UNDERSTANDING FAS 123R – BEYOND THE BASICS

Below are questions/answers from the online seminar presented October 8 and 19 in the SVB Online Seminar Series.

The questions are organized in topics addressed during the seminar sessions with the number of questions for each topic in parentheses:

- Expected Term (5)
- Volatility – Peer Companies – Industry Indices (5)
- Forfeiture Rate (3)
- Post-Transition Expense Recognition (1)
- 409A and Option Grant Pricing (5)
- Expense (7)
- Miscellaneous (6)
- IFRS (2)

For more information, feel free to contact Jann Calix, Director of CapMx Product Development at SVB Analytics-eProsper (650-312-0412) or Sean Scrol at Valtrinsic (312-588-0058).

For a web-based demo of CapMx, please contact sales@eprosper.com.

CapMx: the aspirin for your expensing headache. ™

QUESTIONS AND ANSWERS

EXPECTED TERM

1: With Black-Scholes, do we need to use an expected term? For Black-Scholes, shouldn't we use the full contracted term (e.g. 10 yrs) of the option rather than expected term?

A. The "Expected Term" of a security is one of the valuation parameters required in the computation of the security's fair value.

Paragraph 26 of the FAS 123R Statement sets forth the requirement to use Expected Term rather than contractual life as a parameter when measuring the fair value of an employee grant:

"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 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 because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value. In addition, some employee share options contain prohibitions on exercise during blackout periods. To reflect the effect of those restrictions (which may lead to exercise prior to the end of the option's contractual term) on employee options

relative to transferable options, this Statement requires that the fair value of an employee share option or similar instrument be based on its expected term, rather than its contractual term (paragraphs A3 and A18)."

Paragraph A27 of the Statement provides the definition for Expected Term, with the pertinent part as follows:

"The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement)."

Typically, the service inception date is the grant date, but can precede the grant date in some situations (see Paragraph A79 of the Statement). For private companies, it is usually the grant date. Accordingly, the expected term covers the grant date through the date which the company expects the security to be either (a) exercised, or (b) settled in some other manner ("settlement" may depend on the type of security involved).

However, for grants to non-employees and grants that have performance vesting, in most cases the rules require the use of the full contractual life (or remaining contractual life) when determining the fair value of such options.

"Remaining Contractual Life" ("RCL") is just another form of the expected term of a security. Like the expected term, RCL cannot be less than the vesting life of the grant, i.e., if the vesting schedule is 4 years, then the RCL cannot be less than 4 years.

One method of calculating RCL for a grant is based on the (a) expense report period, (b) the grant's vesting dates that occur within that period, (c) the grant's shares vesting on those vest dates, and (d) the grant's expiration date.

2: How about using the expected length of employment of employees by looking at historical employee tenure data?

3: Use of the expected tenure in many instances is less than the expected term using the simplified approach. How do we justify use of expected tenure rather than simplified term?

A. Since both questions relate to using actual employment period history when calculating expected term, they will be addressed jointly.

In many cases the option holder's employment period is shorter than the expected term as computed using the simplified method under SAB 107.

Pursuant to paragraph A29 of the FAS 123R Statement, "…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."

However, bear in mind that the Statement also states that "…An option's expected term must at least include the vesting period." (Paragraph A28a).

If you wish to use a method other than SAB 107 to compute expected term, it is strongly suggested that you get the approval of your auditors.

4: Do private companies need to abide by SAB 107?

A. There is no requirement that private companies use SAB 107. However, if the circumstances of the company are such that it cannot develop a "reasonable and supportable" method to establish expected term, then it is probably best to use SAB 107. While in our experience it has been very rare that auditors have balked at a private company using SAB 107 to establish expected term, it is always best to check with your auditors before embarking on any path of valuation assumption determination.

The pertinent portion of SAB 107 as reflected by the Bulletin's use of the "question / answer" format (emphasis added):

Question 5 of SAB 107 addresses this issue:

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

"Interpretive Response: A company should use an approach that is reasonable and supportable under Statement 123R's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in determining an exchange price for the share options. 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. A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants, or a lack of variety of price paths that the company may have experienced.

