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IN THIS ISSUE

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ESOARS to Offer Market Pricing of Employee Stock Options?

On January 25, the SEC sent out a letter generally approving the design of a new derivative security developed by Zions Bancorp called ESOARS (Employee Stock Option Appreciation Rights Securities) that could effectively create a market pricing mechanism for employee stock options ("ESOs"). While we must be careful not to misinterpret this news (the SEC did not actually approve this valuation method for immediate practical use in SFAS 123R compliance), there are some interesting implications that merit consideration.

Here is some background: companies have been required to expense the fair value of ESOs granted since the latter half of 2005, and this requirement has significantly impacted reported earnings for companies that use ESO grant compensation heavily. According to a recent article in *Forbes*, if the results from the ESOARS test auction are reasonably accurate, Electronic Arts, Adobe, and eBay could potentially increase pretax profits by 43%, 11%, and 10%, respectively, through the mitigation of ESO expense. Based on most recent quarterly pretax profits, this increase would represent an additional $70 million in pretax earnings for these three companies alone. While the requirement to report option expense is conceptually sound (companies granting ESOs do incur a real cost), some analysts believe that the current option valuation methods prescribed by the SEC (Black Scholes or binomial option-pricing models adjusted for expected life) overstate ESO cost because these models were developed for the pricing of publicly traded stock options. Results of a test ESOARS auction held by Zions in June 2006 suggest that the fair value of ESOs may be substantially lower than that implied by conventional stock option valuation models, which is music to the ears of managers of business struggling with ESO expense—if it ultimately provides a reasonable basis for recording lower option compensation expense.

SFAS 123R

Companies were required to recognize the cost associated with ESOs when SFAS 123R became effective during 2005. Essentially, 123R states that the fair value of ESOs should be measured based on observable market prices for similar securities, or if such information is not available (and it hasn't been), then the fair value should be based on an option-pricing model adjusted for differences between ESOs and regular publicly traded equity options.

In the absence of relevant market information, companies have generally relied on either the Black Scholes model or a binomial model. The problem is that these models were not developed to price ESOs, which differ from traditional publicly traded options in that they are non-transferable and often include vesting requirements. The most common adjustment to account for the unique features of ESOs is to reduce the remaining term assumption from the contractual term of the option to the expected exercise date, since non-transferability often results in early exercise by employees. It has been a matter of debate as to whether this adjustment is sufficient to fully capture the decrement to value associated with non-transferability. Intuitively, the transfer restrictions and forfeitability render ESOs (relative to an otherwise

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comparable publicly traded option) less valuable to the holder and thus less costly to issuer.

In consideration of the difficulties associated with the conventional model-based pricing techniques, the SEC began publicly encouraging the development of market-based techniques to measure the fair value of ESOs. Development of the ESOARS security was based on guidance from the Office of Economic Analysis dated August 31, 2005, which stated that 1) market instruments should be designed to track the flow of the net obligation of the company or the net receipts of the employees and 2) the suitability of any market-based approach depends on not only the actual instrument design, but an appropriate market pricing mechanism and related information plan, as well.

THE INSTRUMENT

The ESOARS instrument is an asset-backed security that tracks the value of a reference pool of ESOs by making payments to holders as reference options are exercised. The holder of an ESOARS instrument receives a pro rata share of the net realized value from the exercise of options in the associated pool of ESOs. In other words, ESOARS are not options themselves; the holder cannot exercise any units in exchange for subject stock. Rather, ESOARS are derivatives for which value is driven by expectations regarding future company stock prices and employee exercise behavior. Consistent with SEC guidance, these securities track the flow of net receipts to the holders of the associated ESOs.

While the size of an ESOARS offering is an important consideration (the offering should be large enough to attract attention, yet not so large that it floods the infant market), the terms of the offering can be adjusted so that the benefits of an ESO and that of an ESOARS unit correspond one-to-one. For example, if a company issued 500,000 options and 100,000 ESOARS units, the aggregate pool of ESOARS would pay out 20% of the net realized value of the ESO reference pool (100,000 ESOARS / 500,000 ESOs = 20%).

