Q&A Session for Private Lives: Stock Option Expensing & Minimum Disclosure Requirements for Private Companies

Date: Wednesday, May 19, 2010

Q: Is 3rd party valuation required if no stock options are granted or other deferred comp transactions during the fiscal year?

A: If the company is not granting options, then a valuation should not be necessary for 409A purposes. However, your auditors may want one as an input to the stock option expensing calculations.

Q: I was of the understanding that an employee's tax burden was based on when they exercised an option. I thought I just heard that the AMT burden now occurs at vesting. Did I hear this correctly? Has this changed recently?

A: The tax rules have not changed recently. The exercise of an NQ option, is, in most cases, the taxable event. For ISOs the taxable event is the disposition, but the ISO exercise is a "preference item" for AMT calculations, so must be considered when calculating taxes. Some companies allow "early exercise" of stock options, also known as "exercise before vest" which can receive slightly different treatment. If the participant exercises the option before it is vesting, she has the ability to file an 83(b) election with the IRS to accelerate the tax liability to the time of exercise. If the participant early exercises and does not file an 83(b) election, then the tax is due at the time of vesting.

Q: The DLOM seems to be quite subjective... so much so that the 409A valuation seems lees of a useful figure that an opinion by the 3rd party generating the valuation. How is this figure generally calculated?

A: There are a couple of standard ways of looking at marketability discounts – restricted stock/pre-IPO studies and put option analyses. The studies look at difference in prices for restricted/unrestricted stock or the difference in value at an IPO and calculated discounts that way. A put option analysis uses one of several option pricing models and calculates a discount that way. Depending upon the stage of the company and its circumstances, one or the other may be appropriate.

Q: If the grant includes time-based vesting, may the Black-Scholes model be used to value the options?

A: Yes. Typically, Black-Scholes is still the model of choice for calculating Fair Value for the vast majority of companies. The fact that the grant has time-based vesting does not make the Black-Scholes model unworthy of being used. Indeed, for such grants, we find that Black-Scholes is the model of choice.

Q: Are options issued to 'new hire', and option is subject to vesting over period of time, considered a performance base (must stay employed) or market-based?

555 Mission St., Suite 900 San Francisco, California 94105 U.S.A.
Phone 408.654.7400 svb.com

© 2010 Silicon Valley Bank. All rights reserved. Member of FDIC and Federal Reserve.
Silicon Valley Bank, SVB, SVB> and SVB>Find a way are all registered trademarks. Rev. 06-15-10

A: No. Such grants are time-based vesting securities. The question found above provides additional detail on this matter. A grant is "performance-based" only when vesting is dependent or contingent upon meeting certain targets related to the company's internal operations and captured by accounting metrics.

A grant is "market-based" when vesting is dependent or contingent upon the company meeting certain stock price performance milestones.

Vesting that is "time-based" (your scenario) is a "service condition".

Q: Regarding expected term, if all a company's history of exercises is for restricted shares, can the company use the simplified method for other vanilla options granted in a year?

A: Yes. The Interpretive Response to Question 6 of Sub-Section D2 of SAB 107 provides the "simplified" method for the expected term calculation for grants made to employees and deemed to be "plain vanilla" per the following criteria:

- Granted at-the-money
- Exercisability is based on service vesting
- Unvested shares are forfeited at termination
- Vested shares have a limited post-termination exercise grace period
- The share options are nontransferable and non-hedgeable

Q: If the vest date starts 6/08 and 10/09 is grant date, should the expense be front loaded in the 1st yr (09) for a graded expensing method?

A: While the "service inception date" is usually the grant date, there are some very specific circumstances under which the service inception date can precede the grant date.

Pursuant to FAS 123R paragraph A79, the service inception date may precede the grant date when:

- The grant is authorized; and,
- Service begins before a mutual understanding of key terms and conditions exists; and,
- Either of the following conditions applies:
  - o Substantive additional service is not required as of the grant date; or
  - o A performance or market condition exists, which, if not satisfied between the service inception and grant date, results in the award being forfeited.

Due to the requirement that one of the "either" conditions must be met, it is rare for the service inception date to be before the grant date.

