



Trends in FAS 123R Valuation: Market Based & Models

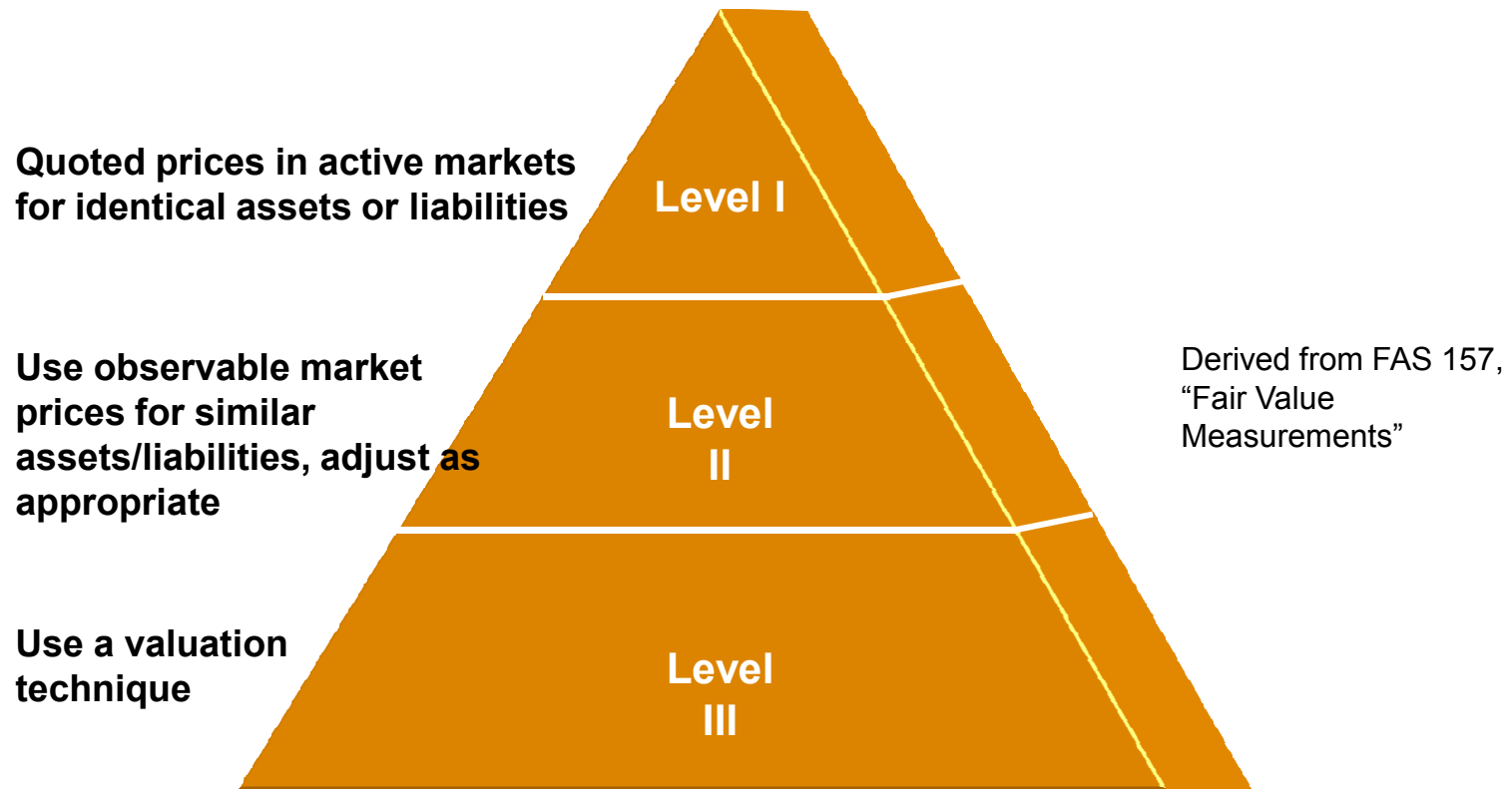
Best Practices Perspective

David Roberts
President & CEO
Equity Methods

www.equitymethods.com

Fair Value and the Fair Value Hierarchy

Fair value has been the topic of considerable research, debate, and regulatory attention—a unified framework is rapidly emerging