To illustrate the mechanics of the ESOARS instrument, assume Company A issues 10,000 ESOs at a $9 strike price as well as 1,000 ESOARS units that collectively pay 10% of net realized value of the ESOs. Consider the event that 1,000 options are exercised by employees when the price per share of Company A is $12. Since the net realized value to employees at this time was $3,000 ($12 stock price - $9 strike price = $3 x 1000 options exercised = $3,000), the ESOARS would pay out an aggregate sum of $300 associated with the exercised ESOs. Accordingly, the holder of 1 ESOARS unit would receive $0.30, which is the pro-rata share of 10% of the net realized value of the exercised ESOs.

	ESOs	ESOARS
Unit Issued	10,000	1,000
Strike Price	$9.00	
Stock Price	$12.00	
Options Exercised	1,000	
Net Realized Value	$3,000	$300
Benefit/Unit		$0.30

TABLE ONE

Zions anticipates that ESOARS would be sold through an online auction on the ESO grant date. The idea is that the market price at which ESOARS transact would provide an indication of the fair value of the ESOs at the time of the grant.

THE TEST RUN

In late June 2006, Zions ran a test auction of ESOARS associated with Zions Bancorp ESOs that were granted May 1, 2006. Prior to the auction, Zions publicly announced and advertised the auction and provided information related to historical ESO exercise patterns for option grants since 1994. The test auction was conducted over a timeframe of 30 hours as a modified Dutch auction (similar to the auction in which US Treasuries are sold) designed to sell the ESOARS at the lowest bid price that would allow all units to be sold. It is important to note that this is a rather simplistic overview of the test auction; Zions put substantial emphasis on details with the intent of creating and maintaining the integrity of the market pricing mechanism of the auction, as evidenced by discussion in the Zions ESOARS submission to the SEC.

Table Two briefly summarizes the results of the auction.

ESOARS Test Auction: Results Summary	
Registered Bidders	82
Actual Bidders	57
Bids	1,041
Winning Bidders	21
Unit Price	$7.50

TABLE TWO

The auction experienced technical issues in the final 22 minutes, which resulted in bidders experiencing outages and poor connectivity. In consideration of the heavy bid volume in the final hour of the auction and discussions with large bidders, Zions believes the market-clearing price would have exceeded $8.00 in the absence of technical difficulty.

The ESOs related to the auctioned ESOARS had a strike price of $81.15 (Zions stock price as of the auction date was $78.22), a seven year life, and a three year vesting schedule. Table Three compares the market-clearing price (actual and $8.00) adjusted for pre-vesting forfeiture (assuming a weighted average expected forfeiture rate of 12.5%).

Valuation Method	Value Indication	Discount - 7 year	Discount - 4 year
Black Scholes - 7 Year Life	$17.70	na	na
Black Scholes - 4 Year Life	$12.89	27%	na
ESOARS - $8.00[1]	$9.14	48%	29%
ESOARS - $7.50[1]	$8.57	52%	34%
(1) To adjust for investor expectation of pre-vesting ESO forfeiture, we have assumed an expected forfeiture rate of 12.5% (i.e. $8.00/.875 = $9.14)			

TABLE THREE

The Black Scholes valuation, based on a four year life to account for early exercises due to the lack of transferability of the ESOs (which is close to how the ESOs would currently be valued under SFAS 123R), indicates a value of $12.89 per option, which implies a discount of 27% for lack of transferability from the seven year value.[1] Assuming the market-clearing price finished at $8.00, the fair value indicated by the ESOARS test auction implies a total discount of 48% from the 7-Year option-pricing model indication of value, or an additional discount of 29% from the adjusted 4-Year indication of value (which is similar to the methods currently used for 123R compliance).

