H.R. 3574—THE STOCK OPTION ACCOUNTING REFORM ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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H.R. 3574—THE STOCK OPTION ACCOUNTING REFORM ACT

Wednesday, March 3, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Shays, Gillmor, Bachus, Shadegg, Biggert, Capito, Hart, Kennedy, Brown-Waite, Kanjorski, Ackerman, Sherman, Meeks, Inslee, Moore, Lucas of Kentucky, Crowley, Israel, Clay, McCarthy, Matheson, Miller of North Carolina, Emanuel, Scott and Velazquez.

Chairman BAKER. [Presiding.] If I could get everyone to please take their seats, we will call the meeting of the Capital Markets Subcommittee to order.

This morning, we are here to conduct a hearing on the elements of H.R. 3574, the Stock Option Accounting Reform Act. Historically in our country, it has been granted that individuals with good ideas, a lot of hard work and the willingness to take a risk could form business enterprises, and if able to convince others of the validity of their vision, could encourage their participation in business formation by granting them a potential slice of future profitability through the granting of options. It has been I think without any dispute a valid methodology for economic activity, job creation and in some cases profitability.

Although in recent days there have been concerns about the granting of these options and the inappropriate exercise of those grants by a relatively small number of executives in the corporate structures, the value of this method continues to be clear in the overall world of business creation, particularly in the world of high technology.

H.R. 3574 preserves the opportunity to take dreams and turn them into reality and success, but I believe would eliminate the opportunity for manipulative management to flip options for fortunes. In support of this view, 84 percent of options granted in the high tech industry have been found to go to the broad class of employees, while 14 percent of options granted went to the executives, which this bill would prohibit from engaging in that practice.

As to the voice or concern of those reporting financial condition accurately, even those who are advocates of expensing will acknowledge that accurate calculation of present-day value is a difficult consideration. Others would say it is not possible to achieve fairly.

What, then, is the most responsible public policy to maintain an engine of economic opportunity and job creation when there are many who are calling the current recovery a jobless recovery, or to adopt an admittedly inaccurate accounting standard in the spirit of accurate financial disclosure. I think these are troubling questions that are worth examination.

Certainly, I have regard for the Financial Accounting Standards Board and their professional conduct on matters of accounting accuracy, but there have been instances in the past where we have not viewed their responsible conduct in similar light. I think primarily in the treatment of derivatives reporting and most recently and troubling in the requirement to reduce loan loss reserves at financial institutions in the face of every financial regulator saying that that position was unsupported and ill advised. I do not believe any governmental grant of authority to set regulatory constraints could be above review by the Congress, and the discussion that follows in the public forum.

To that end, we are here today to receive testimony of those who have differing perspectives on the advisability of the adoption of this measure. I look forward to their testimony in helping the committee reach appropriate public policy determinations.

Mr. Kanjorski for an opening statement?

Mr. KANJORSKI. Mr. Chairman, we meet for the second time in the 108th Congress to study the accounting treatment of stock options. Specifically, we will today examine H.R. 3574, a bill that would unnecessarily interfere with the independence of the Financial Accounting Standards Board. Without question, stock options have played an important and crucial role in the ongoing success of many American businesses and the creation of wealth for many American households.

The accounting treatment of stock options, however, has also caused significant controversy for more than two decades. The decisions of the Financial Accounting Standards Board to revisit this matter last year and issue a draft rule later this month have therefore rekindled a fiery debate. In the wake of the recent tidal wave of accounting scandals, support for mandatory expensing has increased significantly. A recent survey by Merrill Lynch found that more than 90 percent of the institutional investors want stock options expensed. The four largest accounting firms have also now called for the expensing of stock options. Moreover, many respected financial experts have effectively made the case for options expensing, including William Donaldson, William McDonough, Warren Buffett, Alan Greenspan, Paul Volcker and Joseph Stiglitz.

In addition, nearly 500 countries have adopted or are in the process of adopting fair value expensing of stock options. Respected corporations like Home Depot, General Motors, General Electric, Wal-Mart, Microsoft and Amazon have all decided to treat stock options as expenses. Several companies headquartered in Pennsylvania have also done the same, including Mellon Financial, Hershey Foods, and First Keystone Corporation in Berwick.

