

SVB ANALYTICS ONLINE SEMINAR

Understanding FAS 123R (FASB ASC 718)

BEYOND THE BASICS

Wednesday, February 10, 2010

Welcome

- Today's Speakers
 - Sean Scrol, President, Valtrinsic
 - Carolyn Fox, Manager, Client Services, SVB Analytics
 - Jann Calix, Director, Product Development CapMx[®], SVB Analytics (Moderator)
- Format for Today's Discussion

SVB Analytics

- SVB Analytics was formed to provide administrative and analytical solutions to private (mostly venture-backed) companies
- Our CapMx software is a leading solution for FAS 123R accounting; It also tracks and analyzes your complex cap tables
- With over 900 clients and a staff of 50, SVB Analytics is the largest provider of valuation services to address FAS 123R and IRS § 409A requirements
- Our unique research effort on valuations trends in the technology, life science and clean tech sectors covers more than 16,000 companies and 23,000 financings

Codification – FAS 123R is now FASB ASC 718

From the AICPA Web site:

- FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. generally accepted accounting principles (GAAP) by providing the authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force [EITF], and the AICPA) to organize them under approximately 90 topics. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.
- Although the FASB ASC project was not intended to change U.S. GAAP or any requirements of the SEC, it is a major restructuring of accounting and reporting standards in U.S. GAAP. FASB ASC significantly changes the way financial statement preparers, auditors, and academics perform accounting research.

Sean Scrol

Sean Scrol, President, Valtrinsic

Sean Scrol is a leading expert in stock compensation plans. Sean chairs the Society of Actuaries Stock Option Experience Study Task Force, which is producing the first national study of employee stock option exercise behavior. This study is referenced in recent Securities and Exchange Commission regulations and will be the basis for future stock option valuation regulations. Sean is also a resource on stock option issues for major publications such as *Business Week*, *CFO Magazine*, and *The Financial Times*. He has consulted on stock compensation issues for many Fortune 500 companies. Sean is a Fellow of the Conference of Consulting Actuaries and a Member of the American Academy of Actuaries.

Sean Scrol

President, Valtrinsic

Accounting Landscape

- Current accounting standards for share-based payments
 - FAS 123R, issued December 2004, current standard for US companies. Effective for fiscal years beginning after December 15, 2005 for private companies.
 - IFRS 2, issued February 2004, current standard for international companies. SEC approved a “Roadmap” to adopt IFRS for all US companies over next 3 to 4 years.
- Both standards require fair value measurement for stock compensation plans
 - Fair value based on valuation pricing models if observable market prices for equivalent securities are not available
 - APB Opinion 25 treatment, intrinsic value method, no longer available
- Both standards require grant-date measurement for employee awards and expense attribution over vesting schedule. Final expense based on number of awards that actually vest.

Non-employee Awards

- FAS 123R uses strict legal definition, Revenue Ruling 87-41, for employees. Accounting for non-employee awards is governed by EITF 96-18.
- EITF 96-18, in general, specifies vesting date as the measurement date for non-employee awards. Leads to mark-to-market accounting from grant date through vesting period.
- IFRS 2 specifies grant date measurement for employees “and others providing similar services”. In particular, applies to all management personnel.
- IFRS 2 uses actual value of goods and services for parties other than employees (and those providing similar services).

Non-employee Example

- Non-employee award of 1,000 options granted on January 1, 2007 and vesting on December 31, 2009 (cliff vesting)
- Stock price
 - \$5.00 on January 1, 2007 (exercise price is also \$5)
 - \$7.00 on December 31, 2007
 - \$8.00 on December 31, 2008
 - \$10.00 on December 31, 2009
- Option fair value
 - \$2.00 on January 1, 2007 (using \$5 stock price)
 - \$3.75 on December 31, 2007 (using \$7 stock price)
 - \$4.50 on December 31, 2008 (using \$8 stock price)
 - \$6.25 on December 31, 2009 (using \$10 stock price)

Non-employee Example

- Expense accrued over 3 year vesting schedule
- Expense accruals (assuming no forfeitures)
 - 2007: \$1,250 ($= \$3.75 \times 1,000 \times (1/3)$)
 - 2008: \$1,750 ($= (\$4.50 \times 1,000 \times (2/3)) - \$1,250$)
 - 2009: \$3,250 ($= (\$6.25 \times 1,000) - (\$1,250 + \$1,750)$)
- Mechanics of expensing
 - Each year uses new end-of-year stock price and fair value to estimate expense prior to vesting
 - Cumulative calculation includes expense adjustments to reflect new estimated fair values
 - Final total expense based on vesting date fair value

Non-employee – Additional Comments

- Outside Board Member – employee for expensing purposes (if grant was for board work; if grant was for consulting work, the grant will take Mark-to-Market expensing)
- Understanding EITF 96-18 and Mark-to-Market
- Quarterly vs. annual expensing for Mark-to-Market securities

AUDIENCE POLL QUESTION #1

Does your company issue non-employee awards?

