

SVB ONLINE SEMINAR

# Private Lives: Stock Option Expensing and Minimum Disclosure Requirements for Private Companies

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# Panelists

- Elizabeth Dodge – Vice President, Stock & Option Solutions, Inc.
- Jay Seliber – Audit Partner, PricewaterhouseCoopers, LLP
- Jannet Calix – Director, Product Development, SVB Analytics – eProsper
- Carolyn Fox – Manager, SVB Analytics – eProsper (Moderator)

# Agenda

- Valuation of Stock (409A Valuations)
- Accounting
- Disclosure
- Modification

# The Fine Print

The following discussion and examples do not necessarily represent the official views of Stock & Option Solutions, Inc., Silicon Valley Bank or PricewaterhouseCoopers with respect to any of the issues addressed. Moreover, this presentation and the views expressed by the individual presenters should not be relied on as legal, accounting, auditing, or tax advice. The outcome of any individual situation depends on the specific facts and circumstances in which the issue arises and on the interpretation of the relevant literature in effect at the time.

# Valuations

Jay Seliber

Audit Partner

PricewaterhouseCoopers

# Valuation

- IRS code section 409A requires a valuation report by an independent appraiser/ “qualified” individual at least annually
- If significant events occur between annual valuation dates, should consider performing another valuation
- Tax implications on individual can be significant
- AIPCA guide on valuation of private company stock is relevant for accounting purposes

# Valuation Considerations

- Key factors that go into the valuation process:
  - Cash flow forecasts
  - Market comparables
    - Public companies – consider relevant multiples such as revenue, EBITDA, Sale transactions
  - Company stage of life cycle
    - Technology
    - Customers
    - Management team
  - Other financing transactions (i.e. preferred stock)

# Valuation Considerations: Alphabet Soup

- Key models:
  - DCF (discounted cash flows)
  - OPM (option pricing model)
  - PWERM (probability-weighted expected returns method)
  - Liquidation approach/current value method
- Key assumptions:
  - WACC (weighted-average cost of capital)
  - DLOM (discount for lack of marketability)
  - Capitalization rate/terminal value



# Valuation Considerations: What Will the Auditor Look At?

- Will depend on stage of company
- Overall enterprise value in relation to invested capital
- Key assumptions
- Market comparables
- Comparison to outside financing transactions
- Trends from period to period
- Life cycle events

# Accounting

Elizabeth Dodge

Vice President

Stock & Option Solutions

# Definitions: The FASB

- Financial Accounting Standards Board
- Sets accounting standards
- Publications / **Codification**:
  - Standards: FAS or SFAS
    - FAS 123(R) / **ASC 718**
    - FAS 109 / **ASC 740**
    - FAS 128 / **ASC 260**
  - Interpretations: FASB Interpretation Number (FIN)
    - FIN 28 / **ASC 718-10-35-8**
  - Emerging Issues Task Force (EITF)
    - EITF 96-18 / **ASC 505**
  - FASB Staff Technical Bulletins
    - FTB 97-1 / **ASC 718-50**

# Definitions: Option-Pricing Model

- Way to assign value to an Option
  - Created for market-tradable options (porkbellies, corn futures, etc.)
- Required by FASB to generate “fair value” for employee options
  - How do you know how much an option will be worth? You don't!
- Types
  - Black-Scholes
    - By far most common
  - Binomial (Lattice)
    - Used by a few companies
    - Many different models = many different values
  - Monte Carlo
    - Used for market-based performance awards

# Concept: Black-Scholes Input Impact

Input	Impact	Rationale
Market Value	▲	Stock worth more, option worth more
Strike Price	▲	(Assuming strike price = market value, same as market value) If market value held constant, higher strike = lower value, \$20 strike, \$10 market value, not worth as much
Dividend Yield	▼	Don't get the dividends when you have an option, higher dividends = more you're missing!
Risk-free Interest Rate	▲	Higher interest rates = time value of not paying for stock worth more
Volatility	▲	Greater the volatility = greater the chance the price will go way up
Expected Term	▲	Longer to exercise = more time to increase in value

# Performance Grants: Accounting Treatment

	Performance-based	Market-based
Accrual	Variable based on probable payout	Even accrual over service period
	Pitfalls: <ul style="list-style-type: none"> <li>➤ More work ongoing</li> <li>➤ Expense can be volatile</li> </ul>	Perks: <ul style="list-style-type: none"> <li>➤ No ongoing work</li> <li>➤ Expense fixed and known</li> </ul>
Reverse Expense if Forfeited?	Yes	No
	Perk: Recover expense if goals not met	Pitfall: No expense recovery if goals not met
Valuation Model	Stock price (RSA/RSU); Black-Scholes (options)	Monte Carlo, other lattice models
	Perk: Simpler model	Pitfall: More work up front

\*Must set performance goals (at grant) in order to have a “grant date” for accounting purposes.

