet recognized and the weighted average period over which it is expected to be recognized.

End Topic 14

\* \* \* \* \*

Amendments to Codification of Staff Accounting Bulletins

The Codification of Staff Accounting Bulletins is amended to revise Question 2 and the related interpretive response in Topic 4.D., all of Topic 4.E., and all of Topic 5.T. as follows:

Topic 4: Equity Accounts

\* \* \* \* \*

D. Earnings Per Share Computations in an Initial Public Offering

\* \* \* \* \*

Question 2: Does reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share alter the registrant's responsibility to determine whether compensation expense must be recognized for such issuances to employees?

Interpretive Response: No. Registrants must follow GAAP in determining whether the recognition of compensation expense for any issuances of equity instruments to employees is necessary.<sup>107</sup> Reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share does not alter that existing responsibility under GAAP.

\* \* \* \* \*

E. Receivables From Sale of Stock

Facts: Capital stock is sometimes issued to officers or other employees before the cash payment is received.

Question: How should the receivables from the officers or other employees be presented in the balance sheet?

Interpretive Response: The amount recorded as a receivable should be presented in the balance sheet as a deduction from stockholders' equity. This is generally consistent with Rule 5-02.30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.

It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity.

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.

\* \* \* \* \*

Topic 5: Miscellaneous Accounting

\* \* \* \* \*

<sup>105</sup> Statement 123R, paragraph A2.

<sup>106</sup> Statement 123R, paragraphs B258-B269, identify the more significant differences between IFRS 2 and Statement 123R.

<sup>107</sup> As prescribed by Statement 123R.

*T. Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)*

**Facts:** Company X was a defendant in litigation for which the company had not recorded a liability in accordance with Statement 5. A principal stockholder<sup>108</sup> of the company transfers a portion of his shares to the plaintiff to settle such litigation. If the company had settled the litigation directly, the company would have recorded the settlement as an expense.

**Question:** Must the settlement be reflected as an expense in the company's financial statements, and if so, how?

**Interpretive Response:** Yes. The value of the shares transferred should be reflected as an expense in the company's financial statements with a corresponding credit to contributed (paid-in) capital.

The staff believes that such a transaction is similar to those described in paragraph 11 of Statement of Financial Accounting Standards Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123R), which states that "share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest<sup>109</sup> in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity." As explained in paragraph 11 of Statement 123R, the substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and the reporting entity makes a share-based payment to its employee in exchange for services rendered.

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in Statement 123R is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and

<sup>108</sup> Statement 57, paragraph 24e, defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."

<sup>109</sup> Statement 123R defines an economic interest in an entity as "any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses." Accordingly, a principal stockholder would be considered a holder of an economic interest in an entity.

other<sup>110</sup> transactions where a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company.

Some registrants and their accountants have taken the position that since Statement 57 applies to these transactions and requires only the disclosure of material related party transactions, the staff should not analogize to the accounting called for by Statement 123R, paragraph 11 for transactions other than those specifically covered by it. The staff notes, however, that Statement 57 does not address the measurement of related party transactions and that, as a result, such transactions are generally recorded at the amounts indicated by their terms.<sup>111</sup> However, the staff believes that transactions of the type described above differ from the typical related party transactions.

The transactions for which Statement 57 requires disclosure generally are those in which a company receives goods or services directly from, or provides goods or services directly to, a related party, and the form and terms of such transactions may be structured to produce either a direct or indirect benefit to the related party. The participation of a related party in such a transaction negates the presumption that transactions reflected in the financial statements have been consummated at arm's length. Disclosure is therefore required to compensate for the fact that, due to the related party's involvement, the terms of the transaction may produce an accounting measurement for which a more faithful measurement may not be determinable.

However, transactions of the type discussed in the facts given do not have such problems of measurement and appear to be transacted to provide a

<sup>110</sup> For example, SAB Topic 1.B indicates that the separate financial statements of a subsidiary should reflect any costs of its operations which are incurred by the parent on its behalf. Additionally, the staff notes that AICPA Technical Practice Aids § 4160 also indicates that the payment by principal stockholders of a company's debt should be accounted for as a capital contribution.

<sup>111</sup> However, in some circumstances it is necessary to reflect, either in the historical financial statements or a pro forma presentation (depending on the circumstances), related party transactions at amounts other than those indicated by their terms. Two such circumstances are addressed in Staff Accounting Bulletin Topic 1.B.1, Questions 3 and 4. Another example is where the terms of a material contract with a related party are expected to change upon the completion of an offering (*i.e.*, the principal shareholder requires payment for services which had previously been contributed by the shareholder to the company).

benefit to the stockholder through the enhancement or maintenance of the value of the stockholder's investment. The staff believes that the substance of such transactions is the payment of an expense of the company through contributions by the stockholder. Therefore, the staff believes it would be inappropriate to account for such transactions according to the form of the transaction.

[FR Doc. 05-6457 Filed 3-31-05; 8:45 am]

BILLING CODE 8010-01-P

## DEPARTMENT OF TRANSPORTATION

### Federal Highway Administration

#### 23 CFR Part 772

[FHWA Docket No. FHWA-2004-18309]

RIN 2125-AF03

#### Procedures for Abatement of Highway Traffic Noise and Construction Noise

**AGENCY:** Federal Highway Administration (FHWA), DOT.

**ACTION:** Final rule.

**SUMMARY:** This final rule amends the FHWA regulation that specifies the traffic noise prediction method to be used in highway traffic noise analyses. The final rule requires the use of the FHWA Traffic Noise Model (FHWA TNM) or any other model determined by the FHWA to be consistent with the methodology of the FHWA TNM. It also updates the specific reference to acceptable highway traffic noise prediction methodology and removes references to a noise measurement report and vehicle noise emission levels that no longer need to be included in the regulation. Finally, it makes four ministerial corrections to the section on Federal participation.

**DATES:** *Effective Date(s):* May 2, 2005. The incorporation by reference of the publication listed in this rule is approved by the Director of the Federal Register as of May 2, 2005.

**FOR FURTHER INFORMATION CONTACT:** Mr. Mark Ferroni, Office of Natural and Human Environment, HEPN, (202) 366-3233, or Mr. Robert Black, Office of the Chief Counsel, HCC-30, (202) 366-1359, Federal Highway Administration, 400 Seventh Street, SW., Washington, DC 20590.

#### SUPPLEMENTARY INFORMATION:

##### Electronic Access

This document and all comments received by the U.S. DOT Docket Facility, Room PL-401, may be viewed