- Yes
- No
- Not sure

SAB 107 and Expected Term

- SEC issued SAB 107 in March 2005 which provides guidance on
 - Setting the expected term assumption, including grouping employees and simplified method
 - Use of historical volatility and implied volatility from market traded options
- SAB 107 “simplified” method for setting expected term of “plain-vanilla” options
 - Most commonly used method for private companies
 - Plain-vanilla options
 - At-the-money options
 - Serviced based vesting, no performance conditions
 - Short time to exercise vested options after termination
 - Nontransferable and nonhedgeable
 - Formula sets expected term equal to average of vesting term and original contractual term for each vesting tranche. Final expected term is weighted average of calculated expected term for each vesting tranche.

SAB 107 Formula Example

- Grant of 3,000 options with 10 year contractual term
- Vesting Schedule
 - 1,000 options on first anniversary of grant
 - 500 options each six months thereafter for next two years
- Expected term (in years) by vesting tranche
 - $5.5 = (1 + 10) / 2$ (first tranche)
 - $5.75 = (1.5 + 10) / 2$ (second tranche)
 - $6.0 = (2 + 10) / 2$ (third tranche)
 - $6.25 = (2.5 + 10) / 2$ (fourth tranche)
 - $6.5 = (3 + 10) / 2$ (fifth tranche)
- Final expected term (in years)
 - $5.92 = [(1,000/3,000) * (5.5)] + [(500/3,000) * (5.75)] + [(500/3,000) * (6.0)] + [(500/3,000) * (6.25)] + [(500/3,000) * (6.5)]$

SAB 107 Formula Status

- Original SAB 107 formula available only for grants made through December 31, 2007
- In December 2007, SEC issued SAB 110 which amends the use of the SAB 107 simplified formula. Allows continued use of formula when there is
 - Insufficient historical data
 - Significant changes to terms of new options grants
 - Anticipated significant structural changes to business
- Disagreement among auditors about application of formula when “vesting start date” differs from grant date
- Many auditors interpret EITF 96-18 to require full contractual term for valuing non-employee options. Auditors allowing SAB 107 for non-employees disagree about its use when re-measuring over vesting schedule.

Volatility for Private Firms

- Historical stock price data usually not be available for private companies and for companies that recently became public
- FAS 123R allows private companies to use “calculated value” for equity awards rather than fair value
- Calculated value is similar to fair value with historic volatility of an appropriate industry sector index used instead of the expected volatility of the entity’s share price
- Many auditors insist on use of peer group average rather than industry sector. Peer group averages are usually 2 to 3 times higher than industry sector volatilities.

409A Issues

- 409A imposes steep tax penalties for *employees* who are granted in-the-money options
- Auditors reviewing FAS 123R valuations are looking at changes over time in 409A valuations and are sometimes claiming that many employee options should be valued as in-the-money at grant
- Typical example, early 2008 409A valuation gave \$0.35 stock price which company used for all 2006 grants. Early 2009 409A valuation gave \$0.95 stock price. Some auditors want to say many 2008 grants were in-the-money, especially mid and late year grants.
- Volatility used for 409A is not comparable to volatility needed for FAS 123R

AUDIENCE POLL QUESTION #2

What types of share-based payment awards does your company issue?

- Options
- Restricted Stock Awards
- Restricted Stock Units
- SARs
- Cash Settled Awards
- Performance-based Awards

Treatment of Forfeitures

- Original FAS 123 allowed a company to choose between
 - Assuming a 0% forfeiture rate and accounting for forfeitures as they occurred, or
 - Assuming a nonzero forfeiture rate and adjusting as necessary
- FAS 123R and IFRS 2 both allow only the second option – companies must make an assumption as to how many options will ultimately vest and recognize expense based on that number with subsequent adjustments as necessary

Forfeiture Expense Example

- January 1, 2007 option grant to group of employees
 - 1,000,000 options granted in total
 - Options vest over 3 years (cliff vesting)
 - Grant date option fair value is \$1.50
 - Company estimates that only 800,000 options will vest
- Initial annual expense accrual is \$400,000 ($= \$1.50 \times 800,000 \times (1/3)$) for 2007, 2008, and 2009
- If final number of options that vest is 850,000 then there will be an additional 2009 expense adjustment of $\$75,000 = (\$1.50 \times 850,000) - (\$400,000 + \$400,000 + \$400,000)$