# Expected Term

- Perhaps most difficult input to calculate
- Generally based on historic data + assumptions about future
  - If using company history, be sure to consider remaining life cycle of outstanding options
- Private Companies
  - Can continue to rely on SAB 107
  - Life extended by SAB 110
  - Mid-way point between vest and expiration
  - 10 year grant – 4 year vest = 7 year expected term
    - $(10 - 4 / 2) + 4$
    - $(\text{Expiration} - \text{vest} / 2) + \text{vest}$

# Historical Volatility

- Also known as “Look-back” volatility
- Reflects *only* past behavior of stock
- Generally calculated as far back as remaining term of the employee stock option
- If stock not publicly-traded, or is thinly-traded, historical volatility of publicly-traded comparable companies might be used
- Drawback:
  - Expected volatility should be estimated going forward, not back

# Accrual / Attribution Method

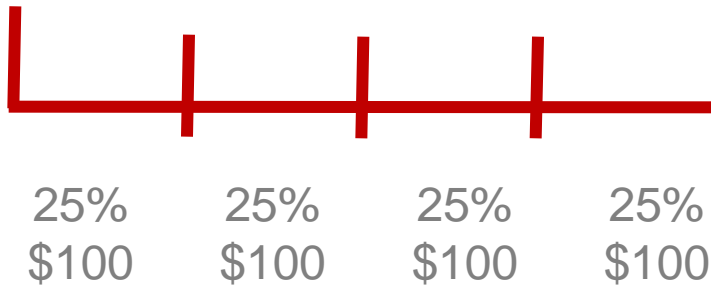
- 718-10-35-8: An entity shall make a policy decision about whether to recognize compensation cost for an award with only a service condition that has a graded vesting schedule in either of the following ways:
  - a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards
  - 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.)
- But must have recognized expense for all vested shares
- A: Also known as:
  - Accelerated attribution, multiple method, FIN 28

# Accrual

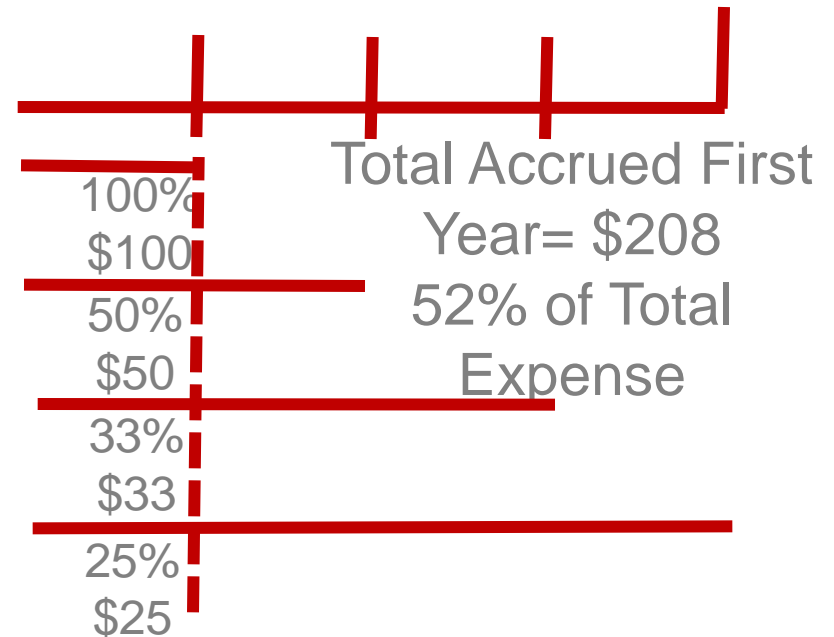
- Most companies use straight-line
  - Don't like the "front-loaded" expense of the "Multiple" approach
- Vesting "locks in" expense for a grant
  - If participant terminates *before* vesting, you can reverse expense
  - Once vested expense cannot be reversed
    - Even if grant is underwater and participant never exercises
    - No employee benefit realized, but the company must take the expense

# Tranche-by-Tranche Attribution Method

Straight-line Attribution  
 \$400 Grant-date  
 Fair Value  
 4-year Annual Vesting



Tranche-by-Tranche Attribution  
 \$100 Grant-date  
 Fair Value per Tranche  
 4-year Annual Vesting



# Tranche-by-Tranche Accrual

- Also required for
  - Most performance grants
  - Non-employee Grants
    - Other than Outside Directors
      - Outside directors can use employee treatment
    - Treatment varies in other ways as well
  - Required under IFRS 2 for all share-based compensation

# Non-Employee Grants

- Non-employee Grants
  - Measurement Date = Vest Date
    - Not Grant Date as with employee grants
  - Expected Term = Contractual Term
    - (time until expiration)
  - Tranche-by-tranche valuation & accrual
  - **Revalued each quarter with current assumptions until vest date**
    - Trued up each quarter
    - Then expense completed/locked down

# Employment Status Changes

- No impact if:
  - Grants fully vested
  - No changes to grants at status change
- Employee to Contractor
  - No modification: Unvested portion accounted for as if granted to non-employee
  - Modification: Type III:
    - Prior expense for unvested shares reversed
    - New fair value calculated and accrued under non-employee accounting for entire unvested award

# Employment Status Changes

- Contractor to Employee
  - No modification:
    - Unvested shares/portion: new fair value assigned on grant date, accrued over remaining service period
  - Modification: Type III (unlikely to be modified)
    - Prior expense for unvested shares/portion reversed
    - New fair value calculated fixed on change in status date
  - Attribution method changed if tranche-by-tranche accrual not in use

# Forfeiture Rates

Elizabeth Dodge

Vice President

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# Forfeiture Rate Introduction

- FAS 123(R) / Topic 718 requires that expense for equity compensation be reduced by an expected forfeiture rate
  - Rationale: to produce even accruals over service period
  - 718 – 10 – 35 – 3 Forfeiture Rates



**35-3** 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. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

# Calculating Forfeiture Rates

- Historic data most frequently used
- Turnover rate?
- What if substantial historic data is not available?
  - Reassess frequently
- Peer groups for private companies?