Statement 123R describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model. In addition, Statement 123R, paragraph A29, states "…expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research." For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative information may not be widely available at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data."

5: If an option holder has up to a year following termination to decide on exercise, does that preclude the SAB 107 simplified method?

A. Keep in mind that SAB 107 reflects the SEC rules for public companies. Auditors accept the SAB 107 calculation for private companies because, in the vast majority of instances, what else does the company have to rely on?

Accordingly, for a private company, a post-termination exercise period up to one year will probably not be an impediment to using SAB 107. We understand that the Bulletin describes "plain vanilla" grants as having a set post-termination exercise period, but, since we are in the private company realm, this should be OK. Of course, the final arbiter will be your auditor, so be sure to check with them before permitting an extended post-termination exercise period.

VOLATILITY – PEER COMPANIES – INDUSTRY INDEX

1: What is considered to be a peer?

A. The standard language in the FAS 123R Statement refers to "similar entities". Paragraph A32c reads in part as follows:

"…A nonpublic entity might base its expected volatility on the expected volatilities of entities that are similar except for having publicly traded securities."

The footnote for that paragraph reads:

"In evaluating similarity, an entity would likely consider factors such as industry, stage of life cycle, size, and financial leverage."

Check with your auditors for additional information as to appropriate peer companies for your company.

2: Where is industry sector information obtained from?

A. Paragraph A139 of the FAS 123R Statement gives a good example of selecting an index and obtaining the data from it:

"A139. Entity W operates exclusively in the medical equipment industry. It visits the Dow Jones Indexes website and, using the Industry Classification Benchmark, reviews the various industry sector components of the Dow Jones U.S. Total Market Index. It identifies the medical equipment sub-sector, within the health care equipment and services sector, as the most appropriate industry sector in relation to its operations. It reviews the current components of the medical equipment index and notes that, based on the most recent assessment of its share price and its issued share capital, in terms of size it would rank among companies in the index with a small market capitalization (or small-cap companies). Entity W selects the small-cap version of the medical equipment index as an appropriate industry sector index because it considers that index to be representative of its size and the industry sector in which it operates. Entity W obtains the historical daily closing total return values of the selected index for the five years immediately prior to January 1, 20X6, from the Dow Jones Indexes website. It calculates the annualized historical volatility of those values to be 24 percent, based on 252 trading days per year."

3: How many "peer companies" are usually selected for a volatility calculation?

A. In our experience, companies select approximately 4 – 8 companies as peers for a volatility calculation.

4: Are there specific sector indices that are more likely to be accepted than others?

A. In general, no; it's not as if the S&P 500 is favored over Dow Jones, or vice versa. Of primary interest to auditors is whether the companies in the index are sufficiently similar to your company. In its explanation of "expected term", the FAS 123R Statement provides footnote 60 to paragraph A32c regarding how to determine "similar entities":

"In evaluating similarity, an entity would likely consider factors such as industry, stage of life cycle, size, and financial leverage."

5: We're thinking about going to implied volatilities. What do we need to consider before going down that route?

A. See Question 3 from Section D.1 of SAB 107. While this is the SEC's guidance for public companies, it is also a good general discussion of what to consider and it covers what auditors will likely ask about. Note: the relevant footnotes to the Interpretive Response have not been included in the following:

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

Interpretive Response: To achieve the objective of estimating expected volatility as stated in paragraph B86 of Statement 123R, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; 45 Statement 123R, paragraph A32(a); and 4) the similarity of the length of the term of the traded and employee share options.

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

2. Synchronization of the Variables - Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. Similarity of the Exercise Prices - The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant. 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.

4. Similarity of Length of Terms - The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share option's contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater. However, when using traded options with a term of less than one year, 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."

FORFEITURE RATE

1: If I assume a 0% forfeiture rate, does that mean that I should true-up to actual forfeitures every year?