IMPLICATIONS

Although this test auction represents only a single observation of a novel security sold in an untested market, the magnitude of the implied discount from regularly employed ESO pricing techniques is noteworthy. If option compensation expense is being overstated by current financial reporting requirements, there are repercussions for management, investors, and regulators alike. Depending on the actual magnitude of this potential overstatement of ESO expense, reported earnings under SFAS 123R may be no more accurate than under APB 25 (which did not require the expensing of option compensation).

This test auction also provides the opportunity to refine ESO valuation models. The availability of empirical market information for ESOs may allow theoretical ESO pricing models to be tested for reliability and lead to more robust valuation models acceptable to auditors and the SEC. In fact, the response from the SEC suggests that observations from market-based ESO pricing could lead to innovations in models used to price ESOs. Several years ago, Mercer Capital introduced a risk-averse binomial employee stock option pricing model, which is an example of a potential innovation in model-based ESO pricing that would benefit from empirical data.

Although encouraging, the SEC's response was less enthusiastic than many media reports seem to imply. The immediate result of the Zions effort to develop an ESO market-pricing method was an open-ended letter from the SEC that, while generally approving of the design of the ESOARS instrument, recommended that future actions should be "analyzed to determine whether it results in an appropriate market pricing mechanism." Loosely translated, we interpret this to mean: We like the design of the instrument itself, but your internet auction does not currently satisfy the requirements under SFAS 123R to measure the fair value of ESOs; call us back with anything new.

The ongoing development of market-based ESO pricing mechanisms is one example of the state of constant change in which fair value accounting currently resides. When dealing with fair value issues for financial reporting, you need someone who understands the issues and has stayed current with fair value changes. If you have any questions related to valuation and fair value accounting, please contact a professional at Mercer Capital.

B. Patrick Lynch
lynchp@mercercapital.com

Value Added™

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1 *The application of the Black Scholes option pricing model also assumes volatility of 18.0%, a dividend yield of 2.0%, and a risk-free rate of 4.949%.*

Value Added™

The Clock is Ticking for Section 409A Compliance

Bring your nonqualified deferred compensation plan into compliance with Section 409A by the deadline or be prepared for an onslaught of penalties and taxes to you and your employees

The deadline for compliance with IRC Section 409A is fast approaching. Section 409A generally became effective in January 2005; however, the IRS recently extended the effective date of the final regulations until January 1, 2008 for most companies. As the new deadline approaches, the IRS is issuing continuing guidance with respect to employee tax reporting, withholding, and transition relief. But the critical point remains: bring your nonqualified deferred compensation plan into compliance with Section 409A by the deadline or be prepared for an onslaught of penalties and taxes to you and your employees.

409A RECAP

Added to the tax code as part of the American Jobs Creation Act of 2004, Section 409A generally requires that amounts deferred under a nonqualified deferred compensation plan (including stock options and stock appreciation rights or "SARs") for all taxable years are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. With respect to stock options, the IRS concern is that stock options and SARs issued "in the money" are really just a form of deferred compensation, representing a shift of current compensation to a future taxable year. In order to avoid being subject to Section 409A, employers need to demonstrate that all stock options and SARs are issued "at the money" (strike price equal to the FMV of the underlying shares at the grant date).

Stock options that were granted or that vest on or after January 1, 2005, and that have an exercise price that is less than the fair market value of the company's stock on the date of grant are subject to Section 409A (referred to as Discounted Options). If the Discounted Options are not corrected by either fixing the payment terms or increasing

Mercer Capital Highlights

UPCOMING SPEECHES

April 23, 2007
"A Theoretical and Practical Review of the DCF Method"
FCG University
Atlanta, Georgia
Travis W. Harms, CFA, CPA/ABV

May 21, 2007
"Application of Industry & Economic Data in Business Valuation"
New York Society of CPAs
Business Valuation Conference
New York, New York
Timothy R. Lee, ASA

June 21, 2007
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"
The Institute of Business Appraisers
2007 Annual Conference
Denver, Colorado
Z. Christopher Mercer, ASA, CFA

QMDM IN THE NEWS

In *Juan Armstrong v. LaSalle Bank National Association*, No. 05-3417 (7th Cir. May 4, 2006), the U.S. Court of Appeals for the Seventh Circuit determined that the appropriate standard of review to apply when considering whether an employee stock ownership plan trustee adopts a valuation of the subject stock is the abuse of discretion standard. It noted that one method for testing a trustee's abuse of discretion is whether a marketability discount should have been applied.