# Rolling 12 months/average

Take the forfeiture rate (aggregate) for each of the last 12 months and use a weighted average

Jan – 10%

Feb – 12%

March – 15%

April – 8%

May – 20%

June – 20%

Average of 12 months = 12.33%

July – 20%

Aug – 10%

Sept – 15%

Oct – 8%

Nov – 5%

Dec – 5%

Note: Since this is monthly and a rolling average comparison, this may be a comparison of unvested or outstanding shares to forfeited shares

# Forfeiture Rate Calculation

- Make sure your calculation is defensible
- Make sure your calculation is easily repeated
- Make sure your calculation matches the attribution method
  - Aggregate / Flat vs. Annualized
- Common Mistakes
  - Excel miscalculations
  - Calculating an “aggregate rate” but application of rate is annual
  - Weighted average used/overstating true rate
  - Not updating rate when circumstances change

# Materiality Analysis

- What if you only have:
  - 3 grants?
  - 10 grants?
  - 30 grants?
- Can you use zero forfeiture rate?

# Forfeiture Rate Types

## Annualized Forfeiture Rates

Most Frequently Used

What % of grants forfeited annually?

5% chance *each year* of forfeiting

Same rate can be used for grants with different service periods

Formula to apply:

- o Service Period = Vest Date minus Grant Date

$(1 - \text{Rate})^{\text{Service Period}}$

**Match estimation to application**

## Flat/Aggregate Forfeiture Rates

Haircut by set amount

Example: 5% off the top

Problems:

- o Not very complex or flexible
- o Does not take varied vesting schedules into account
- o Tends to overstate forfeiture rate when applied

**Match estimation to application**

# Applying Forfeiture Rates: Static Method

- True Up at Vest (Static)
  - Use same rate over the service period (if nothing changes)
  - Wait until vest date to true up
  - Examples given in ASC 718 (formerly known as 123R)
  - Use full service period to apply forfeiture rate
  - Forfeited grants remain on accrual reports until after FINAL vest date
  - If forfeiture rate accurate = even accrual over time
  - If forfeiture rate inaccurate, large true ups common
- Example
  - 4-year, cliff vesting
  - $(1-5\%)^4$
  - $= .95 * .95 * .95 * .95$
  - = 81% Expected to Vest Rate

# Vest Date True Up

- Stop applying Forfeiture Rate once tranche vests – true up to 100% expense
  - Comply with ASC 718-10-35-8 (formerly paragraph 42 of 123R):
    - “... 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.”

# Applying Forfeiture Rates: Tranche-specific Forfeiture Rate

- True Up at Vest (Static)
- Example
  - 4-year, graded vesting

Tranche	Service Period	Applied	Result	Note
1	1	$(1-5\%)^1$	95%	Used while first tranche accrues – trued up to 100% at vest.
2	2	$(1-5\%)^2$	90%	Used while 2 <sup>nd</sup> tranche accrues – trued up to 100% at vest.
3	3	$(1-5\%)^3$	86%	Used while 3 <sup>rd</sup> tranche accrues – trued up to 100% at vest.
4	4	$(1-5\%)^4$	81%	Used while 4 <sup>th</sup> tranche accrues – trued up to 100% at vest.