A. Paragraph 43 of the FAS 123R Statement addresses your concerns:

"…An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change."

In plain English, your forfeiture rate is based on the percentage of shares that you expect will actually vest, and, therefore, will have to be expensed. That forfeiture rate should be changed if the expectation as to vesting changes.

By using a 0% forfeiture rate, you are saying that the expectation is that 100% of the shares will vest and be expensed. However, if x% of the shares are actually cancelled, then any of those shares that were expensed prior to vesting should result in a true-up credit to the company. However, please note that shares that were vested at the time of expensing will not result in a credit to the company.

You, of course, will have to input your revised forfeiture rates, but your software solution should be able to automatically handle the true-up reconciliation.

2: What is the common way to determine the 10% rate you used as an example in the forfeiture calculation?

A. Please note that for your FAS 123R expense calculations, you are to use the "expected" forfeiture rate, i.e., the percentage of shares that your company expects will not vest and will not, therefore, have to be expensed.

That being said, most companies start the process of determining the "expected" forfeiture rate by computing its "historical" rate and extrapolating from that number what the expected rate should be. Please check with your auditors on their preferred method of calculating historical forfeitures.

One method of calculating historical forfeitures that has been accepted by audit firms nationwide (and incorporated in the SVB Analytics – eProsper software, CapMx) is based on (a) the number of shares granted, and (b) the number of those shares that were unvested and cancelled. The latter is a combined number, i.e., both must be satisfied (the shares must be both unvested and cancelled) in order to include those shares in the historical calculation. Shares that were vested at the time they cancelled cannot be included in the forfeiture rate calculation due to the requirements of paragraph 42 of the FAS 123R Statement which provides that any shares that vest must be expensed. See below for that paragraph with the pertinent portion emphasized:

"An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, *the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date*. Illustration 4(b) (paragraphs A97–A104) provides an example of the accounting for an award with a graded vesting schedule."

3: For accounting for forfeitures, I have been told by the accounting firms that we have to true up to the actual forfeitures every year.

A. That is not quite our understanding. Paragraph 43 of the FAS 123R Statement says companies should revise the number expected to vest "…if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates". This is definitely not a requirement to annually true-up to actual forfeitures. The only time you

automatically true-up to actual forfeitures is if you started with a 0% forfeiture rate assumption, i.e. you were assuming the whole grant would vest. See the response to the first question in this section.

Paragraph 43 in full:

"The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change."

POST-TRANSITION EXPENSE RECOGNITION

1: If I have options granted prior to 1/1/06 – do I need to recognize any portion of that grant that has a service period after 1/1/06?

A. Yes, but whether the post-1/1/06 (the "Transition Date") expense is computed using "fair value" under FAS 123R or "intrinsic value" under APB 25 will depend on how you handled the expense and the footnote disclosure obligation for those grants issued prior to the Transition Date.

For private companies, the "mandatory" transition to using the FAS 123R fair value expensing method was "…as of the beginning of the first annual reporting period that begins after December 15, 2005" (FAS 123R Statement paragraph 69c).

Please see paragraphs 69 – 85 of the FAS 123R Statement regarding transition methods. Pursuant to FAS 123R Statement paragraph 83: "Nonpublic entities…shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (either the minimum value method under Statement 123 or the provision of Opinion 25 and its related interpretive guidance)."

The following table reflects the treatment for grants issued before your company's Transition Date (the assumption here being that your company has a 12/31 FYE):

Pre-1/1/06 Expense Method	Pre-1/1/06 Footnote Method	Post-1/1/06 Expense Method
Intrinsic Value (APB 25)	Minimum Value	Intrinsic Value
Intrinsic Value (APB 25)	Fair Value	Fair Value
Minimum Value	Fair Value	Minimum Value
Fair Value	n/a	Fair Value

409A AND OPTION GRANT PRICING

1: For a small private company with monthly vesting, how often should they have a valuation performed?

A. The requirement is that the valuation should be performed at least annually or more often if the company has a material event, e.g., a financing, obtaining/losing a major customer or vendor, reaching regulatory compliance milestones, etc.