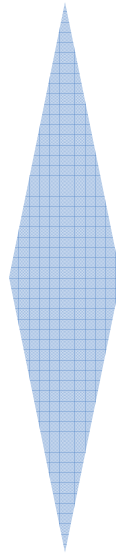
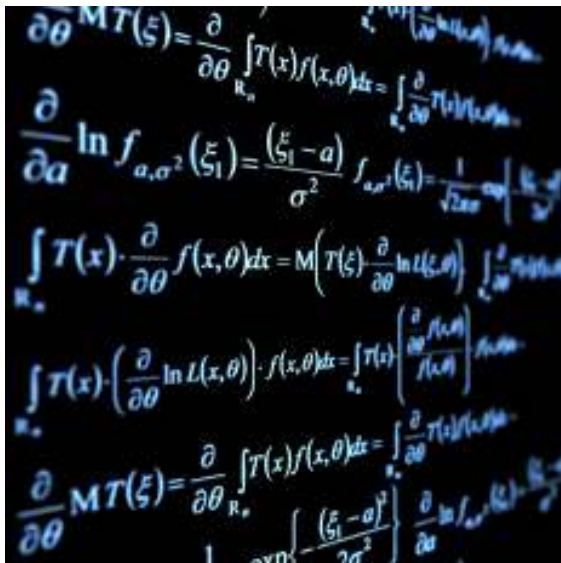


Markets versus Models

Share-based compensation instruments are not tradable

- Why observable market prices have historically not existed for employee options
- Models became the de facto standard in measuring the fair value of employee options

A model estimates fair value by *modeling* how a market *would* price the employee option if it could price the employee option (i.e., if it were tradable)



Market-based Valuation: Finally?

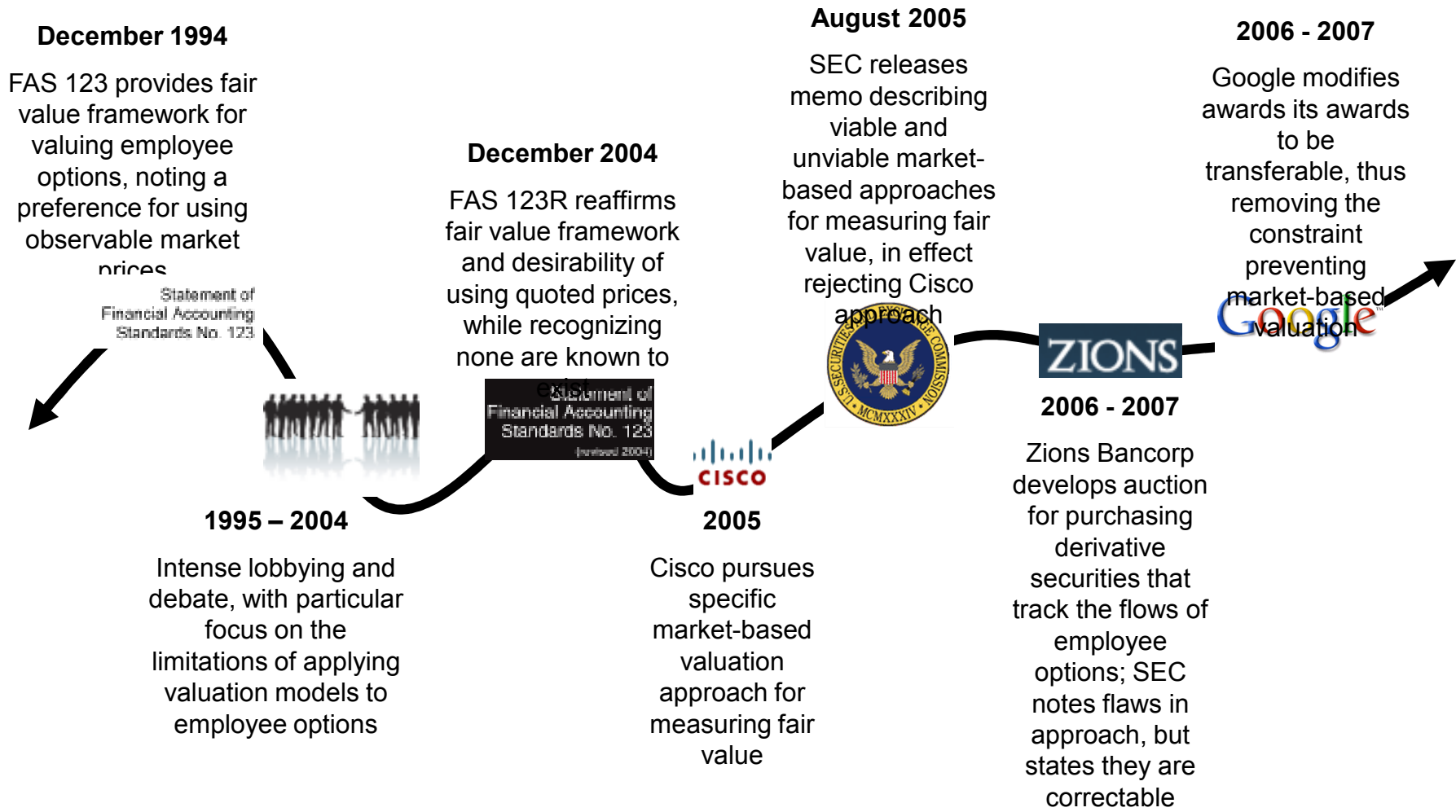
Search for a market-based valuation methodology is not a new phenomenon, and even traces back to FAS 123R and prior standards, in which it is heralded as the preferred approach