# Applying Forfeiture Rates: Dynamic Method

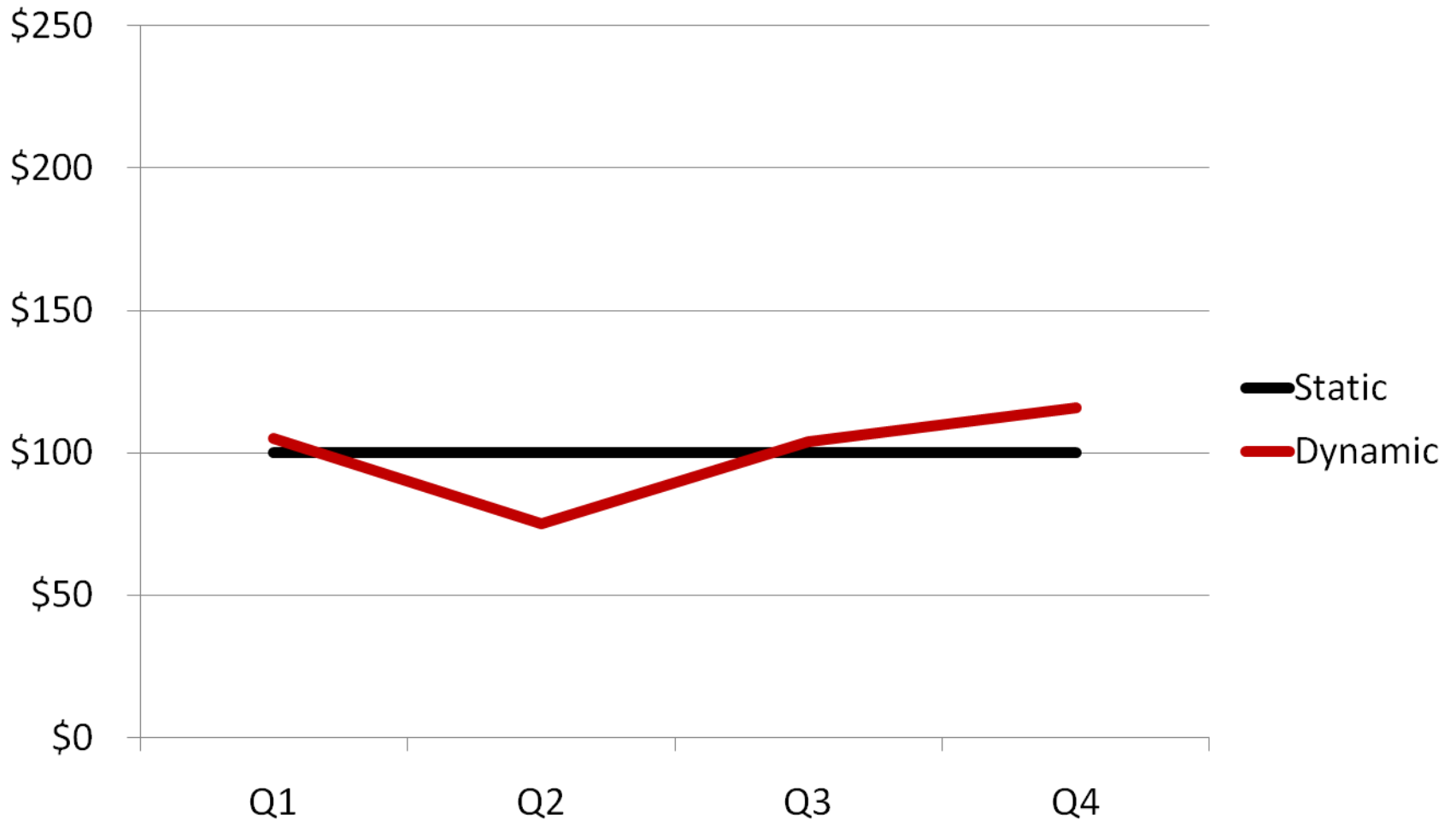
- True Up at Termination (Dynamic)
  - Rate *changes* over service period
  - Reverse all accrued expense at termination, stop accruing for forfeited grants
  - Developed after the release of ASC 718
  - Use remaining service period to apply forfeiture rate
  - Less even accrual over time, however...
  - If forfeiture rate inaccurate, true ups are smaller, more frequent
- Example on next slide