As we proceed today and in the future, I must caution my colleagues about the ongoing need to protect the independence of the Financial Accounting Standards Board. A decade ago, the Congress unfortunately strong-armed this private regulatory body into abandoning its efforts to adopt a rule regarding stock options expensing. We now know that this retreat contributed to the financial storm on Wall Street in 2001 and 2002.

To protect against similar incidences in the future and safeguard the public interest, we incorporated into the Sarbanes-Oxley Act a provision granting an independent funding stream to the Financial Accounting Standards Board. The active consideration of the Stock Options Accounting Reform Act by our panel, in my view, would threaten this recently approved and enhanced independence, intervening in the board's ability to make unbiased decisions and disrupting an objective process for reasons other than sound financial reporting.

Other leaders on Capitol Hill agree with me about the wisdom of protecting the independence of the Financial Accounting Standards Board. Earlier this year, Senator Shelby and Senator Sarbanes, the two most powerful members of the Senate Banking Committee, asserted their bipartisan opposition to intervening in the activities of the board. Chairman Oxley has also previously said that compromising the independence of the board, "could negatively impact efforts to improve the transparency of financial reports." I wholeheartedly agree.

Deciding what should be accounted for and how it should be accounted for is the job of the Financial Accounting Standards Board, not the Congress. Although the board has not yet released its draft rule on expensing stock options, I am pleased that the agency is working to address this important issue. Employee stock options are a type of compensation just like a salary or a bonus. Because compensation is an expense and because expenses influence earnings, employee stock options should be counted against earnings and subtracted from income.

Mandatory stock option expensing would further help investors to make better decisions. Individuals, for example, might have previously made different choices about the stock of AOL Time-Warner. In 2001, the failure to account for employee stock option on the company's balance sheet resulted in a profit of $700 million, instead of an operating loss of $1.7 billion. Unlike the current system where some businesses expense options and others do not, a mandatory expensing rule would also facilitate comparisons between companies, helping investors to make apple-to-apple evaluations, rather than apples-to-oranges assessments.

In closing, Mr. Chairman, our capital markets remain the strongest in the world only when the rules are clear and credible, corporate activity is transparent, and the data is unbiased and comparable. Stock options are expenses. To strengthen investor confidence and promote the international convergence of corporate reporting standards, the Financial Accounting Standards Board must therefore proceed with diligence and without political interference in these matters.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 46 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Mr. Gillmor, did you have an opening statement?

Mr. GILLMOR. Thank you very much, Mr. Chairman, and also thank you for holding what is a very important and timely hearing.

The issue of how to account for employee stock options in a company's financial statements is a very significant one, particularly given the many high profile cases of accounting fraud in large publicly traded companies. As a member of the Committee on Energy and Commerce, which used to have jurisdiction in this area, and the House Financial Services Committee since 1994, I have been monitoring the Financial Accounting Standards Board rulemaking process on the accounting of stock options. I was supportive of their final rule addressing stock options and allowing them to be recorded as an expense on their annual profit and loss statements.

Unfortunately, I have to say I oppose H.R. 3574, the Stock Option Accounting Reform Act which we are reviewing this morning. I feel that Congress and this committee should stand by our statement in the Sarbanes-Oxley Act of 2002 and the recent SEC policy statement reaffirming FASB as the nation's accounting standard setter, and we should allow them to do their job and retain the independence mandated in these matters by Congress itself.

This week, I am circulating a letter to all my colleagues that I received from the Ohio Public Employees Retirement System, a $56 billion fund and the tenth-largest state pension fund in the United States, expressing their support of FASB's actions and opposition to the bill. As Laurie Hacking, who is the executive director of that organization, states in her letter, "FASB has considerable financial expertise and is best-suited to consider complex financial accounting issues. It also has a measured process in place for soliciting public feedback on proposed accounting standards."

U.S. financial markets remain the envy of the world due to the quality, the timeliness, and the credibility of financial information and disclosures provided by companies. The result is a better allocation of resources and lower overall cost of capital. We ought to ensure that this remains the case by allowing our standards setter to operate independently of public and private special interests.

