FENWICK & WEST LLP

Executive Compensation and Benefits

New Accounting Valuation Rules for Option Grants—Definition of Grant Date

August 18 , 2005

As the deadline for companies to begin accounting for option grants in accordance with FAS Statement 123(R) approaches, the manner in which options are accounted for becomes increasingly important. Under Statement 123(R) options granted to employees are valued based on their fair value as of the "grant date" of the option. Several companies were surprised earlier this month when they were alerted by their accountants of a "grant date" problem.

The Problem

In the past, employers have treated the grant date as the date that the company's board of directors approved an option grant regardless of when the employee was notified of the grant. FAS statement 123(R) changes the rules of the game. It provides that the grant date is the date on which *both an employer and an employee reach a mutual understanding of the key terms and conditions of the award*. FASB is taking the position that the grant date cannot occur until the employee has been notified of the material terms of the option grant. This is important because one of the factors in determining the fair value of an option is the price of the underlying shares on the grant date. If there is a change in the price of the company's stock between the date the board of directors approves the grant and the date the employee is notified of the grant, the exercise price of the option may be more or less than the price of the stock on the grant date which would cause a decrease or increase in the fair value of the option and would result in the company recognizing a lesser or greater compensation expense than originally anticipated.

What Companies Can Do—Some Alternatives

Companies that wish to have some certainty with respect to the compensation charge they will incur for option grants do have some alternatives that would provide that certainty.

1. A system could be implemented that would automatically inform employees of the material terms of their option grants on the same date the option grants are approved by the board of directors. Such a system could be implemented through e-mail or other web based software and the notices could be prepared prior to the meeting and could be modified to include those terms that were approved at the meeting. This would ensure that the price of the company stock on the date the board of directors approved the option grants would be the stock price used in determining the fair value of the option grant. The disadvantage of such a system is that employees would learn about their option grants through an e-mail as opposed to having their manager discuss it with them.

2. The board of directors could approve option grants to employees to become effective at some date in the future with an exercise price as of that date. The employees would be notified prior to the designated date of their award. For example, at a February 20th meeting the board of directors could approve option grants to become effective as of March 5th with the exercise price of the options to be the closing price of the company's stock on March 5th. The employees

would be notified of the material terms of the awards prior to March 5th. In such a case the grant date would be March 5th. The disadvantage of this approach is that the company would not know the exercise price of the options when approved by the board of directors and the employee would receive an award notice that did not contain a specific exercise price.

3. The company could use an average share price over the period between the date the options were approved by the board of directors and the date the material terms were communicated to the employees. This approach would require additional effort to calculate the compensation expense and may not be the best choice for some companies in certain situations depending upon the length of time between board approval and employee notification and the volatility of the company's stock.

4. The company could simply continue with its current practice. Note that FAS 123(R) only governs the accounting treatment of options and does not have any effect on the exercise price of an option regardless of whether the "grant date" for accounting purposes results in a lesser or greater compensation expense.

Valuation in Other Contexts

The discussion above is only relevant with respect to option valuation for financial accounting purposes. The valuation rules for incentive stock options under Section 424 of the Internal Revenue Code of 1986, as amended (the "Code") and non-qualified stock options under Section 409A of the Code are not affected.

If you have any questions regarding this notice please call Scott Spector at (650) 335-7251 or e-mail sspector@fenwick.com.

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