2: For 409A, is the issue of granting options at the existing 409A value really only a concern when the valuation has substantially increased year-to-year?

For example, options are granted 11/15/07 based on the company's 409A of $0.25, which valuation was effective as of 03/31/07. The company is expecting a new 409A to be delivered sometime in early January 2008 (with an anticipated valuation effective date of 12/31/07). When delivered, that new 409A reflects a valuation of $0.47.

A. Yes; auditors are only considering options to have been granted in-the-money when the stock price has significantly increased from one 409A valuation to the next.

In the above example, the 12/31/07 valuation increased by 88 percent and auditors would probably deem the 11/15/07 options as being granted in-the-money.

3: How do you avoid having those mid and late year grants be seen as in-the-money? Especially if the auditors say they are?

4: How do you handle auditors attempting to value late-year grants as in-the-money so that the employees are protected under 409A?

A. As both questions relate to issues with option pricing vis-à-vis 409A valuations, they will be addressed jointly. The more appropriate approach may be how the company handles issuing the grants. Consider the following example:

a. Company obtains a 409A with an effective date 04/30/07 and a value of $0.25/share
b. The company issues options on 06/30/07 with a $0.25/share exercise price
c. The company issues options on 08/31/07 with a $0.25/share exercise price
d. The company issues options on 10/31/07 with a $0.25/share exercise price
e. The company issues options on 12/31/07 with a $0.25/share exercise price
f. Company obtains a new 409A with an effective date of 01/31/08 and a value of $0.40/share

Your auditors will have their mind set as to whether grants issued on 12/31/07 at $0.25 were actually granted in-the-money based on the 01/31/08 409A valuation. One way to avoid this is to have a company policy that no grant will be issued for a set period of time (say, 45 – 60 days) before a 409A valuation is expected to be delivered to the company.

In the above situation, with the company expecting a 409A with an effective date of 01/31/08, no grant would be issued during the period 12/15/07 – 01/31/08 (45 days) or 12/01/07 – 01/31/08 (60 days) (always remember that the vesting start date can precede the grant date). Auditors may be more accepting of this approach if it shows a good faith effort to issue grants within a time period in which the exercise price is closer in time to the 409A determination.

5: Our auditors are challenging our common stock valuation that we had done for 409A and FAS 123R. We have been granting at the price that the valuation come in at. Can you please speak in more detail about what effect this has on the employee, financial reporting and tax?

A. Keep in mind that 409A imposes steep tax penalties for employees who are granted in-the-money options. However, a complete discussion of all of the ramifications is beyond the scope of a written reply. Please contact Sean Scrol at Valtrinsic, 312-588-0058, if you wish to discuss.

EXPENSE

1: How do you handle situations where options are cancelled, but previously were used in expense calculations?

A. If a grant is cancelled, any of the grant shares that were expensed prior to vesting should result in a true-up credit to the company. However, please note that shares that were vested at the time of expensing will not result in a credit to the company as the requirement is that "…the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date" (FAS 123R Statement paragraph 42).

2: Why, when there is no "cost" to the company if the employee leaves and options are not vested, do you have to expense over the initial vesting period? Why not expense at the end of the vesting period?

A. The requirement to expense at vest is found in FAS 123R Statement paragraph 42 (emphasis added):

"An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, *the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date*. Illustration 4(b) (paragraphs A97–A104) provides an example of the accounting for an award with a graded vesting schedule."

Accordingly, in whatever period the vesting actually occurs, those vested shares must be expensed.

3: If the 3rd party year-end valuation is below the option grant price, is there any expense under 123R?

A. Yes, there will be expense.

However, the ramifications of a 409A valuation that is lower than the "Board of Directors good-faith-determined" Fair Market Value is beyond the scope of this answer. If you would like to discuss more in depth, please contact either Jann Calix at SVB Analytics-eProsper (650-312-0412) or Sean Scrol at Valtrinsic (312-588-0058).