# Applying Forfeiture Rates: Dynamic Method

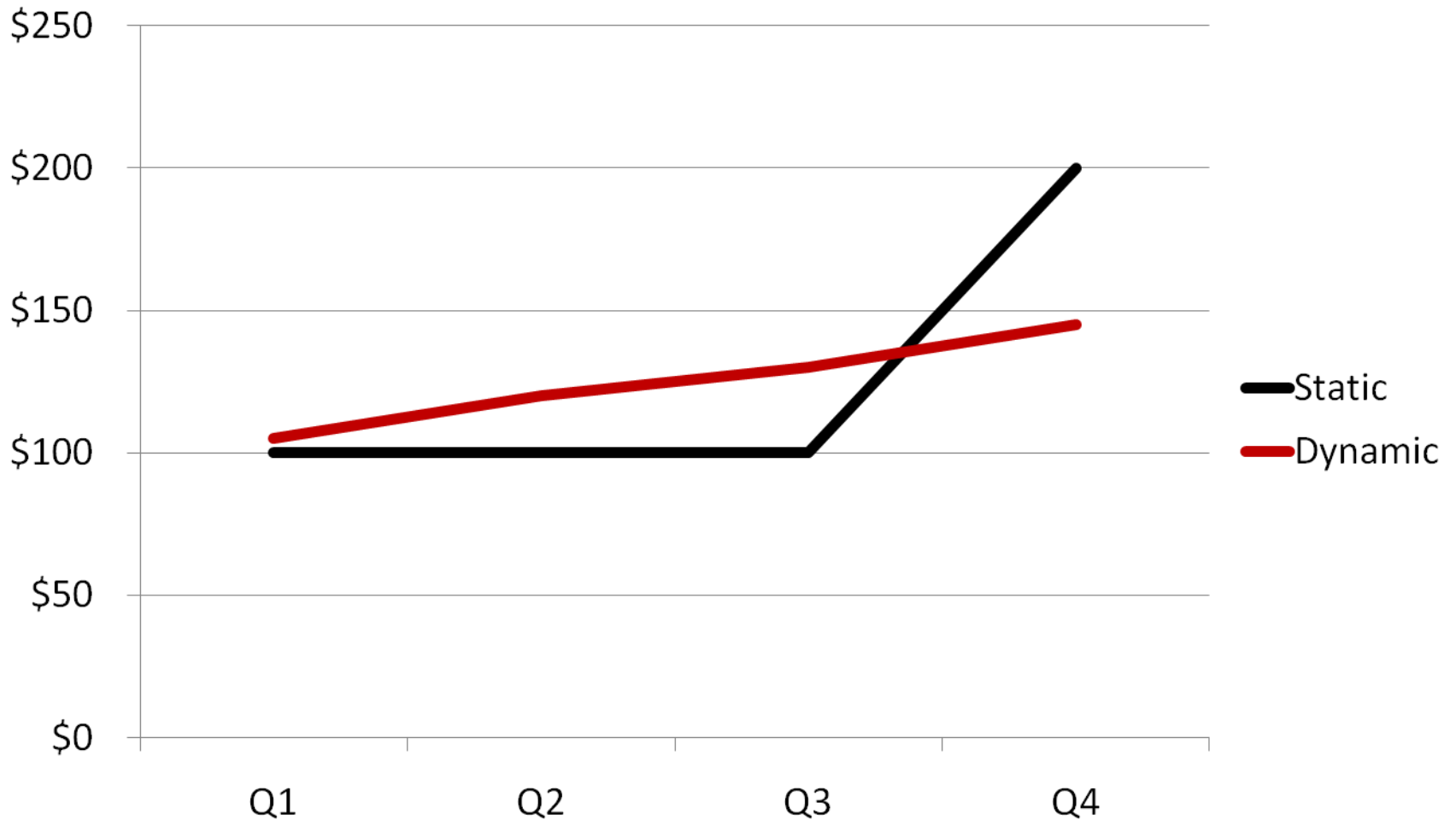
- Example
  - 4-year, cliff vesting

End of Quarter	Remaining Service Period	Applied	Result
1	3.75	$(1-5\%)^{3.75}$	83%
2	3.5	$(1-5\%)^{3.5}$	84%
3...	3.25	$(1-5\%)^3$	86%
8...	2	$(1-5\%)^2$	90%
12...	1	$(1-5\%)^1$	95%
15	.25	$(1-5\%)^{.25}$	99%
16	0	$(1-5\%)^0$	100%

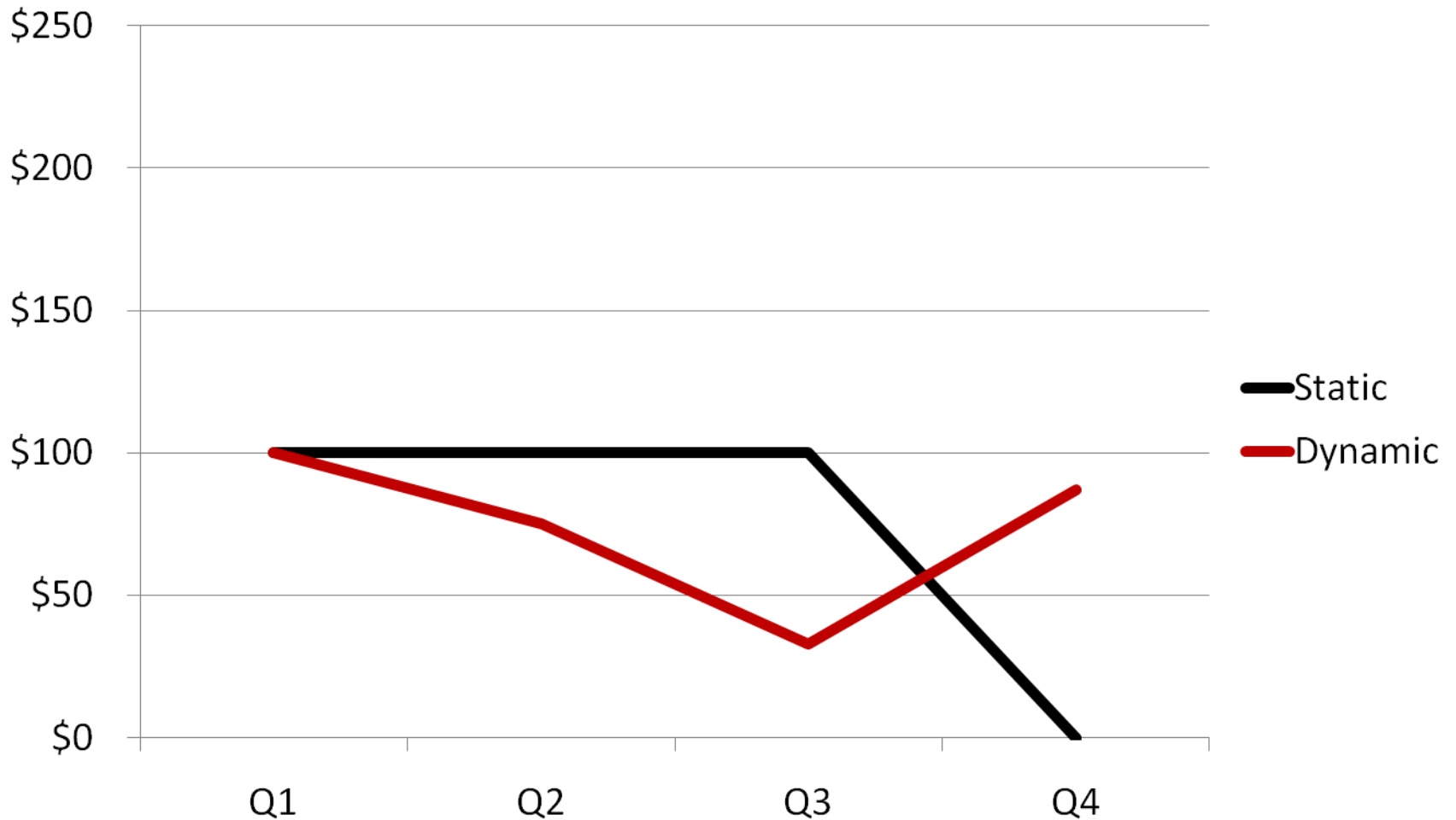
# Static vs. Dynamic: Accurate Rates



# Static vs. Dynamic: Rate Too High



# Static vs. Dynamic: Rate Too Low



# Pros & Cons

	Pros	Cons
Static	<ul style="list-style-type: none"> <li>• Perfectly even accrual if forfeiture perfectly accurate</li> <li>• Examples in the standard use this method</li> </ul>	<ul style="list-style-type: none"> <li>• Not intuitive</li> <li>• Large company events must be included in estimated rate (execs leaving, RIFs, etc.)</li> </ul>
Dynamic	<ul style="list-style-type: none"> <li>• Less dramatic swings in expense if estimate not accurate</li> <li>• Takes time into account</li> <li>• More intuitive?</li> <li>• Some Big 4 firms call “best practice”</li> </ul>	<ul style="list-style-type: none"> <li>• No documentation – not in standard, etc.</li> <li>• Difficult to perform calculations in a spreadsheet</li> <li>• More complex, more effort to prove</li> </ul>

Combining methods of application can result in large true ups in expense.

