TOPIC 14: SHARE-BASED PAYMENT

The interpretations in this SAB express views of the staff regarding the interaction between FASB ASC Topic 718, Compensation – Stock Compensation, and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. FASB ASC Topic 718 is based on the underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value.[1] Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information.[2]

FASB ASC Topic 718 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.

FASB ASC Topic 718 replaces guidance as originally issued in 1995, that established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of FASB ASC Topic 718 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

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[1] FASB ASC paragraphs 718-10-30-2 through 718-10-30-4.

[2] [Original footnote removed by SAB 114.]

entity[3] 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 FASB ASC Topic 718 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 FASB ASC Topic 718, the modification of employee share options prior to adoption of FASB ASC Topic 718 and disclosures in MD&A subsequent to adoption of FASB ASC Topic 718.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement FASB ASC Topic 718, and the interpretive guidance provided by this SAB, particularly during the period of the Topic'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 FASB ASC Topic 718 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

[3] Defined in the FASB ASC Master Glossary.

predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made under FASB ASC Topic 718. Over time, as issuers and accountants gain more experience in applying FASB ASC Topic 718 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 FASB ASC Topic 718?

Interpretive Response: Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by FASB ASC Topic 718. This Topic explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments;[4] 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.[5]

FASB ASC Topic 718 does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, FASB ASC Topic 718 does not specify the measurement date for share-based

[4] FASB ASC paragraph 718-10-30-2.

[5] Ibid.

payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued.[6] For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to FASB ASC Subtopic 505-50, Equity – Equity Based Payments to Non-Employees.

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 FASB ASC Topic 718 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 FASB ASC Topic 718 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 FASB ASC Topic 718 would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement.[7] For example, the staff believes the guidance in FASB ASC Topic 718 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.

[6] [Original footnote removed by SAB 114.]

[7] 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, FASB ASC Topic 718 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.

B. Transition from Nonpublic to Public Entity Status

Facts: Company A is a nonpublic entity[8] that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8.[9] As a nonpublic entity, Company A had been assigning value to its share options[10] under the calculated value method prescribed by FASB ASC Topic 718, Compensation – Stock Compensation,[11] and 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,

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[8] Defined in the FASB ASC Master Glossary.

[9] 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 FASB ASC Topic 718.

[10] For purposes of this staff accounting bulletin, the phrase "share options" is used to refer to "share options or similar instruments."

[11] FASB ASC paragraph 718-10-30-20 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. FASB ASC paragraph 718-10-55-51 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 FASB ASC subparagraph 718-10-50-2(f)(2)(ii).

repurchased or cancelled.[12] If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of FASB ASC Topic 718. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under FASB ASC subparagraph 718-20-35-3(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.[13]

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 FASB ASC Topic 718 at intrinsic value.[14] When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with FASB ASC Topic 718.[15] In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under FASB ASC Topic 718 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 ending after January 2, 20X8 (when Company A becomes a

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[12] This view is consistent with the FASB's basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

[13] FASB ASC paragraph 718-20-55-94. 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.

[14] FASB ASC paragraph 718-30-30-2.

[15] FASB ASC paragraph 718-30-35-3.

public entity), assume the intrinsic value of the award is $12 and the fair value as determined in accordance with FASB ASC Topic 718 is $15. The measured cost in the first reporting period after December 31, 20X7 would be $5.[16]

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.[17]

Question 4: Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by FASB ASC Topic 718?[18]

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 FASB ASC Topic 718 in subsequent periods and the reasonably likely material future effects.[19] In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition,

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[16] $15 fair value less $10 intrinsic value equals $5 of incremental cost.

[17] This view is consistent with the FASB's basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

[18] FASB ASC Section 718-10-50.

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

Company A should consider the applicability of SEC Release No. FR-60[20] and Section V, "Critical Accounting Estimates," in SEC Release No. FR-72[21] regarding critical accounting policies and estimates in MD&A.

C. Valuation Methods

FASB ASC paragraph 718-10-30-6 (Compensation – Stock Compensation Topic) 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 Topic 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.[22] 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 FASB ASC Topic 718.[23]

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?