Accordingly, the expense should be recognized beginning with the grant date and continuing over the remaining vesting life of the grant.

555 MISSION ST., SUITE 900 San Francisco, California 94105 U.S.A.
PHONE 408.654.7400 svb.com

© 2010 Silicon Valley Bank. All rights reserved. Member of FDIC and Federal Reserve.
Silicon Valley Bank, SVB, SVB> and SVB>Find a way are all registered trademarks. Rev. 06-15-10

For example, a 4-year vesting schedule with the Vest Start Date of 06/01/08 but a Grant Date of 10/01/09 would expense straight line from 10/09 – 6/12, i.e., over a 32-month period, not a 48-month period.

Having stated the above, it is important to consider paragraph 42 to ensure that at the time of the first vesting all expense for the vested shares has been recognized.

Q: With a seed funded start-up when does doing a valuation of Founder's Stock become important to retain tax benefits to the founders? When does an outside valuation become important; VC investment; installing a Qualified Plan; or when?

A: We would generally expect to see a valuation done for 409A purposes at the time of the first professional round of financing. The trigger tends to be material events in the development of business and an equity financing is, by definition, a material event. Establishing a Qualified Plan may be a trigger for the Board to establish a stock option strike price that is different than the basis for founders stock, but in the absence of another event, may not require a more formal valuation.

Q: Are there special issues dealing with employees of foreign subsidiaries of US companies granted stock options in US company?

A: Yes, the special issues for dealing with non-U.S. employees are vast and diverse. Not only must you comply with the tax regulations of the country in which your employee resides (and/or works), but in many countries there are also securities regulations that must be complied with as well. Also, many countries are now adopting the International Financial Reporting Standards (IFRS) and so your subsidiaries may have to report under a different accounting standard (which requires a different accrual method, different tax accounting, and accrual of employment tax liabilities).

Q: You made the comment if options are not converted the expense is not reversed - my understanding is that if individual leaves BEFORE vesting, then expense is reversed.

A: Correct. If an employee terminates prior to vesting, the expense associated with the unvested shares is reversed. If any portion of the shares for that grant DO vest, however, the expense is not reversed, even if the shares are never exercised.

Q: On slide 22 - this second point seems in conflict. Do you modify grant to reflect non-employee status?

A: The slide is trying to say that if the grant is NOT modified (i.e. if the original terms of the grant allow the contractor to retain the option when they become an employee), which is the most common case, then you assign a new fair value and accrue the expense over the remaining service period.

If the grant would normally be forfeited when the participant converts from contractor to employee (which is very uncommon) and you modify the grant so that they retain the grant, then it is a Type 3 modification and you would reverse previously accrued expense for any unvested shares, revalue the grant and accrue the new fair value over the remaining service period.

© 2010 Silicon Valley Bank. All rights reserved. Member of FDIC and Federal Reserve.
Silicon Valley Bank, SVB, SVB> and SVB>Find a way are all registered trademarks. Rev. 06-15-10

Q: If a company is recording vesting for options along with forfeitures, can't the company use specific identification?

A: If the question is, "if the company can true up for vestings and forfeitures as they occur, specific to the grant instead of applying a blanket forfeiture rate to the accrual of expense for all grants", the A is a partial no. You are required to true up for vestings for a specific grant, but you are also required to apply a forfeiture rate to the accrual of expense for all grants, unless you truly believe (and can "prove") that the forfeiture rate will be zero for all grants. You are not allowed to true up for forfeitures as they occur and not apply a forfeiture rate to the accrual of expense. That was a policy decision under FAS 123, but under FAS 123R you no longer have a choice.

Q: Are most start up companies (less than 50 people), using software in house or are they outsourcing?

A: As in the case of most things, it depends. If someone at the company has the requisite knowledge, then the company will license software and handle it in-house. However, due to the very specific nature of such knowledge, we find most companies out-sourcing to an expert consultant. Such consultant will use the company's licensed software.

Q: Do forfeiture rates only apply to new grants or do they restate/true up old grants?

A: Forfeiture rates apply to all grants/options that are still vesting. Once an option (or a tranche) vests, the shares will no longer have the forfeiture rate applied. But if the forfeiture rate changes and you have an unvested grant from some time ago (let's say cliff vesting over 3 years), you would apply the change in forfeiture rate to that grant just as you would to the new grants.