Determination of Forfeiture Rate

- Two most common methods are aggregate method and annualized forfeiture rate method
- Aggregate method
 - Simple “haircut” approach
 - Single estimate of expected *total* forfeitures over vesting schedule
 - Different vesting schedules require different aggregate rates
 - Difficult to revise mid-stream
- Annualized forfeiture rate
 - Estimate of *annual* forfeitures
 - Applied exponentially to each vesting tranche
 - Applied uniformly to any vesting schedule and simplifies mid-stream revisions

Forfeiture Rate Example

- Grant of 4,000 options that vest 25% annually
- Assuming 10% *annual* forfeiture rate then number of options expected to vest by tranche is
 - 900 ($= 1,000 \times (1 - 0.1)^1$) (first tranche)
 - 810 ($= 1,000 \times (1 - 0.1)^2$) (second tranche)
 - 729 ($= 1,000 \times (1 - 0.1)^3$) (third tranche)
 - 656 ($= 1,000 \times (1 - 0.1)^4$) (fourth tranche)
- Total expected to vest for this grant is 3,095 options
- Equivalent *aggregate* forfeiture rate would be 22.625% ($= 1 - (3,095 / 4,000)$)
- Note that assuming 10% *aggregate* rate would have produced expected to vest of 3,600 ($= 4,000 \times (1 - 0.1)$)

Expense Attribution for Graded Vesting

- FAS 123R allows companies to make a policy decision for expensing awards with graded vesting (e.g. 25% vesting per year)
 - Straight-line over entire vesting schedule
 - FIN 28 approach of expensing each tranche separately over respective vesting periods
- IFRS 2 does not allow for straight-line expensing. All awards are expensed using FIN 28 approach.

Graded Vesting Attribution Example

- January 1, 2007 grant of 3,000 options vesting one-third per year
- Option fair value is \$3
- Assuming no forfeitures, total expense will be \$9,000
- FIN 28 approach (each tranche separately)
 - 2007 expense: $\$5,500 = [\$3 \times 1,000] + [\$3 \times 1,000 \times (1/2)] + [\$3 \times 1,000 \times (1/3)]$
 - 2008 expense: $\$2,500 = [\$3 \times 1,000 \times (1/2)] + [\$3 \times 1,000 \times (1/3)]$
 - 2009 expense: $\$1,000 = [\$3 \times 1,000 \times (1/3)]$
- Straight-line approach, annual expense each year is \$3,000 (= \$9,000 / 3)

FAS 123R Income Tax Effects

- FAS 123R requires calculation of ongoing “APIC Pool”. IFRS 2 does not have an “APIC Pool” requirement.
- Deductible temporary difference
 - Compensation cost is accrued beginning at grant date and is based on fair value measurement
 - Tax deduction is not realized until exercise and is based on intrinsic value measurement
 - Upon grant, deferred tax asset (sometimes deferred tax liability) is established
- Deferred tax asset is not adjusted because of general changes in the company’s share price over the life of the award
- Upon exercise of options, if realized tax benefit is greater than the deferred tax asset, the “excess tax benefit” is recognized as additional paid-in capital

FAS 123R Income Tax Effects

- Upon exercise or expiration of options, if realized tax benefit is less than the deferred tax asset
 - Write-off of deferred tax asset is first applied to additional paid-in capital to the extent there is remaining excess tax benefits from previously exercised awards
 - If write-off of deferred tax asset exceeds available cumulative excess tax benefits then remaining write-off is recognized as an expense on the income statement.
- If APB Opinion 25 has been used, amount available for offset is the net amount of excess tax benefits that would have been accumulated had the company been using FAS 123R from the original effective date (December 15, 1995)
- Can use all award types that fall under FAS 123R in calculating offset

FAS 123R– Disclosure Requirements

- FAS 123R paragraph A240
- Issues with early exercise

AUDIENCE POLL QUESTION #3

Has your company undergone a repricing?

- Yes – in the last 12 months
- Yes – in the last 24 months
- No
- No, but we plan to within the next 12 months

Questions

Thank You

- If we did not get to your question, please e-mail us at svba@svb.com
- Our white paper on FAS 123R (FASB ASC 718) is now available and will be e-mailed to you
- For a quick and simple software solution to your FAS 123R (FASB ASC 718) accounting headaches, e-mail us svba@svb.com for more information on our CapMx solution

Upcoming Online Seminars

- Look for our upcoming Repricing seminar in March
- Visit www.svb.com for additional information

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