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[20] SEC Release No. FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

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

[22] FASB ASC paragraph 718-10-55-10.

[23] FASB ASC paragraph 718-10-55-11.

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.[24] 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 FASB ASC Topic 718 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 FASB ASC Topic 718, are certain valuation techniques preferred over others?

Interpretive Response: FASB ASC paragraph 718-10-55-17 clarifies that the Topic does not specify a preference for a particular valuation technique or model. As stated in FASB ASC paragraph 718-10-55-11 in order to meet the fair value measurement

[24] FASB ASC paragraph 718-10-55-15 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."

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 FASB ASC Topic 718, (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.[25]

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

Question 3: In subsequent periods, may a company change the valuation technique

[25] See FASB ASC paragraphs 718-10-55-16 and 718-10-55-20.

or model chosen to value instruments with similar characteristics?[26]

Interpretive Response: As long as the new technique or model meets the fair value measurement objective as described in Question 2 above, the staff would not object to a company changing its valuation technique or model.[27] 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.[28] 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.[29]

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

FASB ASC Topic 718's (Compensation – Stock Compensation Topic) fair value

[26] FASB ASC paragraph 718-10-55-17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.

[27] 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 Topic.

[28] FASB ASC paragraph 718-10-55-27.

[29] See generally FASB ASC paragraph 718-10-50-1.

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 to earn the right to benefit from the instruments.[30] 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 FASB ASC Topic 718 and in sections (1) and (2) below. Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes.[31]

1. Expected Volatility

FASB ASC paragraph 718-10-55-36 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

[30] FASB ASC paragraph 718-10-55-4.

[31] FASB ASC paragraph 718-10-50-2.

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: FASB ASC Topic 718 does not specify a particular method of estimating expected volatility. However, the Topic 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.[32] FASB ASC Topic 718 provides a list of factors entities should consider in estimating expected volatility.[33] Company B may begin its process of estimating expected volatility by considering its historical volatility.[34] However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility.[35] Implied volatility[36] can be useful in estimating expected volatility because it is generally reflective of both historical volatility and

[32] FASB ASC paragraph 718-10-55-35.

[33] FASB ASC paragraph 718-10-55-37.

[34] FASB ASC paragraph 718-10-55-40.

[35] Ibid.

[36] 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.

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[37] 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 company should incorporate that information.

Question 2: What should Company B consider if computing historical volatility?[38]

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

[37] 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.

[38] See FASB ASC paragraph 718-10-55-37.

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[39] 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.[40] 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.[41]

2. Amount of Historical Data -

FASB ASC subparagraph 718-10-55-37(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.

[39] 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."

[40] FASB ASC subparagraph 718-10-55-37(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.

[41] Generalized Autoregressive Conditional Heteroskedasticity ("GARCH") is an example of a method that demonstrates this characteristic.

3. Frequency of Price Observations -

FASB ASC subparagraph 718-10-55-37(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.[42] Company B should select a consistent point in time within each interval when selecting data points.[43]

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.[44] 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

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[42] 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.

[43] FASB ASC paragraph 718-10-55-40 states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, FASB ASC paragraph 718-10-55-27 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.

[44] FASB ASC paragraph 718-10-55-35.

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.[45] 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 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 FASB ASC paragraphs 718-10-55-35 through 718-10-55-41, 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.[46]

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

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[45] FASB ASC paragraph 718-10-55-37.

[46] See generally Options, Futures, and Other Derivatives by John C. Hull (Prentice Hall, 5th Edition, 2003).

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.[47] If, however, 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.[48]

4. Similarity of Length of Terms -

[47] 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 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.

[48] 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.

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.[49] However, when using traded options with a term of less than one year,[50] 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 that Company B reasonably places on the implied volatility.

<u>Question 4</u>: 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?

<u>Interpretive Response</u>: As stated above, FASB ASC Topic 718 does not specify a

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[49] 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.

[50] 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.

