SEC Regulations Committee

April 17, 2007 - Joint Meeting with SEC Staff

SEC Offices – Washington DC

Discussion Document I

Topic: Grant Date Fair Value of Equity Award with Performance Conditions in Grants of Plan-Based Awards Table (Item 402(d)(2)(viii) of Regulation S-K)

Background: In the interim-final rules issued in December 2006, the SEC added a column to the Grant of Plan-Based Awards Table (Grant Table) to report the grant date fair value of stock and option awards granted during the year (Column L). The rules state that the amount to be presented in the table is "the grant date fair value of each equity award computed in accordance with FAS 123R."(Item 402(d)(2)(viii))

Column L in the Grant Table is essentially the sum of Columns E (Stock Awards) and F (Options Awards) in the *original* Summary Compensation Table. Those two columns required presentation of "the aggregate grant date fair value computed in accordance with FAS 123R" (see Item 402(c)(2)(v) and (vi) in the August 2006 release). The requirements for Columns E and F were amended in the interim-final rules to require that registrants present "the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R" (see Item 402(c)(2)(v) and (vi) in the December 2006 release). The interim-final release instructs that such amounts should "disregard the estimate of forfeitures related to service-based vesting conditions"." (See Instruction to Item 402(c)(2)(v) and (vi)).

FASB Statement No. 123(R), *Share-Based Payment*, considers the question of measurement (i.e., how to value stock and option awards) to be separate from the question of recognition (i.e. when to report the compensation arising from those awards). The measurement objective of FAS 123R is "to estimate the fair value at the grant date 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 (for example, to exercise share options. That estimate is based on the share price and other pertinent factors, such as expected volatility at the grant date." (paragraph 16 of FAS 123R).

FAS 123R explicitly states that "performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date." (paragraph 48) FAS 123R treats these conditions as matters affecting recognition. Therefore, if a performance condition that affects vesting is not met, no compensation cost is recognized[1]. This aspect of FAS 123R is further explained in Illustration 5(a) of FAS 123R. Footnote 87 in that illustration observes that whether an employee will vest upon providing a defined number of years of service or upon achieving a performance target, "the equity instruments being valued have the same estimate of grant-date fair value. That is a consequence of the modified grant-date method, which accounts for the effects of vesting requirements or other restrictions that apply

[1] Performance conditions under FAS 123R are distinct from market conditions. Performance conditions reflect one or more targets that are defined solely by reference to the employer's own operations or activities. Examples of performance conditions include: EPS, revenue, growth in revenue, obtaining regulatory approval to market a product, market share or increase in market share. Market conditions, on the other hand, relate to the achievement of a specified price of the issuer's shares or a specified price of the issuer's shares in terms of a similar equity security. Examples of market conditions include: market price of the company's common stock for a certain number of days, total shareholder return in excess of a peer group, company's common stock outperforms the S&P index for a specified period. The probability of achieving a market condition is considered in determining the fair value of an equity award at grant date and thus failure to achieve a market condition does not affect the recognition of compensation cost under FAS 123R.

during the vesting period by recognizing compensation cost only for the instruments that actually vest."

Question:

What is the fair value of the award to be reported in the Grant Table when the number of shares or options that the executive will vest in is based on performance?

For example, assume that on March 19, 2007, the Board grants options to the CEO. The number of options that will vest is tied to EPS for the year ended March 31, 2009 as follows:

If EPS is $3.00 or more, the CEO will vest in 20,000 options
If EPS is more than $2.50 but less than $3.00, the CEO will vest in 5,000 options
If EPS is less than $2.50, the CEO will vest in no options.

Regardless of the EPS target achieved, the strike price and term of the option are the same. At the grant date, the fair value of an option is $10.00. At grant date, management believes it is probable that EPS for 2009 will be above $2.50 but will less than $3.00. Accordingly, for accounting purposes, the amount of compensation expense for 2007 is being recognized based on the CEO vesting in 5,000 options.

View A: The fair value of the award is based on the probable number of options that will vest. Using the example, $50,000 (i.e. 5,000, options x $10.00 = $50,000) is reported in Column L of the Grant Table.

View B: The fair value of the award is based on the maximum number of options that will vest. Using the example, $200,000 (i.e. 20,000 options x $10.00 = $200,000) is reported in Column L of the Grant Table.

Supporters of View A believe that the principle in the executive compensation disclosure rules is that the amount reported for equity-based compensation should be computed using both the measurement and recognition criteria of FAS 123R, ignoring only service-based forfeitures. Supporters of View A acknowledge that the Grant Table could report a $0 fair value at grant date if the performance criteria were not probable of being achieved. For example, in the above example, if it were probable that EPS would be less $2.50 in 2009, the grant date fair value of the award would be $0 since no options would vest in that scenario. However, that result is consistent with FAS 123R.

Supporters of View B believe that the objective of the equity award disclosure in the Grants Table is provide investors with information about the fair value of the full amount of the award as measured under FAS 123R, regardless of when or whether such amounts are ultimately recognized in the financial statements. They note that the amount of compensation recognized for financial reporting purposes is presented in the Summary Compensation Table and thus the Grant Table information is provided for an alternative purpose. Further, they note that the failure to vest in a performance-based award is considered a forfeiture (see paragraph 48 of SFAS 123R). Although the Summary Table disclosure of equity-based compensation earned in the current year excludes only service-based forfeitures, supporters of View B believe that Grants Table information was intended to exclude all forfeitures. Supporters of View B are troubled by the notion that a probability assessment could result in reporting $0 fair value in the Grants Table. They observe that an equity award with a market condition would not result in a $0 fair value at grant date even if the valuation model used to value the award indicated that achieving the market condition was not probable.

Committee Recommendation: The Committee supports View B.

SEC Staff Response: The staff supports View B.