

SEC Regulations Committee
July 10, 2007 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

Discussion Document D

Topic: When Stock Based Executive Compensation That Is Capitalized or Deferred Should Be Reported In The Summary Compensation Table

Background: Page 10 of the adopting release of the SEC's December 2006 Interim Final Rule, *Executive Compensation Disclosure* (Release Nos. 33-8765; 34-55009), in describing the reporting of compensation cost in the Summary Compensation Table (SCT) under the interim final rule, states:

“Under the amendments we adopt today as interim final rules, the dollar amount of compensation cost recognized over the requisite service period, as described in FAS 123R, will be the amount reported in the Stock Awards and Option Awards columns in the Summary Compensation Table.²⁶ Compensation cost will include both the amounts recorded as compensation expense in the income statement for the fiscal year as well as any amounts earned by an executive that have been *capitalized* on the balance sheet for the fiscal year. This amount will include compensation cost recognized in the financial statements with respect to awards granted in previous fiscal years and the subject fiscal year.” [emphasis added and footnote excluded]

We understand there may be some confusion among practitioners regarding the reporting in the SCT for amounts earned by an executive that have been capitalized on the balance sheet. Some believe the second sentence above indicates that compensation earned by an NEO during a fiscal year and capitalized on the company's balance sheet should be reported in the SCT in the year the compensation is recorded in the financial statements (balance sheet or income statement), as described in FAS 123R, *Share-Based Payment* (FAS 123R). Others believe the reporting of the compensation in the SCT should occur in future periods when the capitalized costs are recorded in the income statement as a component of depreciation or amortization expense.

Items 402(c)(2)(v) and (vi) of Regulation S-K require reporting in the SCT “(v) For awards of stock, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column(e)); (vi) For awards of options, with or without tandem SARs, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (f));...”

It is clear that stock and option awards granted in a given fiscal year should be reported in the SCT as those awards are recognized in the financial statements over the requisite service period, in accordance with FAS 123R. This may result in the reporting of a particular award in the SCT over several years as services are provided. However, it is less clear if these compensation costs should be reported in the SCT in the periods when the FAS 123R compensation costs are capitalized (e.g., as part of inventory or property, plant & equipment) or deferred on the balance sheet under other accounting literature (e.g., by directly following, or analogizing to, FAS 91 or FTB 90-1). Paragraph 5 of FAS 123R recognizes “In some circumstances, the cost of services (or goods) may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed.” In addition, FAS 123R refers to the recognition of *compensation cost* rather than *compensation expense* because any compensation cost that is capitalized as part of the cost to

acquire or construct an asset would not be recognized as compensation expense on the income statement (footnote 5).

Situation 1 – Cost deferred on balance sheet as deferred costs

During fiscal 2006, Company X's Chief Operating Officer (NEO 3) participates in a sales incentive plan whereby NEO 3 is entitled to receive an option award based on a specified formula if NEO 3 generates/sells qualifying new business. NEO 3 is one of the company's named executive officers for purposes of reporting executive compensation. Assume during fiscal 2006 NEO 3 sells qualifying new business, for which the company will generate new revenues during fiscal 2007 through 2009 (e.g., a new 3 year customer contract to begin in the next fiscal year). In fiscal 2006, resulting from NEO 3's sale of qualifying new business, Company X's compensation committee awards NEO 3 options with a 10 year life to purchase 10,000 shares of Company X stock (in addition to her cash salary of \$300,000). The option award is fully earned during fiscal 2006, with no future service by NEO 3 required (even if the customer ultimately cancels the contract or is unable to fulfill their obligations), and is fully vested and non-forfeitable. Company X estimates these option awards have a FAS 123R grant date fair value of \$500,000. Company X forecasts profits on this new customer contract during fiscal 2007 through 2009 in excess of the grant date fair value of the option award (i.e., not a loss contract).

Because NEO 3's sales effort was an integral part of the direct selling effort associated with obtaining the new customer contract, for financial statement reporting purposes Company X defers NEO 3's option award compensation cost associated with the sales effort (the \$500,000 grant date fair value becomes a deferred cost on the balance sheet), and will amortize the deferred cost ratably over the new customer contract life (i.e., 2007 through 2009).

Question: When should Company X report the \$500,000 compensation cost associated with the 2006 option award in column (f), Option Awards, of the SCT?

View A: Company X should report the entire \$500,000 grant date fair value (compensation cost) associated with the 2006 option award in fiscal 2006 in the SCT. Proponents of View A observe that the award was earned and granted during fiscal 2006, and therefore the requisite service period pursuant to FAS 123R is fiscal 2006. Therefore, consistent with Item 402(c)(2)(v) of Regulation S-K, column (e) of the SCT should report "the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R." Proponents of View A also observe the fact that even though Company X deferred this cost under separate accounting literature (e.g., by directly applying, or analogizing to, FAS 91 or FTB 90-1), and will amortize the cost over future contract periods (2007 through 2009), the compensation was earned in fiscal 2006 and should be reported in the SCT.