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.[51] Many of the factors listed in FASB ASC Topic 718 are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in FASB ASC Topic 718, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option.[52] The staff believes that a company, after considering the factors listed in FASB ASC Topic 718, 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;[53]
- 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;

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[51] FASB ASC paragraphs 718-10-55-36 through 718-10-55-37.

[52] FASB ASC paragraph 718-10-55-35.

[53] FASB ASC paragraphs 718-10-55-18 and 718-10-55-39 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 FASB ASC Topic 718, 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.

- 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;[54] and
- 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;[55]
- 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.[56]

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: FASB ASC paragraph 718-10-50-2 prescribes the

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[54] 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.

[55] See FASB ASC paragraph 718-10-55-38. 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.

[56] 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.

minimum information needed to achieve the Topic's disclosure objectives.[57] Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it.[58] 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 FASB ASC Topic 718. 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, "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

[57] FASB ASC Section 718-10-50.

[58] FASB ASC subparagraph 718-10-50-2(f) (2) (ii).

order to estimate the expected volatility of its share price?

Interpretive Response: FASB ASC Topic 718 provides guidance on estimating expected volatility for newly public and nonpublic entities that do not have company specific historical or implied volatility information available.[59] 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.[60]

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.[61] 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.[62] 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.[63]

After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified

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[59] FASB ASC paragraphs 718-10-55-25 and 718-10-55-51.

[60] FASB ASC paragraph 718-10-55-25.

[61] 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.

[62] FASB ASC paragraph 718-10-55-51.

[63] FASB ASC paragraph 718-10-55-25.

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.[64] 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.[65]

2. Expected Term

FASB ASC paragraph 718-10-55-29 states "The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous 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, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework the fair value of

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[64] FASB ASC paragraph 718-10-55-37. 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.

[65] FASB ASC paragraph 718-10-55-40.

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 FASB ASC subparagraph 718-10-50-2(f)(2)(i).

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 FASB ASC Topic 718. 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 FASB ASC Topic 718, should Company D consider an additional discount for nonhedgability and nontransferability?

Interpretive Response: No. FASB ASC paragraph 718-10-55-29 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.[66]

Question 2: Should forfeitures or terms that stem from forfeitability be factored into the determination of expected term?

Interpretive Response: No. FASB ASC Topic 718 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 FASB ASC Topic 718, 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.[67]

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.[68]

Question 4: FASB ASC paragraph 718-10-55-34 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

[66] 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.

[67] FASB ASC paragraph 718-10-30-11.

[68] FASB ASC paragraph 718-10-55-31.

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.[69]

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 FASB ASC Topic 718'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.[70] 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.[71]

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

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[69] 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.

[70] FASB ASC paragraph 718-10-55-13.

[71] Historical share option exercise experience encompasses data related to share option exercise, post-vesting termination, and share option contractual term expiration.

its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants,[72] or a lack of variety of price paths that the company may have experienced.[73]

FASB ASC Topic 718 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.[74] In addition, FASB ASC paragraph 718-10-55-32 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:[75]

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[72] 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.

[73] 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.

[74] FASB ASC paragraph 718-10-55-30.

[75] Employee share options with these features are sometimes referred to as "plain vanilla" options.

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;[76]
- 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 is unable 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, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, if a company concludes that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term, the staff will accept the following "simplified" method for "plain vanilla" options consistent with those in the fact set above: expected term = ((vesting term + 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

[76] In this fact pattern the requisite service period equals the vesting period.

the fact set described above, the resultant expected term would be 6.25 years.[77] 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.[78]

Examples of situations in which the staff believes that it may be appropriate to use this simplified method include the following:

- A company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time its equity shares have been publicly traded.
- A company significantly changes the terms of its share option grants or the types of employees that receive share option grants such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.
- A company has or expects to have significant structural changes in its business such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.