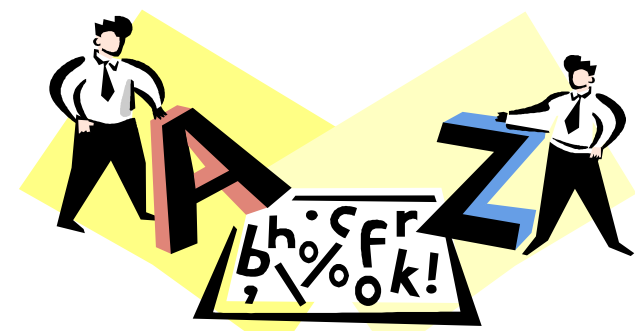
# Disclosures

Jannet Calix

Director, Product Development  
SVB Analytics

# Minimum Disclosures – Requirements

- With ASC 718 (FAS 123R), companies are required to provide investors more details into the who-what-when-where-why-how of the company’s share-based securities – for private companies, typically options and restricted stock. It’s almost as if companies are being asked to show the “A – Z” of options, restricted stock, and any other share-based compensatory security issued by the company.
- The basics per Paragraph 64 of the FAS 123R Statement:
- An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand:
  - a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders



# Minimum Disclosures – Requirements

- b. The effect of compensation cost arising from share-based payment arrangements on the income statement
  - c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period
  - d. The cash flow effects resulting from share-based payment arrangements
- Paragraphs A240 and A241 indicate the minimum information needed to achieve those objectives and illustrate how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond that listed in Paragraph A240 to achieve the disclosure objectives.
  - The “supplemental” disclosures are referenced in Paragraph A242.

**The disclosure requirements in Paragraph A240 are now found in  
FASB ASC 718-10-50**

# Minimum Disclosures – Rationale



- So we got the expense values, now what?
- “Equity” values are not necessarily the same as “disclosure” values.
- What would a potential investor want to know about the company?
- What does an existing investor want to know about the company?
- Presentation of the information in a clear, concise manner.
- Math??? Make it easy to understand (i.e., tables are appreciated).

# Minimum Disclosures – Is That All There Is?

- There are “required” Minimum Disclosures (FAS 123R paragraph A240)
- Then there are “supplemental” disclosures (FAS 123R paragraph A242)
- The “required” Minimum Disclosures are only the starting point – always keep in mind the expectation is that the company will disclose supplemental information if it is useful to the financial statement reader and does not impair the credibility of the required disclosures.

# Minimum Disclosures – What are They?

- The following are usually presented as text narratives because they are primarily descriptive, as opposed to numerical, in nature:
  - The general terms and substantive conditions of share-based payments, such as requisite service periods, vesting schedules, maximum contractual terms, number of shares authorized and methods used for measuring compensation cost
  - Details regarding significant modifications, including the terms of the modifications, the number of employees affected and the total incremental compensation cost resulting from the modifications
  - The company's policy, if any, for issuing shares upon option exercise or share unit conversion, including the source of those shares, and an estimate of the number of shares expected to be repurchased during the following annual period in connection with such policy

# Minimum Disclosures – What are They? *Cont'd*

- Information related to changes in share-based payments for the current year. The following items are much easier to present in tabular form and readers find such tables easier to understand (FAS 123R Paragraph A241 provides the examples):

Options	No. of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at FYB				
Granted			n/a	n/a
Exercised*			n/a	n/a
Forfeited or Expired			n/a	n/a
Outstanding at FYE				
Exercisable at FYE*				

# Minimum Disclosures – What are They? *Cont'd*

- *Exercised and Exercisable at FYE* – vested shares, only
- If your company allows “early exercise”, i.e., exercise prior to vesting, break-out the values separately
  - How many exercised shares are unvested at FYE
  - How many unvested shares are exercisable at FYE

# Minimum Disclosures – What are They? *Cont'd*

Information related to changes in nonvested shares for the current year.

Nonvested Shares	No. of Shares	Weighted-Average Grant-Date Fair Value	Total Unrecognized Compensation Cost	Weighted-Average Period over which Cost is Expected to be Recognized
Outstanding at FYB			n/a	n/a
Granted			n/a	n/a
Vested			n/a	n/a
Forfeited			n/a	n/a
Nonvested at FYE				

# Minimum Disclosures – What are They? *Cont'd*

Information related to the valuation assumptions used in calculating fair value for the last *three* fiscal years.

	FYE 2008	FYE 2009	FYE 2010
Expected Volatility			
Weighted-Average Volatility			
Expected Dividends			
Expected Term (in years)			
Risk-Free Interest Rate			

# Minimum Disclosures – What are They? *Cont'd*

The trickiest disclosure..

The infamous...