In making this recommendation, the court stated:

> "There are techniques for calculating a marketability, or illiquidity, discount, see Z. Christopher Mercer, "A Primer on the Quantitative Marketability Discount Model," CPA Journal, July 2003, www.nysscpa.org/cpajournal/2003/0703/dept/d076603.htm, visited Apr. 6, 2006...."

Brief summary above provided by John J. Stockdale, Jr. and appeared in the Summer 2006 issue of the Business Valuation Review. For more about the QMDM, download the updated QMDM Fact Sheet at www.mercercapital.com the exercise price to fair market value as of the date of grant, such options will violate Section 409A and be subject to a 20% penalty tax and interest in addition to regular income and employment taxes.

SO WHAT'S NEW?

The original proposed regulations of Section 409A were expected to become effective January 1, 2007. But in October of 2006, the IRS issued Notice 2006-79, which extended the compliance deadline to December 31, 2007 for most companies. Companies that have had problems with backdated options or may have to restate financial statements in the future as a result of backdated options were not given the one year extension for compliance. For these companies, the deadline remains December 31, 2006.

But that's not all. In November 2006, the IRS issued guidance to the effect that under Section 409A, all existing discounted options (even those that are unexercised) are subject to current income tax withholding and reporting for employees holding the options. The withholding and reporting pertains to deferred amounts that have now become includible in income in 2005 or 2006. This means that an employer must start withholding money from an employee's wages for payroll taxes based upon the "deferred amount." For stock options and SARs, the amount includible in income is equal to the fair market value of the underlying stock less (1) the exercise price, less (2) any amount paid for the option, less (3) any amount previously included in income with respect to the right.

One would not expect Average Joe Employee to be pleased to learn that he (and not his employer) is suddenly responsible for paying income taxes and penalty taxes on "discounted" stock options he has not yet exercised! The options may not even be in the money at the time the taxes and penalty are due. While there is no cure-all remedy, there are a few possible solutions to the problem. The Company could reprice the options to set the exercise price to the fair market value at the grant date. While this solves the issue of 409A compliance for the option itself, it does nothing to comfort Average Joe Employee whose options will decline in value as a result of a higher strike price. Companies may choose to offer cash bonuses to employees to offset the loss in option value, although it is important to note that such payments would be considered additional, and taxable, ordinary income. A similar situation might exist for employees who exercised discounted options in 2006 and now face 409A penalty taxes.

For companies that still have until the end of 2007 to bring their plans into compliance with Section 409A, the extra time should be seen as an opportunity to get things right ASAP. If compliance is achieved before the final regulations become effective, the withholding and reporting requirements as well as the 409A penalty taxes could potentially be avoided.

HOW TO ENSURE COMPLIANCE?

Generally, a nonqualified deferred compensation plan adopted on or before December 31, 2007 will not be treated as violating Section 409A if (1) the plan is operated through December 31, 2007 in reasonable, good faith compliance with the provisions of Section 409A and other applicable provisions and guidance and (2) the plan is amended on or before December 31, 2007, to conform to the provisions of 409A and the final regulations.

For both public and private companies, it is crucial that the exercise price not be less than the fair market value of the underlying stock at the grant date for stock options that may fall under the net of Section 409A. If you currently have a stock option plan or other deferred compensation plan in place, then the clock is ticking to make sure that your plan is Section 409A compliant. If the plan does not conform to Section 409A by the deadline, there could be significant adverse tax consequences to both employer and employee related to the 2005 and 2006 tax years.