I encourage my colleagues to support the role of FASB. We should not be setting accounting standards on a political basis. Also, the failure to expense options provides false and misleading statements to shareholders because it does not accurately reflect the true cost to the company and the shareholders. That, I think, explains the broad support for stock option expensing by financial experts such as SEC Chairman Bill Donaldson, Federal Reserve Chairman Alan Greenspan, former FED Chairman Paul Volcker, and Warren Buffett.

Thank you, Mr. Chairman, for calling this hearing and I look forward to the debate. I would also, if it is appropriate, Mr. Chairman, request unanimous consent to enter into the record a statement I have received from the Ohio Highway Patrol Retirement System.

[The following information can be found on page 116 in the appendix.]

Chairman BAKER. Without objection. I thank the gentleman.

Mr. Crowley, did you have an opening statement?

[The prepared statement of Hon. Paul E. Gillmor can be found on page 44 in the appendix.]

Mr. CROWLEY. Thank you, Mr. Chairman. I want to thank you, Chairman Baker and Ranking Member Kanjorski for conducting this important hearing this morning and for our panelists before us today on the expensing of stock options and the possible effects that this could have on our economy.

The Financial Accounting Standards Board will soon issue a proposal on the accounting treatment for employee stock options. While I welcome the role the FASB plays in our economy, that of ensuring the independence and credibility of our nation's accounting system, I must disagree with FASB on their expected upcoming actions dealing with the expensing of stock options. I do not believe that any prohibition on the mandatory expensing of options would cloud basic accounting principles. Investors and analysts who are interested in adjusting an issuers income statement for the cost of stock options already have the necessary information available in the footnotes included in their annual reports.

Additionally, while many supporters of expensing will argue that it would help restore credibility and investor confidence to our markets, again I would respectfully argue the opposite would occur. The mandatory expensing of stock options would effectively destroy broad-based stock option plans which enhance financial opportunities for workers at all levels, stimulate economic growth and helped create the new economy of the 1990s, a new economy that resulted in a burst of new wealth, productivity and ingenuity that we still enjoy today in America.

In fact, it is these stock options that have spread wealth throughout all sectors and to all employees of the new economy, from CEO to secretary. Ninety-eight of the nation's top 100 largest high-tech firms that focus on the Internet provide options to most or all of their employees. Most of these options go to the rank-and-file workers, helping stimulate wealth creation for employees, while allowing employers to attract the best and top talent.

Why did and do educated people flock to corporations that offer their employees stock options? Because they understand the value of options for their company's bottom line and for their own personal bottom line. Stock options promote wealth sharing and we should not hamper that as a means to address what some see as a questionable issue of corporate governance. While the stories of the high-tech boom gone bust are everywhere, can anyone honestly say our nation or economy or our people would be better off without the Internet boom of the 1990s and resulting and long-lasting benefits it provides to America and the world today and every day?

That is why I am a strong supporter and cosponsor of both H.R. 1372 by Congressman Dreier and Congresswoman Eshoo, both of California; and H.R. 3574 by Chairman Baker and Congresswoman Eshoo. I believe these are important bills that will protect job and wealth creation in America, while not threatening our nation's accounting standards or FASB's independence.

Once again, I want to thank Chairman Baker and Ranking Member Kanjorski and all the witnesses. I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Mr. Shadegg, did you have a statement this morning?

Mr. SHADEGG. Thank you, Mr. Chairman. I want to thank you for holding this hearing.

Let me state at the outset that I am a supporter and cosponsor of H.R. 3574, the Stock Option Accounting Reform Act. However, I would have ideally preferred the Dreier legislation that was referred to. It is my preference that there be no statutory requirement for stock options. I believe this is an issue which needs to be resolved in the marketplace on a case-by-case, corporation-by-corporation basis. However, I do recognize that there is a significant movement toward some sort of expensing, and I believe that the limited expensing coupled with an absolutely necessary study of the economic effects of expensing contained in H.R. 3574 is appropriate.