The dreaded...



## Vested and Expected to Vest

- Seems so innocent on its face, a simple calculation of:  
“Vested Shares plus Shares Expected to Vest”
- “Vested Shares” = shares that are (a) vested and (b) outstanding at FYE
- “Shares Expected to Vest” = shares that are (a) projected to vest per the application of the Forfeiture Rate and (b) outstanding at FYE

# Minimum Disclosures – What are They? *Cont'd*

Additional information for the last *three* fiscal years.

	FYE 2008	FYE 2009	FYE 2010
Weighted-Average Grant-Date Fair Value of Option Granted			
Total Intrinsic Value of Options Exercised			
Total Compensation Cost Recognized			
Total Income Tax Benefit Recognized from Share-Based Payments			
Total Compensation Cost Capitalized			

# Minimum Disclosures – What are They? *Cont'd*

- Other standard disclosure tables:
  - Option Plan Roll-forward (for each FY thru current FYE)
    - Plan increase/decrease
    - Granted
    - Exercised
    - Forfeited
    - Expired
    - Repurchased
    - Year End Balance
  - Options Outstanding and Exercisable (by Exercise Price/Range)
    - Outstanding Shares
      - No. of Shares
      - Weighted Average Remaining Contractual Life
      - Weighted Average Exercise Price
    - Exercisable Shares
      - Vested Shares
      - Unvested Shares
      - Weighted Average Exercise Price

# Modifications

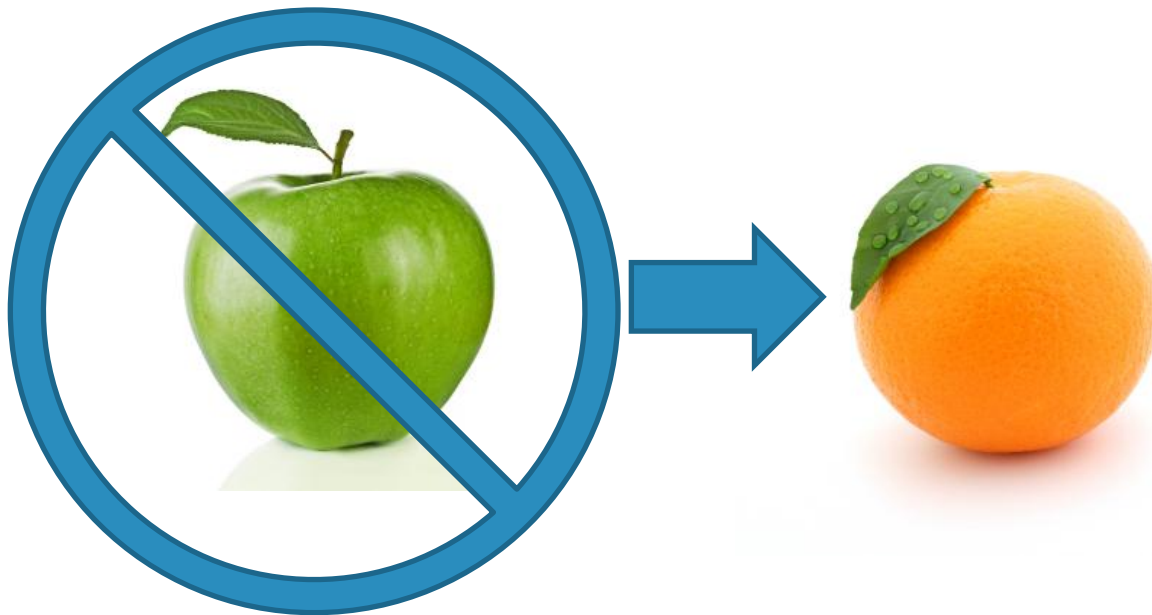
Elizabeth Dodge  
Jannet Calix

# What Triggers Modification Accounting?

- Changes to option/award not in original terms of grant
  - Option Exchanges
    - Repricings, Option-for-option, Option-for-RSU, Option-for-cash
    - “Value-for-value” + NO incremental expense still accounting impact
  - Restructuring (some spin-off /stock-split transactions)
  - Acquisitions
  - Other changes to original terms of grant
    - Extension of exercise grace period
    - Allow consultant to retain option after termination
    - Acceleration of vesting
    - 409A Exchanges – upward repricing
    - Changes to performance conditions
  - Etc.

# What is Modification Accounting?

- 718-20-35-3: A modification of the terms or conditions of an equity award shall be treated as **an exchange of the original award for a new award**.



# Incremental Expense

- ASC Topic 718
  - Type I Modifications:
    - Generally continue to account for original award, plus account for “incremental cost” of replacement award
      - Incremental cost = excess of fair value of new award over current fair value of original award
      - No negative incremental cost



=



# Types of Modification Accounting Under Topic 718

Before ↓ After → Modification	Probable	Improbable
Probable	<b>Probable to Probable Type I</b> Example 13(a) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any	<b>Probable to Improbable Type II</b> Example 13(b) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any
Improbable	<b>Improbable to Probable Type III</b> Example 13(c) & (e) Fair value of new grant only	<b>Improbable to Improbable Type IV</b> Example 13(d) Fair value of new grant only

\*Not applicable if vest schedule not changed – goals before & after modification are the same.