If an observable market price is not available for a share option or similar instrument with the same or similar terms and conditions, an entity shall estimate the fair value of that instrument using a valuation technique or model that meets the requirements in paragraph A8 and takes into account... (FAS 123R, Paragraph A18)


A quoted market price, if one is available, is the best measure of the fair value of an asset, liability, or equity instrument. In its deliberations leading to this Statement, the Board was not able to identify currently available quoted market prices or negotiated prices for employee stock options that would qualify as a price at which a willing buyer and a willing seller would exchange cash for an option.... (FAS 123, Paragraph 161)



Market-based Valuation: Chronology of Events



Making Decisions: Is Market-based Valuation Right for You?



*"When we deal in generalities
we shall never succeed.
When we deal in specifics
we shall rarely have a failure."
-Thomas Monson*



Issue 1: Lower Valuation

Undoubtedly, a central question companies will ask is how market-based valuations are likely to differ from existing model-based approaches

- Answers to these questions must be grounded in thoughtful economic analysis
- Making *quick* assumptions as to the potential results of a market-based valuation is a recipe for disaster



“You've got to ask yourself one question: 'Do I feel lucky?'”

- Clint Eastwood

Issue 1: Lower Valuation

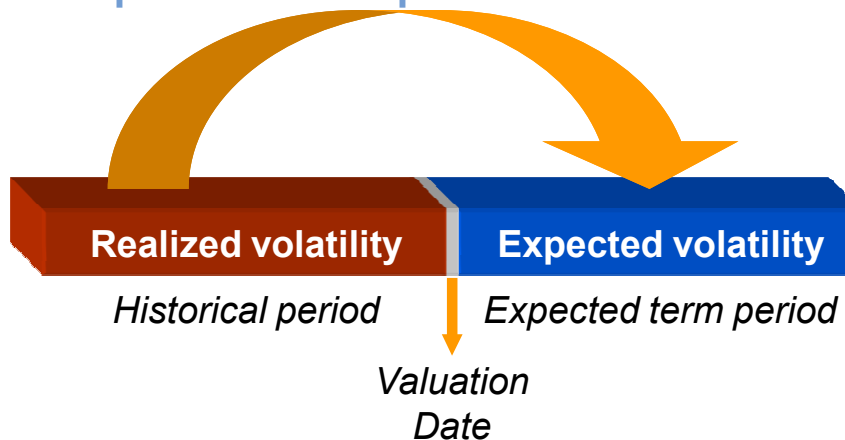
Market-based values may not always be lower than model-based values

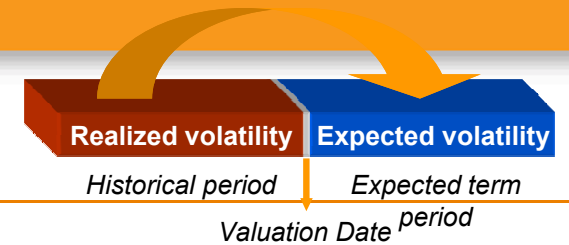
- This is a firm-specific question companies should investigate based upon their own unique circumstances

A more meaningful assessment will examine two general questions:

- First, is there some requirement in FAS 123R that **my company** is rigidly required to follow that may deviate from how the market would otherwise process this information in the context of **my company**
- Second, is there some difference between how the model-driven fair value developed for **my company** may differ from how the capital markets would price the same option

An example of each is provided...