4: What happens if an employee "switches" to a non-employee status during the life of the option grant?

A. Grants to employees are typically expensed using the Grant Date method, i.e., the total expense of the grant is computed as of the date of the grant and is never re-measured.

If the employee switches to non-employee status, that portion of the grant that is unvested as of the date of the switch is then expensed using the Mark-to-Market method and is re-measured at each expense period during the remaining vesting life of the grant.

5: Can you comment on how a reverse vest effects the calculations. By this I mean the grant has immediate vest, but the company has the right to buy-back shares during a predefined period of time.

A. Assuming that the company has a standard early exercise program where upon termination of the holder, for a set time period the company is allowed to repurchase unvested shares at the original exercise price, then, such grants and the exercise of them will not impact the expense calculations. With the repurchase right attached, the exercised shares are seen as "vesting" and the expense will be calculated based on that vesting.

6: For public companies what is the effective date for having to mark-to-market account for "non-employee" option grants?

A. The mark-to-market requirement has been around since 1996 via EITF (Emerging Issues Task Force) 96-18, and specifies the grant's vesting date(s) as the measurement date(s) for non-employee grants, and provides for mark-to-market accounting for such grants from grant date through the grant's vesting period.

7: For FAS 123R purposes, is there a distinction between an option issued under an option plan vs. a warrant to purchase common or preferred stock?

A. Always keep in mind that the FAS 123R Statement covers securities that are issued in exchange for goods/services.

Warrants that are issued in connection with lease facilities, lines of credit, as the "cherry on top" to an investor that participates in a bridge financing, those Warrants are not issued for "goods/services" and are not expensed under FAS 123R.

However, if the Warrant is actually issued as a compensatory instrument for "goods/services", then it takes the same expensing treatment as an option under FAS 123R.

MISCELLANEOUS

1: Are Board members considered non-employees for purposes of FAS 123R expensing?

A. It depends on why the Board member got his/her grant.

Your answer is found in the FAS 123R glossary definition for "Employee". At the end of that definition, Board members are addressed:

"A non-employee director does not satisfy this definition of employee. Nevertheless, for purposes of this Statement, non-employee directors acting in their role as members of a board of directors are treated as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to non-employee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to non-employees for purposes of this Statement."

Bottom line: if the Board member got his/her grant in connection with their services as a Board member, that grant is treated like an employee grant for expensing purposes. However, if the Board member got his/her grant for consulting work he/she did for the company, that grant is treated as a non-employee grant and takes the mark-to-market expensing method.

2: Is the company's secretary, an outside counsel, considered an employee?

A. No. The definition of "employee" is very particular and follows the strict legal definition of Revenue Ruling 87-41. As such, "outside counsel" is, by definition, a non-employee.

3: Is there a bright line for time to exercise post-termination?

A. Your Option Plan will layout the time period permitted for post-termination exercise; the options granted under that Plan will then follow that timetable.

Keep in mind that in order for an ISO to maintain its tax advantages, it must be exercised no more than 3 months after termination. Please see IRC 422(a) as follows:

> (a) In general
>
> Section 421 (a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if—
>
> (1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share to him, and
>
> (2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 424 (a) applies.

4: What is the logic behind the FIN 28 approach?

A. See FAS 123R Statement paragraphs B144 – B148 regarding why FASB chose the attribution methods of Straight Line and FIN28.

"B144. Statement 123 retained the provisions of Opinion 25 and Interpretation 28 that share-based compensation cost is to be recognized over the period or periods during which the employee performs the related services—the requisite service period.

"Recognizing share-based compensation over the requisite service period is consistent with the manner in which other forms of compensation are recognized. This Statement continues that general requirement, but it explicitly defines the requisite service period and introduces the notion of the service inception date. This Statement also defines and provides guidance on explicit, implicit, and derived service periods.