View B: Company X should report the \$500,000 compensation cost associated with the 2006 option award ratably over the three years in which the deferred compensation cost capitalized on the balance sheet is amortized to expense. That is, Company X would report \$166,666.67 of compensation cost in the Option Awards column of the SCT in each of fiscal 2007, 2008 and 2009. There would be no compensation cost reported in the Option Awards column of the SCT in fiscal 2006 notwithstanding NEO 3 earning and Company X granting the option award in fiscal 2006. Company X would, however, report the option grant in fiscal 2006 in the Grants of Plan-Based Awards table and should consider footnote disclosure of the relevant features of the award, including its anticipated expense recognition in Company X's income statement. Proponents of View B argue this approach aligns the reporting of compensation in the SCT with the financial reporting periods that reflect the revenues generated by the NEO.

Committee Recommendation: The Committee supports View A, though understands the SEC staff may have provided View B as an answer in at least one instance.

SEC Staff Response: The staff supports View A. For other forms of compensation, registrants should follow the reporting instructions in SK 402. The SCT reporting of other forms of compensation may not necessarily be consistent with the financial statement reporting of the corresponding compensation cost.

Situation 2 – Cost capitalized on balance sheet as part of an asset

During fiscal 2006, Company X constructs a new building to be used in the company's operations. Company X's Chief Operating Officer (NEO 3) is one of the company's named executive officers for purposes of reporting executive compensation. Due to the importance of this new building to Company X, NEO 3 is integrally involved in the development of the design and layout of the new building, and oversees the construction of the new building, spending all of her time on the project during the course of fiscal 2006. Due to NEO 3's significant contributions to the construction project, in fiscal 2006 Company X's compensation committee awards NEO 3 options with a 10 year contractual term to purchase 10,000 shares of Company X stock (in addition to her cash salary of \$300,000). The option award is fully earned during fiscal 2006, with no future service by NEO 3 required, and is fully vested and non-forfeitable. Company X estimated that these option awards have a FAS 123R grant date fair value of \$500,000. Company X capitalizes the new building as an asset on its balance sheet, including all "costs necessarily incurred to bring it to the condition and location necessary for its intended use." [FAS 34] Because NEO 3 spent all of her time during fiscal 2006 working on the new building construction, NEO 3's total cash and option award compensation cost in fiscal 2006 of \$800,000 is capitalized as part of the cost of the new building, which will be depreciated over its estimated 20 year useful life.

Question: When should Company X report the \$500,000 compensation cost associated with the 2006 option award in column (f), Option Awards, of the SCT?

View A: Company X should report the entire \$500,000 grant date fair value (compensation cost) of the option award in the Option Award column of the SCT in fiscal 2006. The award was granted and earned during fiscal 2006, and therefore the requisite service period pursuant to FAS 123R is fiscal 2006. Therefore, consistent with Item 402(c)(2)(v) of Regulation S-K, column (e) of the SCT should report "the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R." Proponents of View A observe that the cash salary compensation of \$300,000 paid to NEO 3 during fiscal 2006 is required to be reported in fiscal 2006 in column (c) of the SCT, notwithstanding the company's capitalization of such amount as part of the new building, and View A provides consistent presentation of these compensation costs in the SCT regardless of their form. Proponents of View A also observe the use of the term "compensation cost" in FAS 123R rather than "compensation expense" clearly indicates the FASB's view that the principles for recognizing compensation in the financial statements apply to amounts recognized on the balance sheet as well as the income statement.

View B: Company X should report the compensation cost associated with the 2006 option award in the SCT ratably in each period in which the building is depreciated. That is, assuming a 20 year useful life, with depreciation beginning 1/1/07, \$25,000 per year (\$500,000 / 20 years) would be reported in the SCT for NEO 3 beginning in fiscal 2007. Proponents of View B observe that the intent of the phrase "as well as any amounts earned by an executive that have been *capitalized* on the balance sheet for the fiscal year" is intended to focus on when those capitalized costs are actually recognized in the income statement. Opponents of View B believe that the reporting of compensation amounts in the SCT in each period when the building is depreciated does not provide investors with disclosure of the compensation earned by the NEO.

Committee Recommendation: The Committee supports View A.

SEC Staff Response: The staff supports View A. For other forms of compensation, registrants should follow the reporting instructions in SK 402. The SCT reporting of other forms of compensation may not necessarily be consistent with the financial statement reporting of the corresponding compensation cost.