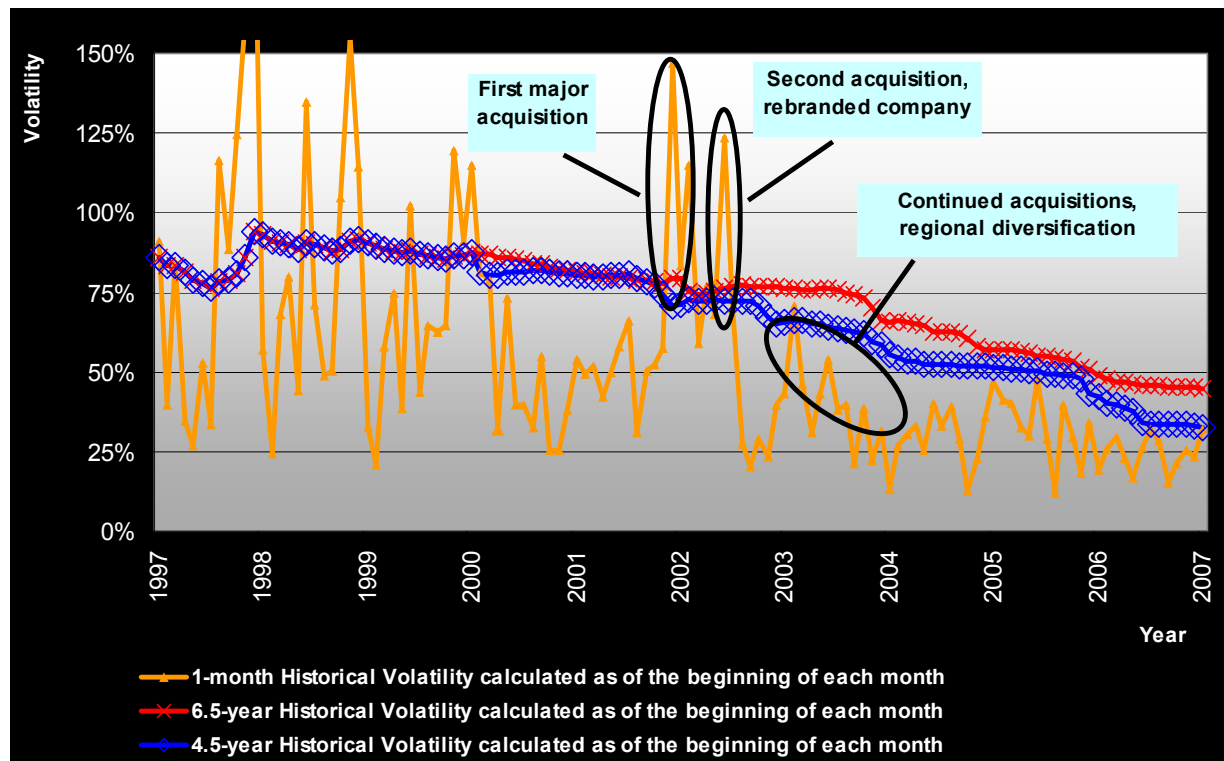


Example 1: Term-matching Principle

FAS 123R states the core volatility objective is to estimate volatility as a market participant would

- When using historical volatility, a general approach presented in FAS 123R is the term-matching principle

Consider the following example: Unfortunately, in some cases, this creates tension with the core objective



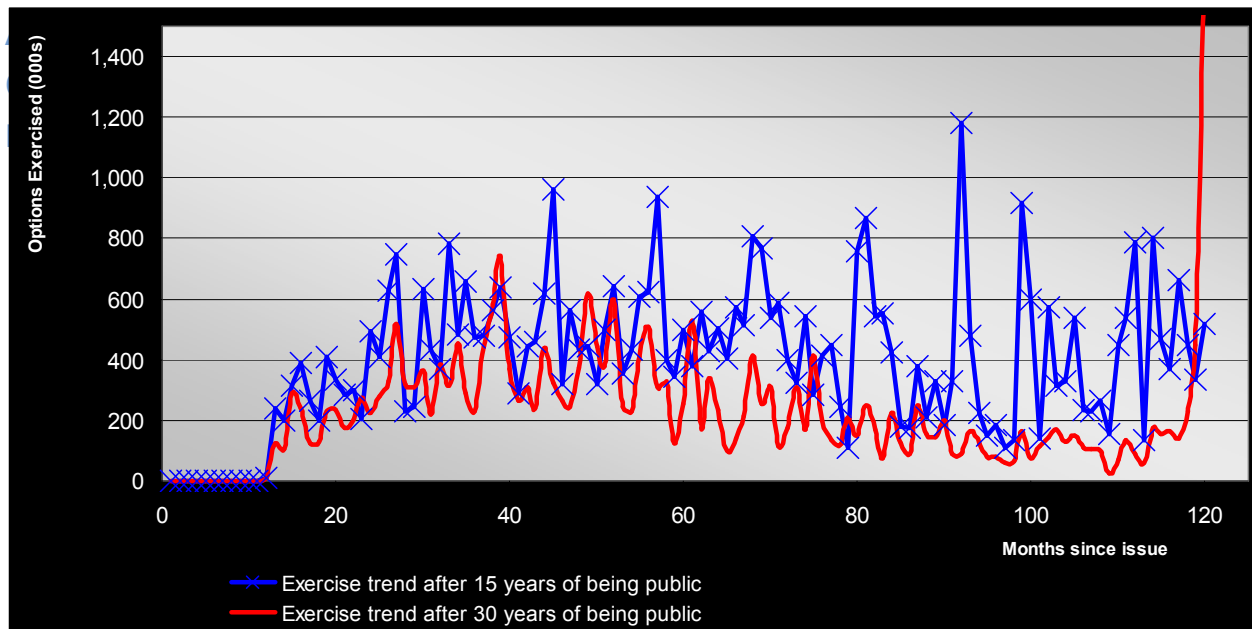
Measurement Details:

