

October 24, 2007
Vol. 14, Issue 21

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Companies issuing employee share options may be able to use ESOARS (or an acceptably designed alternative) in lieu of existing valuation techniques.

ESOARS Take Off

SEC OKs Use of a Surrogate to Value Employee Share Options

by John Sarno, Deloitte & Touche LLP

Introduction

In an October 17, 2007, [letter](#) to Zions Bancorporation ("Zions"), SEC Chief Accountant Conrad Hewitt (the "Chief Accountant") indicated that ESOARS ("employee stock option appreciation rights securities") are sufficiently designed to meet the measurement objective of FASB Statement No. 123(R), *Share-Based Payment*. In other words, the SEC did not object to Zions's use of ESOARS as an appropriate surrogate on which the company can base the value of employee share options that it issued.

In short, companies issuing employee share options may be able to use ESOARS (or an acceptably designed alternative) in lieu of existing valuation techniques (e.g., the Black-Scholes-Merton formula or a binomial model) to determine the grant-date fair value of an employee share option, a value that is used, in turn, to determine compensation cost. Companies may find the use of ESOARS (or ESOARS-like) instruments especially appealing if, as some predict, these market-based surrogates result in a lower, more accurate reflection of fair value than do traditional valuation models (see, however, the Chief Accountant's caution about inappropriate downward bias, described below).

Background on ESOARS

As described in Deloitte & Touche LLP's [February 20, 2007, Heads Up](#), ESOARS are derivative securities that are sold to investors. ESOARS are designed to (1) track the value of a referenced pool of employee share options (i.e., there is no one-to-one correlation between the issuance of an employee share option and ESOARS), (2) pay investors as employee share options are exercised, (3) make payments to their investors on the basis of a pro rata share of the intrinsic value realized by employees upon exercise of their share options in the referenced pool, and (4) be priced, upon issuance, through a modified Dutch auction. A more detailed description of ESOARS and the auction process is available on the [Zions Direct Auctions Web site](#).

Caution: Factors to Consider in Future Auctions

While the letter to Zions focused on a May 2007 ESOARS auction, it also discussed factors that Zions needs to consider in future auctions of ESOARS (or ESOARS-like) instruments, including (1) review of the auction clearing price for downward bias and (2) comparison of the auction price against values determined with standard valuation techniques.

With respect to downward bias, the Chief Accountant noted that the ESOARS auction process focuses only on the bid price of the bid-ask spread. While Statement 123(R) does not specifically address the price that a company should use in the bid-ask spread when valuing an employee share option with a market-based instrument, the illiquid nature of the current market for ESOARS and only focusing on the bid price could cause a downward bias on the value of the instrument.

Editor's Note: A downward bias on the value of the instrument (and, therefore, on the grant-date fair value of the referenced employee share options) is of concern because it would be advantageous both to the company issuing the ESOARS (since it drives down the compensation cost recorded in the financial statements) and to the investors buying the ESOARS (since it reduces their cost to purchase the instrument).

To alleviate these concerns, the Chief Accountant stated in his letter that a company should consider, at a minimum, the following questions:

- Are there sufficient sophisticated bidders to constitute an active market?
- Do the bidders have sufficient information to value the investment and make an investment decision?
- Does the pattern of bidding reflect what one normally observes in an active market (e.g., a reasonably low disparity between the lowest and highest bids among the winning bidders)?
- Do the bidders' perceptions of material costs of holding, hedging or trading the instrument substantially affect their valuation of the instrument?

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The Chief Accountant also noted that as part of its validation of the May 2007 auction results, Zions compared the auction price against the value derived with a standard valuation technique. The Chief Accountant thought it would be appropriate to continue such comparisons in the future. He observes that using a market-based instrument is not intended to replicate the value derived from a standard valuation technique. However, given that the use of market-based instruments is in its infancy, substantial deviations between the price of the market-based instrument and the value derived from standard valuation techniques may indicate deficiencies in the auction process.

Accounting for ESOARS and Other Financial Instruments

In addition to whether ESOARS (or ESOARS-like instruments) serve as a reliable indicator of the grant-date fair value of issued employee share options, companies need to determine the appropriate financial reporting of these instruments, especially whether they are classified and accounted for as derivatives or as equity instruments. As derivatives, these instruments would be remeasured to current fair value at each reporting date, creating income statement volatility. Amounts recorded as equity, on the other hand, would typically never require subsequent adjustment (unless, for example, the instrument is modified).

Although the Chief Accountant's letter did not touch on the topic, companies need to carefully consider the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In particular, they should monitor the Emerging Issues Task Force's ongoing deliberations of EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock." For ESOARS, ESOARS-like instruments, and a variety of other financial instruments, the outcome of this issue could mean the difference between equity or derivative classification. The EITF is scheduled to continue its discussion of Issue 07-5 at its November 29, 2007, meeting.

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