"B145. The Board considered whether the attribution period for employee share options should extend beyond the vesting date, perhaps to the service expiration date (paragraph B40), even though the measurement date is the grant date. Advocates of that method, which might be considered consistent with amortization of postretirement health care benefits over the period to full eligibility date, contended that employees have not earned the full benefit to which they are entitled until termination of service no longer shortens the life of the option. They would use the longer attribution period to allocate the time value of an option.

"B146. Most respondents who addressed this issue agreed with the Exposure Draft that the attribution period should not extend beyond the vesting date. However, some respondents suggested attribution over the option's expected life, which would be consistent with the method described in paragraph B145. They said that the option serves as an incentive during its entire life and that attribution over the longer period would better match recognized compensation cost with the related benefits to the entity, for example, increased revenues.

"B147. Although amortization of the time value of an option beyond the vesting date has some conceptual appeal, the Board concluded that no compelling reason exists to extend the attribution period beyond the period now used for share options that give rise to compensation cost. The Board notes that the decision on when to exercise a vested option is the employee's. The right to exercise an option has been earned by the date the option becomes vested.

"B148. As noted in paragraph B47, equity instruments are issued to employees when the entity has received the consideration for those instruments (usually, the vesting date). It might be argued that the full amount of the compensation cost resulting from an award of equity instruments should be recognized at the vesting date, once the equity instrument has been fully earned and issued to the employee. However, the cost of services received in exchange for other employee benefits with a vesting period, such 156An award may have multiple requisite service periods. For convenience, however, the discussion of attribution of compensation cost in this appendix refers only to a single requisite service period as pensions and other post-employment benefits, generally is recognized in the periods in which the services are received even if the benefits are not yet vested. Although those employee benefit plans generally result in the incurrence of liabilities rather than the issuance of equity instruments, the Board decided that the form of eventual settlement should not change the general principle that the costs of employee services are recognized over the periods in which employees are required to render service to earn the right to the benefit."

5: A company has granted options for 3 years and never booked any expense. The company is now inputting all the options into a software platform. Should the company enter all options ever granted or exclude those that were granted and then forfeited before vesting?

A. As a "best practices" approach, input all grants – including those forfeited, expired, exercised, and rescinded. Additionally, shares that were "forfeited", i.e., cancelled before vesting, will be required in order to accurately compute the company's historical forfeiture rate, which includes unvested cancelled shares.

If you do that, you will be able to generate reports for any time period that will accurately reflect the option status as of that date. If your software is capable of producing cap tables, this all encompassing information will be necessary.

6: What types of software currently compute stock option expense under the Black-Scholes model in compliance with International Accounting Standards?

A. There are numerous software packages in the marketplace. The SVB Analytics–eProsper software, CapMx, provides the ability to expense under both the FAS and IFRS standards. For a web-based demo, please contact sales@eprosper.com.

IFRS

1: Under IFRS2, would grants to members of a board of directors or an advisory board be treated as employee grants or non-employee grants?

A. Due to the IFRS' broad interpretation of "service provider" (in contrast to the narrow definition of "employee" used under FAS 123R), board and advisory board members are treated as employees under IFRS.

2: Can you talk about transition methods to IFRS2?

A. FASB and IASB have not yet finalized the issues surrounding the transition. Please contact your auditor who will probably have some documentation that they can give you.

Valtrinsic is an independent third party and is not affiliated with SVB Financial Group or its affiliates. SVB Financial Group does not provide tax or legal advice and clients should consult their own accountants and attorneys for such advice.

SVB Analytics is a non-bank affiliate of Silicon Valley Bank. Products and services offered by SVB Analytics are not insured by the FDIC or any other Federal Government Agency and are not guaranteed by Silicon Valley Bank or its affiliates. Silicon Valley Bank is a member of the FDIC and the Federal Reserve and it is the California bank subsidiary of SVB Financial Group, which is also a member of the Federal Reserve.
© 2008 Silicon Valley Bank.® All rights reserved. SVB, SVB> and SVB>Find a way are all registered trademarks of SVB Financial Group.

185 Berry Street Suite 3000 San Francisco, California 94107 U.S.A.
PHONE 866.719.9117 svb.com