- Date: Summer 2007
- Expected term: 6.5 years
- 6.5-year historical volatility: 46%
- 4.5-year historical volatility: 32%

Example 2: Evolutions in Exercise Patterns

While both model- and market-based valuations will be historically contingent, markets have more flexibility and resources to formulate reliable expectations as to how/when patterns will emerge

- A market encompasses a plurality of expectations, and the clearing price represents a “consensus” expectation
- The manner in which models are utilized under FAS 123R gives precedence to singular expectations



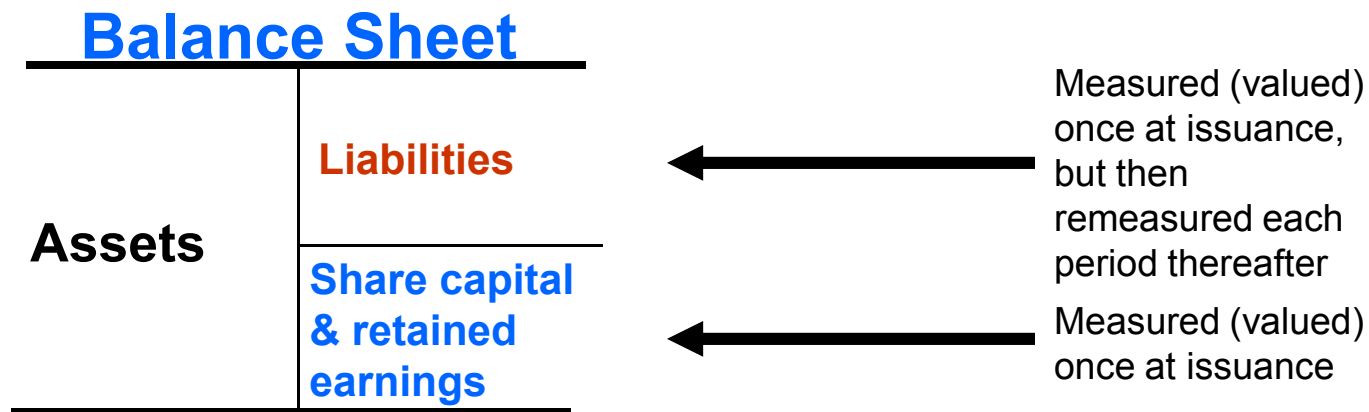
the market will be
live as the company also



Issue 2: Liability vs Equity Treatment

In their current form, market-based valuation approaches will result in the issuance of securities that create a contingent claim on the assets (cash) or equity of the issuing company, most likely the equity

- Balance sheet classification as either equity or a long-term liability
- This classification will have substantial implications on the design of the market instrument



Some considerations:

- How will this classification decision be made? FAS 150? Future guidance?
- If classified as liabilities, will periodic remeasurement result in a forced retreat to valuation models?
- Why is the company issuing the securities? Are third parties capable of issuing them, instead?
- Issue may even be resolved by the NASPP date?

Issue 3: Trading Volume

Markets exist everywhere



Market-based valuation requires a competitive market, which can be measured by factors such as:

- Number of buyers and sellers
- Number of instruments demanded relative to the number of instruments offered
- Technology issues
- Bidders' perceptions regarding holding, hedging, and trading costs of instrument

Issue 3: Trading Volume

Insufficient competition will preclude the market-clearing price from being usable for FAS 123R fair value estimation purposes—this would be bad news for issuing companies

On the front end, companies should evaluate very carefully the likelihood of achieving sufficient market competition

A few ways of assessing the potential outcome include:

- Experience in other derivatives markets (quoted options, convertible debt)
- Richness of employee option data made available (to induce market participation)
- Track record of market maker / auction platform
- Experimental economics

Where is your Company?

The next 1 – 2 years will be pivotal as companies begin to assess the fit of a market-based valuation scheme given their unique circumstances