For companies that are considering the implementation of a nonqualified deferred compensation plan before the end of the year, the most obvious course of action is also the correct one - obtain an independent appraisal of the fair market value of the company's stock as of the grant date. By establishing a sound and reasonable valuation of the stock on the front end of the process, the potential headaches of Section 409A can be substantially reduced and possibly even eliminated. Mercer Capital has the experience and knowledge necessary to provide you with a reasonable, reliable, and defensible valuation for Section 409A compliance.

Lucas M. Parris
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For companies that are considering the implementation of a nonqualified deferred compensation plan before the end of the year... obtain an independent appraisal of the fair market value of the company's stock as of the grant date

The Reviews Are In...

Buy-Sell Agreements

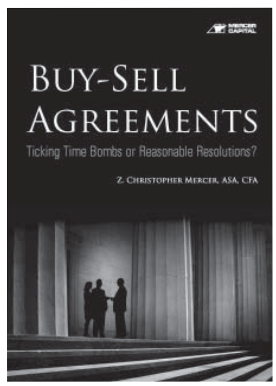
Ticking Time Bombs or Reasonable Resolutions?

...Is A Hit!

Released in January 2007, *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"* has quickly become a valuable tool for attorneys, business advisors and business owners who recognize the importance of buy-sell agreements. Don't take our word for it. Below are just some of the published reviews of *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?."*

To summarize *Buy-Sell Agreements* in one word, that word would be "methodical." Mercer focuses like a laser beam on virtually all of the possible permutations of the pricing and valuation provisions of buy-sell agreements, together with the advantages and disadvantages of each...*Buy-Sell Agreements* offers a comprehensive buy-sell audit checklist that alone makes it worthy of purchase, serious use and study...If you are looking for a book that has a comprehensive discussion of the pricing and valuation aspects of buy-sell agreements (which I've really not ever seen before), this is it...*Buy-Sell Agreements* is a no-brainer addition to the library of every one who works with or who drafts buy-sell agreements.

L. PAUL HOOD, ESQ.
Steve Leimberg's Business Entities Newsletter,
Issue 119, February 13, 2007.
Courtesy: Leimberg Information Services, Inc. (LISI)
at www.leimbergservices.com



In the teacher's manual to our *Business Associations* case book, my friend, colleague and coauthor Bill Klein posits that "any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice." Z. Christopher Mercer's new book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions* offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

STEPHEN BAINBRIDGE
William D. Warren Professor of Law, UCLA
Published on ProfessorBainbridge.com

In this eminently well-written, concise, and non-technical book, Chris lays out the fundamental parameters and processes that must be considered to minimize problems...Appraisers who read this book and apply its lessons will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.

RAND M. CURTISS, FIBA, MCBA, ASA, ASA
President, Loveman-Curtiss, Inc.
Chair of the American Business Appraisers National Network
Published on IBA Discussions Blog at www.go-iba.org/blog

Mr. Mercer has done a great job of addressing the reasons business owners might want to have a buy-sell agreement and the business factors these business owners should consider in the agreement...Overall, Mr. Mercer provides valuation practitioners, business consultants, and business owners with a very useful handbook for preparing, reviewing and interpreting buy-sell agreements.

DAVID A. ELLNER, CPA/ABV
The Financial Valuation Group
Published in the AICPA ABV e-Alert
Volume 9, Issue 2, February/March 2007

Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

"...is terrific - sophisticated, refreshingly thoughtful and the first really new ideas (to me, anyway) in this area I've heard or seen in a long time."

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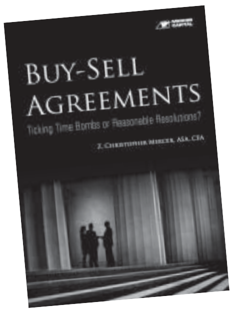

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HIGHLIGHT SECTIONS/CHAPTERS INCLUDE:

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- **The Six Defining Elements of Buy-Sell Agreements -** *Agreements must have all six but most do not!*
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