The staff understands that a company may have sufficient historical exercise data for some of its share option grants but not for others. In such cases, the staff will accept the use of the simplified method for only some but not all share option grants. The staff

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[77] Calculated as [[[1 year vesting term (for the first 25% vested) plus 2 year vesting term (for the second 25% vested) plus 3 year vesting term (for the third 25% vested) plus 4 year vesting term (for the last 25% vested)] divided by 4 total years of vesting] plus 10 year contractual life] divided by 2; that is, $(((1+2+3+4)/4) + 10) /2 = 6.25$ years.

[78] J.N. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial 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.

also does not believe that it is necessary for a company to consider using a lattice model before it decides that it is eligible to use this simplified method. Further, the staff will not object to the use of this simplified method in periods prior to the time a company's equity shares are traded in a public market.

If a company uses this simplified method, the company should disclose in the notes to its financial statements the use of the method, the reason why the method was used, the types of share option grants for which the method was used if the method was not used for all share option grants, and the periods for which the method was used if the method was not used in all periods. Companies that have sufficient historical share option exercise experience upon which to estimate expected term may not 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 in Question 5, the staff believes that more detailed external 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 when more relevant detailed information becomes widely available.

E. FASB ASC Topic 718, Compensation – Stock Compensation, 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.[79] FASB ASC

[79] 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

Topic 718 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 liabilities; however, some redeemable instruments will qualify for equity classification.[80] SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks,"[81] ("ASR 268") and related guidance[82] 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 FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of FASB ASC Topic 718. 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.

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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.

[80] FASB ASC paragraphs 718-10-25-6 through 718-10-25-19.

[81] ASR 268, July 27, 1979, Rule 5-02.28 of Regulation S-X.

[82] Related guidance includes FASB ASC paragraph 480-10-S99-3 (Distinguishing Liabilities from Equity Topic).

Question 1: While the instruments are subject to FASB ASC Topic 718,[83] is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under FASB ASC Topic 718?

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 FASB ASC Topic 718 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.[84]

When an instrument ceases to be subject to FASB ASC Topic 718 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?

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[83] FASB ASC paragraph 718-10-35-13 states that an instrument ceases to be subject to this Topic 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)."

[84] 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 FASB ASC Section 815-40-25, Derivatives and Hedging – Contracts in Entity's Own Equity – Recognition, would otherwise require the assumption of net cash settlement. See FASB ASC paragraph 815-40-25-11, which states, in part: "…the events or actions necessary to deliver registered shares are not controlled by an entity and, therefore, except under the circumstances described in FASB ASC paragraph 815-40-25-16, if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract." See also FASB ASC subparagraph 718-10-25-15(a).

Interpretive Response: Under FASB ASC Topic 718, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital[85] 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 FASB ASC Topic 718. 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 FASB ASC Topic 718 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 stock that qualifies for equity classification under FASB ASC Topic 718 is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic[86] value of the option should be presented as temporary equity at that date.

Question 3: Would the methodology described for employee awards in the

[85] Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

[86] 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.

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 FASB ASC Topic 718 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.[87] 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 the financial statements, or within MD&A.

G. Removed by SAB 114[88, 89]

[87] FASB ASC Topic 718 does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

[88] [Original footnote removed by SAB 114.]

H. Removed by SAB 114[90, 91, 92, 93]

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.[94]

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. FASB ASC Topic 718, Compensation – Stock Compensation, 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

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[89] [Original footnote removed by SAB 114.]

[90] [Original footnote removed by SAB 114.]

[91] [Original footnote removed by SAB 114.]

[92] [Original footnote removed by SAB 114.]

[93] [Original footnote removed by SAB 114.]

[94] FASB ASC paragraph 718-10-25-2.

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,[95] is effective.

J. Removed by SAB 114[96, 97, 98]

K. Removed by SAB 114[99, 100, 101, 102, 103]

L. Removed by SAB 114[104, 105, 106]

M. Removed by SAB 114

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[95] 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.

[96] [Original footnote removed by SAB 114.]

[97] [Original footnote removed by SAB 114.]

[98] [Original footnote removed by SAB 114.]

[99] [Original footnote removed by SAB 114.]

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[105] [Original footnote removed by SAB 114.]

[106] [Original footnote removed by SAB 114.]