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SEC Issues Extension for Using Simplified Method to Calculate Employee Stock Option Expense

Under the Financial Accounting Statement that requires the expensing of employee stock options (*Shared-Based Payment*, Statement 123R), companies are required to calculate the income statement expense relating to stock options using an option-pricing model, assuming observable market prices are not available. A common approach is to use a closed-form model, such as the Black-Scholes-Merton formula, that requires companies to estimate the expected term of an option grant. For those companies who lacked sufficient historical or industry data to accurately predict the expected term, in March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107 that allowed these companies to use a simplified method to estimate the expected term of a "plain vanilla option."

SAB 107 allows for the use of the simplified method until December 31, 2007, at which time it was expected companies would have adequate historical information available to them to calculate a reliable expected option term. The SEC understands that this historical data may not yet be readily available and on December 21, 2007, the SEC issued SAB 110 which extends the timeframe eligible companies will have to use the simplified method on an interim basis. Once detailed information on exercise terms becomes readily available, the SEC will suspend use of the method and will require companies to estimate the expected term of an option using historical data.

This action taken by the SEC is reasonable in that it continues to provide relief mainly to smaller public companies whose historical experience does not provide a rational basis with which to estimate the expected term of an option. The simplified method allows them to compute the expected term as the average of the full term of the option and the vesting period.

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This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal or accounting advice. Specific questions should be referred to the company's legal counsel and professional accountants. General questions about this letter may be directed to Kathryn L. Neel at 212-299-3721 or by e-mail at klneel@fwcook.com or Thomas M. Haines at 312-332-0190 or by e-mail at tmhaines@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.