S.E.C. Approves New Method for Companies to Value Stock Options
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Can an auction of a new type of security prove that stock options are not worth as much as financial models say they are -- and therefore allow companies to report higher profits while handing out options to employees and executives?

The Securities and Exchange Commission has given a tentative approval to one auction method, while warning that auditors should study the results of the auction before actually using the results in their financial statements.

The approval was announced by the Zions Bancorporation, a Utah bank that hopes not only to use the method to cut its own reported expense but also to develop a business of issuing similar securities for other companies. It has even copyrighted the name ''Esoar'' for the securities.

Under current accounting rules, companies must report as an expense the value of stock options given to executives and employees. That value is now determined by financial models like the Black-Scholes model, which can produce values higher than companies wish.

The Zion securities are aimed at producing cash flows for investors similar to those that are actually realized by the recipients of stock options. In effect, the company would have issued additional options to investors. The price investors pay for those securities could then be used to value the options issued to employees.

Selling the securities would produce capital for the company, but that is viewed as an incidental result, not a reason to issue the securities. If the securities sold for a high value, few companies would choose to issue them -- the reverse of what would be expected with a normal security.

''Esoars seek to solve the problem of Black-Scholes overstating the options value,'' said Evan Hill, a vice president of Zions who helped develop the security. ''If Black-Scholes is not overstating the value, then Esoars does not solve anyone's problem.''

The Zion plan calls for investors to receive cash flows based on the profits received by option holders when they exercise their options, but after a delay averaging two months.

The S.E.C. released a letter sent by its chief accountant, Conrad Hewitt, provisionally blessing the security as ''sufficiently designed to be used as a market-based approach'' to valuing employee stock options.

In a statement Wednesday, Mr. Hewitt added that ''an instrument's design is just one of several factors that would have to be considered.''

In his letter, he warned that the actual conduct of auctions could be critical, including whether there were enough bidders. If results of the auction diverged too much from what models forecast, that could be a reason not to use the results, he indicated.

J. Richard Dietrich, the chairman of the accounting department at Ohio State University and a former academic fellow in the chief accountant's office of the S.E.C., called the idea promising but warned of potential problems.

Zion, he said, may have an incentive to produce low values through the auction process. ''It would potentially get them a lot more customers,'' he said.

He said that one area that might need addressing was the timing of payments to investors.

Under Zion's proposal, if a company was issuing 10 million options to employees, it might sell securities representing 1 million options to investors. The offering would need to be large enough to attract investors, but not so large as to overwhelm the market and produce an unreasonably low price.

To the extent employees forfeited options by leaving the company before they were allowed to cash in the options, the investors would receive a refund of the value of the security, plus interest.

Then, when options were exercised by employees who remained, the investors would get the cash flow as if they had exercised the options, paid on a quarterly basis with an average delay of two months.

Mr. Dietrich said that delay was one reason the auction could yield too low a price, and the S.E.C., in its letter, said issues relating to investor costs of holding would have to be considered.

Mr. Hill of Zions said the security could be modified to include paying interest to offset the delay in the cash payments.

A major problem with such auctions, and the reason that the S.E.C. may have to watch over them, is that they are fundamentally unlike other security sales in that both the seller and the buyer would be happy to see a low price -- the buyer to get something cheap and the seller to be able to minimize the reported expense of issuing options to employees.

Mr. Dietrich voiced questions about a statement by Zions that it might disqualify option bids intended to manipulate the market, asking if that might be a signal Zions was worried about keeping the price low.

Mr. Hill said the possible manipulation he had sought to prevent with that proposal came from a worry that Wall Street competitors might try to drive up the price and thus reduce the attractiveness of Zion's security to potential issuers.

Photo: Conrad Hewitt is the chief accountant for the S.E.C. (Photo by Adam Rountree/Bloomberg News)