There are numerous reasons why I oppose statutory requirements for the expensing of stock options and I associate myself particularly with the comprehensive discussion of this issue contained in the written testimony of Arthur Coviello. There are two points which deserve special mention. First, requiring the expensing of stock options will stifle the ability of small companies on the cutting edge of innovation to attract and retain the high quality employees they need to turn concepts into real-world products. Time and again throughout our nation's economic history, and especially during the high-tech revolution of the 1990s, small firms that were long on ideas, but short on earnings, have been able to conceive of, develop and bring to the market new products which have had profound impacts on all of the economy. To do so, small companies have relied above all on their human capital, on intelligence, motivated, hard-working employees who are able to think outside the box.

The primary way they have been able to attract and retain these individuals is by offering them the opportunity to grow with the company, to share directly in the success of their innovations through stock option grants. By increasing the cost of granting stock options, the playing field will be tilted away from these small firms and innovation in the marketplace will suffer.

The second and perhaps more critical point is the democracy which broad-based employee stock options bring to corporations. Employees who own stock in their company are far more than labor. They are the owners of the company. They share both financially and psychologically in its success to a much greater degree than mere numbers on a balance sheet can ever capture. It would be a sad triumph of myopia to decide that the placement of another, and quite frankly not very accurate, number on a corporation's balance sheet is more important than the commitment to the success of that corporation brought by employee ownership.

Again, Mr. Chairman, I commend you for holding this hearing and for introducing H.R. 3574. I look forward to working with you to enact this legislation into law.

[The prepared statement of Hon. John B. Shadegg can be found on page 49 in the appendix.]

Chairman BAKER. I thank the gentleman.

Ms. Moore?

Mr. MOORE. Thank you, Mr. Chairman. I would like to thank you for holding this hearing today on H.R. 3574, the Stock Option Accounting Reform Act. I look forward to working with you, with my members and colleagues on both sides of the aisle on this issue, as I have in the past. I hope we can move this legislation in the 108th Congress.

The members of this subcommittee and our invited witnesses are well aware of the issues surrounding the mandatory stock options expensing debate, so I will not discuss those at length here today. It is worth noting why the Baker-Eshoo bill would take necessary and important steps toward curbing many of the abuses in stock options that have given them a bad name.

The various corporate scandals of the late 20th and early 21st century exposed the need for Congress to ensure that highly compensated senior executives cannot misuse stock options. As we have seen, the prominence of options and executive compensation packages has actually served as an incentive for executives of certain now-defunct companies like Enron to engage in complex structured finance deals that had the practical effect of manipulating the company's stock price. Enron executives had every reason to work to maintain an artificially high stock price. The higher the stock price of the company, the more valuable these executives's options became.

It is important to remember that options do not inherently lend themselves to abuse. I am concerned that proposals to require public companies to expense all employee stock options may have the unintended consequence of decreasing the number of options that companies will offer their employees in the future. Broad-based employee stock options played a significant role in the capital formation that led to the technology boom, and consequent productivity gains of the late 1990s. Congress should be focused on putting an end to the abuses that threaten to curtail broad-based options issuance and the Baker-Eshoo bill, Mr. Chairman, is an important step forward in that regard.

Finally, while I generally believe that Congress should allow FASB to set accounting standards without congressional interference, I think it is entirely appropriate that we continue to monitor the issue of options expensing and take action if necessary to ensure that proposals affecting stock options expensing will not overreach. FASB should be extremely careful to take into account the differences between rank-and-file employee stock programs and nonqualified option grants that have led to the corporate abuses we have discussed earlier.

Thank you again, Mr. Chairman, for holding this hearing. I look forward to hearing the witnesses's testimony.

Chairman BAKER. I thank the gentleman.

Mr. Scott, did you have a statement?

Mr. SCOTT. Thank you very much, Chairman Baker.

This is an important issue, given the pending action by the Financial Accounting Standards Board, to issue rules requiring companies to report the value of their stock options and their income statements. I am a cosponsor of H.R. 3574 and I commend Chairman Baker and Representative Hooley for introducing this balanced legislation.

As we move forward in this committee, we should make sure that rank-and-file employees who have benefited from broad-based stock option plans in the past can continue to reap these benefits in the future, while combating abuse in executive compensation.

We also must ensure that companies have all the tools they need to stay on the cutting edge of innovation and maintain all the tools we have to expand the jobs based here in the United States. H.R. 3574 encourages small companies to innovate, rather than stifling them.