Q: How do you account for changes in forfeiture rates in Equity Edge expense recognition report? Should you just run the expense using the old rate and new rate for the current quarter or should you go back the whole year and run the expense with new rate?

A: The Expense Allocation – Recognition report allows you to input a Prior Rate and a Current Rate. For the prior rate, input the rate you used when you ran the reports last quarter. For the current rate, put in your current best estimate of a forfeiture rate. The report will apply the true up in the current quarter. You need not go back and re-run the report for the entire year.

Q: Several of the A240 requirements say "Options (or share units)." Should RSU's be disclosed with options or with Restricted Share awards?

A: FASB seems to indicate that an RSU is more like an option than a Restricted Stock Award. It is recommended that you seek auditor guidance on this issue.

Q: What are the taxation issues/requirements for the stock options - that is, taxation of the individual receiving the options?

A: For US taxation: Option grants generally fall into two varieties: incentive and nonstatutory (also known as non-qualified).

555 MISSION ST., SUITE 900 San Francisco, California 94105 U.S.A.
PHONE 408.654.7400 svb.com

© 2010 Silicon Valley Bank. All rights reserved. Member of FDIC and Federal Reserve.
Silicon Valley Bank, SVB, SVB> and SVB>Find a way are all registered trademarks. Rev. 06-15-10

Incentive Stock Options are not taxed at grant or exercise. They are taxed only upon sale of the exercised shares. However, the exercise of an ISO is included as an AMT preference item. Also, if shares are exercised before vest, an 83(b) election can be filed to accelerate the taxable event from vest to exercise (when, presumably the taxable amount will be lower).

Nonstatutory stock options are not taxed at grant, but are taxed at ordinary income rates at the time of exercise and at capital gain rates upon the sale of the exercised shares.

Please note that the above addresses only the United States tax requirements. Foreign jurisdictions may have other rules – be sure to check with a qualified tax professional in all countries in which the company will issue options.

Q: Please talk about when a valuation should be based on a recent funding round using the OPM method and when that method is not applicable (i.e. how long after a funding).

A: The 'option pricing model backsolve' starts with the price paid for each share of the most recent round of preferred stock and solves for a company value that results in that price. The values of the other classes of stock then fall out of that based on the capital structure and terms. We generally look at this methodology first, unless the terms of the round suggest it is not appropriate. Examples of that can include an inside round that is not an arms-length market-based transaction, pari passu liquidation preferences which can artificially inflate the required company value without consideration of the value transfer from the new round to the previous round, or the need to raise significant future rounds in order to get to an exit. In terms of how long after the round this technique is 'usable', it depends in part on how stable market conditions have been and whether or not something significant occurred within the company after the round closed (for example, a large customer left and so the forecasts on which the round valuation were based are no longer valid).

Q: Could forfeiture and volatility be different for 409A purposes and accounting purposes?

A: Forfeiture Rates are not used for the purpose of a 409A valuation. In terms of volatility, they can be different because the term can be different. For example, a 409A uses volatility in an option pricing model based on a term that is a proxy for an exit. The volatility for option expense purposes is based upon expected life of the options.

This foregoing Q&A Session is provided for your information only and does not take into account the specifics of your business. It is not a substitute for seeking legal advice and should not be relied upon as formal legal or business advice regarding your business transactions. Clients should obtain guidance from their counsel or advisors regarding all the information provided herein.

SVB Analytics is a non-bank affiliate of Silicon Valley Bank. EProsper is a majority-owned subsidiary of SVB Analytics and a non-bank affiliate of Silicon Valley Bank. Products and services offered by SVB Analytics and eProsper 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 System and it is the California bank subsidiary of SVB Financial Group, which is also a member of the Federal Reserve System. SVB analytics and eProsper do not provide tax or legal advice. Please consult your tax or legal advisors for such guidance.

© 2010 Silicon Valley Bank. All rights reserved. Member of FDIC and Federal Reserve.
Silicon Valley Bank, SVB, SVB> and SVB>Find a way are all registered trademarks. Rev. 06-15-10