# Expected Term for Original Options

## Expected Term

- Normal methods for valuing at-the-money option grants, unlikely to be appropriate
- Remaining contractual term?
  - Most aggressive
  - Longer term = higher value for current option = less incremental expense
- SAB 107?
  - Says should only be used for at-the-money awards
- Binomial model / Monte Carlo Simulation
  - Account for “underwateriness” of options when calculating possible outcomes

# Extension of Exercisable Period (Example)

## Company ABC grants

- o 10,000 stock options on 1/1/2007
- o 1-year cliff vesting (vested already on 1/1/2008)
- o Strike price of \$10
- o Original fair value of stock options \$5

## On 1/1/2009, participant terminates

- o Market Value \$5
- o Since options have no intrinsic value
- o Company ABC elects to extend the exercisable period post-termination from 30 days to 5 years

What are the accounting ramifications of the modification?

•\*Slide courtesy of Radford Valuation Services



# Extension of Exercisable Period

Modification requires valuation before and after

Immediately before modification:

- o Participant has **30 days** to exercise
- o Expected life in determining fair value = 30 days

Immediately after the modification:

- o Participant has **5 years** remaining on contractual term
- o No longer employee, refer to EITF 96-18
- o Generally, company should calculate fair value using the full contractual term of 5 years

(In certain circumstances, when company can illustrate that non-employees exercise sub-optimally, company can select an expected life shorter than the contractual term. )

\*Slide courtesy of Radford Valuation Services

# Extension of Exercisable Period - Answer

Any incremental cost should be recognized immediately. Even if new vesting is added which restricts exercise, **since there is no risk of forfeiture**, incremental expense should be recognized in the current reporting period.

	Immediately Before	Immediately After	Incremental
Stock Price	\$5.00	\$5.00	
Strike Price	\$10.00	\$10.00	
Expected Life	0.0833	5.0000	
Black-Scholes Fair Value	\$0.00	\$1.31	\$1.31
Number Modified	10,000	10,000	10,000
Expense	\$0	\$13,085	\$13,085

\*Slide courtesy of Radford Valuation Services

# Tax Accounting for Modifications

- Both the old (original) and the new (incremental) expense tied to new grant
  - Both used when determining excess or deficiency for tax accounting purposes
  - Deferred tax assets (DTA) from both old and new grant are reversed at time of settlement
  - **Published guidance on this treatment is scarce**
    - Prevailing practice – may be diversity in practice

# Other Common Pitfalls

- Founders' stock
- Repurchase features
  - Can trigger liability accounting if not structured correctly
- Providing liquidity to common stockholders
- Loans

# Appendix

# Static Method: Accurate Rate

Example: 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
2	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
3	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
4	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
5	\$20	\$20	\$20	-\$60	Forfeited in 2 <sup>nd</sup> Qtr. True up to \$0 in vest quarter.
	\$100	\$100	\$100	\$100	\$400

# Static Method: Inaccurate Rate

## Example:

- o 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate
- o No grants forfeited

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
2	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
3	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
4	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
5	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
	\$100	\$100	\$100	\$200	\$500

# Static Method: Inaccurate Rate

## Example:

- o 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate
- o 40% of grants forfeited

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
2	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
3	\$20	\$20	\$20	\$40	True up to \$100 in vest quarter.
4	\$20	\$20	\$20	\$-60	Forfeited in 2 <sup>nd</sup> Qtr. True up to \$0 in vest quarter.
5	\$20	\$20	\$20	\$-60	Forfeited in 3 <sup>rd</sup> Qtr. True up to \$0 in vest quarter.
	\$100	\$100	\$100	\$0	\$300

# Dynamic Method: Accurate Rate

## Example:

- o 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
2	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
3	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
4	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
5	\$21	-\$21	\$0	\$0	Forfeited in 2 <sup>nd</sup> Qtr. True up to \$0 in vest quarter.
	\$105	\$75	\$104	\$116	\$400

# Dynamic Method: Inaccurate Rate

## Example:

- 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate
- No grants forfeited

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
2	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
3	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
4	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
5	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
	\$105	\$120	\$130	\$145	\$500

# Dynamic Method: Inaccurate Rate

## Example:

- o 5 grants, \$100 fair value, one-year vesting, 20% forfeiture rate
- o 40% of grants forfeited

Grant #	1 <sup>st</sup> Qtr	2 <sup>nd</sup> Qtr	3 <sup>rd</sup> Qtr	4 <sup>th</sup> Qtr	Comment/Total
1	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
2	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
3	\$21	\$24	\$26	\$29	True up to \$100 in vest quarter.
4	\$21	-\$21	\$0	\$0	Forfeited in 2 <sup>nd</sup> Qtr. True up to \$0 in vest quarter.
5	\$21	\$24	-\$45	\$0	Forfeited in 3 <sup>rd</sup> Qtr. True up to \$0 in vest quarter.
	\$100	\$75	\$33	\$87	\$300

# Tax Accounting 101

- Corporate tax deduction for NQ/RS/RSU at exercise or delivery
  - To anticipate future deduction, company books
    - Deferred Tax Asset (DTA) as expense accrues (**expense** \* corporate tax rate) <sup>1</sup>
  - At settlement, true up DTA to ACTUAL Tax Benefit
  - Consider valuation allowances for DTA, but not current stock price

If	Result	Impact
Actual Tax Benefit > DTA	Excess / Windfall	Increase APIC
Actual Tax Benefit < DTA	Deficiency / Shortfall	Decrease APIC / Increase Tax Expense

<sup>1</sup> At same time Deferred Tax Benefit reduces income tax expense.

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