U.S. Securities and Exchange Commission

Speech by SEC Staff: Statement Regarding Use of Market Instruments in Valuing Employee Stock Options

by

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Donald T. Nicolaisen, Chief Accountant for the U.S. Securities and Exchange Commission, today released the following statement regarding the use of market instruments to estimate the grant-date fair value of employee stock options.

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In December 2004, the Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (Statement 123R), which addresses the accounting for employee stock options. As I stated at the time, I believe the issuance of Statement 123R will result in more comparable information in financial statements provided to investors. On March 29, 2005 Staff Accounting Bulletin No. 107 (SAB 107) was issued to express the SEC staff's views regarding the application of Statement 123R. At that time I stated that the staff would continue to monitor the implementation of Statement 123R and would consider whether additional guidance might be necessary.

Since then, my staff has become aware of several different strategies being considered by issuers in an attempt to bring market forces to bear on the valuation of employee stock options. These strategies include attempts to design instruments that could be sold into the market at a value intended to be reasonably equivalent to the fair value of employee stock options. I encourage ongoing discussion of valuation strategies and, to that end, this statement provides my current views on the ability of the alternative strategies considered by us to provide a fair value for employee stock options that complies with Statement 123R. As a part of the consideration of these strategies, I asked the staff of the Commission's Office of Economic Analysis

(OEA) to provide their views. A memo which summarizes their views and provides a fuller understanding of the issues is available on the Commission's website at http://www.sec.gov//news/extra/memo083105.htm.

The measurement objective in Statement 123R is to estimate the grant-date fair value of the equity instruments that an entity is obligated to issue when employees have earned the right to benefit from the instruments. The standard also states that the best evidence of fair value for employee stock options is observable market prices of identical or similar instruments in active markets. While the FASB concluded in Statement 123R that the market price of a similar instrument would provide the best evidence of fair value, the FASB did not attempt to consider the appropriate design of an instrument that might be specifically created for the purpose of obtaining a market-based value of employee stock options. Nonetheless, the creation and sale of such instruments may indeed provide a useful reference point in estimating fair value.

Replicating all of the terms and conditions of employee stock options with a market instrument is difficult. I also recognize that there may be alternative ways to provide an adequate estimate of the fair value of an employee stock option. As noted in the memo from OEA, there already are several methods that have been considered. Broadly speaking, my staff and I, with help from OEA, have become comfortable that it should be possible to design instruments whose transaction prices would be a reasonable estimate of the fair value of underlying employee stock options using either of the methodologies that seek to track returns to holders of options or the obligations of the issuer of those options. Further, while I recognize alternative views and new facts are possible, at this point, we have significant doubts based on OEA's views, as to whether it would be possible to design an instrument that would achieve the measurement objective of Statement 123R by relying on similar contractual terms and conditions. That is primarily because of the difficulties inherent in replicating the employer-employee relationship in an issuer-investor arrangement.

While various strategies have been considered and I encourage further efforts in the future, we are not aware of any instruments that have actually been sold in the market in an effort to obtain an observable market price for use in valuing employee stock options. Without actual market information, I do not believe at this point that it is possible to definitively conclude that the strategies that have been considered, or others that could be developed, would produce an estimate of fair value that complies with Statement 123R. For example, if an instrument were designed that my staff and I believed could produce an appropriate value in a market-based transaction, but the actual transaction price proved to be significantly different from the price that would be expected based on broadly accepted modeling techniques, questions would arise about whether the instrument itself and the marketing of the instrument were sufficient to achieve a true fair value exchange price. These questions may dissipate over time should market-based transactions become common, but early users would have to address and resolve such questions to their satisfaction and to that of their auditor before the transaction price could be used as the only basis to measure the fair value of the applicable employee stock options. In addition, appropriate disclosures would be required to be included in filings regarding the approach used to estimate the fair value of employee stock options.

In my nearly forty years of professional experience, I have found that the best results come from having a public and wide-ranging discussion about issues. To facilitate such discussion on the issue of using a market instrument to value employee stock options, I have talked over the last few months with a variety of interested parties and the Financial Accounting Standards Board. I also have received numerous letters concerning the use of these kinds of strategies to valuing employee stock options and the SEC staff's process for considering any such strategies. While public discussion of specific strategies from individual registrants is not appropriate, I do believe that continuing the public dialogue and research on methods to obtain estimates of fair value of employee stock options is useful. And, the actual issuance of such instruments would contribute to the body of information available. Thus, we encourage interested parties to continue to provide us with any further thoughts they have on this issue.

Many companies already have begun applying Statement 123R using the guidance provided by the standard and the views expressed by the staff in SAB 107. In addition to considering the valuation issues noted above, the SEC staff is continuing to monitor the implementation of Statement 123R and will consider the need for additional guidance as necessary.

See Press Release 2005-129

http://www.sec.gov/news/speech/spch090905dtn.htm