I look forward to hearing from today's distinguished panel about H.R. 3574 and the pending regulatory action by the Financial Accounting Standards Board.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Emanuel, did you have a statement?

Mr. EMANUEL. Yes, Mr. Chairman. Thank you and I will try to be quick because I know we want to get to the panel. Thank you for holding this hearing.

In general, my view is that this decision should be left to the FASB board and the private sector. I have expressed that view in the past, but I also believe we should be sensitive to startups and young businesses if we are going to make any decisions about the expensing of options. But I firmly believe it is the jurisdiction of FASB and the private sector to regulate this area. It needs some reforms as there clearly were abuses in the past.

I want to caution us that we should not micromanage the private sector on issues like expensing options and board independence, and at the same time leave major issues that we actually should be involved in, such as health care, retirement security and employment safety, untouched. So my view is that we shouldn't be setting a precedent by getting involved in things that might better be left to the private sector; and things that we should be involved in.

I understand that some of the issues I raised are beyond the jurisdiction of this committee, but it worries me that we are micromanaging private sector interests, when the major social issues are left undiscussed and untouched by this Congress.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Sherman?

Mr. SHERMAN. Thank you.

As one of two CPA on this subcommittee, I take a strong interest in these hearings. Only as I understand it, one out of five of all those testifying are skeptical or opposed to the bill in front of us. That is not surprising, because the most powerful people in our society as a group are corporate executives, and the best way for a corporate executive to get rich is on stock options. Stock options have had a favorable treatment both under our tax law and especially under our accounting rules for a long time.

I should point out that we should be loyal here to investors. Investors should be given the truth. We should not fool investors or steer investors into companies just because the companies are doing good things. If a company has a democratic process of spreading the wealth, that is a good thing. But that does not mean we should fool investors as to the total costs of compensating their employees.

Likewise, if a company was going to add 1,000 jobs to its payroll and every single added employee was a former welfare recipient, who would propose that in order to encourage that great corporate activity, that we would say that the money spent for those employees as their payroll should not be charged against income? No one would say we are penalizing a company by making them record as an expense the cash that they pay, the very people we most desperately want them to hire.

Now, I think one ultimate solution to all this, and I agree with my friend from Illinois that it should be the FASB that wrestles with these issues, is that we let 1,000 flowers bloom; that we provide to investors an income statement, an earnings per share number that reflects what I would call the Coca-Cola approach, and what was up until I believe recently the Pepsi approach. One soft-drink company expensing stock options; the other I believe until recently capitalizing. Actually, both changes were recent, but I guess Coke was the original on this.

So if we provided both, then we would eliminate this as an issue. Those investors who wanted to invest in companies based on their earnings per share unadjusted for stock option expense could do it on that basis. And those who believe that they would make better decisions with the other number could use that number.

Now, it is not a penalty against a company to list something as an expense if it really does cost the shareholders something. An example of that would be, say, health care coverage. You folks, we are all talking here about employee stock options. If you gave the exact same option to a health care company and the corporation said, you know, we cannot afford health care coverage. Our people are going to be going to emergency room. They are going to be dying because we do not give them health care coverage, so here is what we are going to do. We do not have the cash. Those stock options we were going to give the investors, we are going to give to a health care company, and because we are a hot company, because they have faith in us, they are going to take stock options instead of cash.

Every single person in this room would say you have to book it as an expense. If you pay the health care company in stock options or you pay him in cash, you have to book it as an expense.

So we are in a position here to say that stock options when given to executives, that is such a noble purpose that its favored position must be continued, if we give it to executives or even if more democratically around the company. But if we use it to provide health care, that is an expense.

I would also add that this is a matter of fairness among sectors. I will wrap up soon. I have more high-tech companies than the Chairman. Well, proportionately, you probably have more steel companies. I am guessing.

Chairman BAKER. Oil and gas.

Mr. SHERMAN. Okay, excuse me.

Chairman BAKER. We used to.

[Laughter.]

Mr. SHERMAN. In any case, there still is an old economy that does not use stock options. If the company in my district that uses stock options has to report 7 cents per share earnings instead of 9 cents, what it means is the capital flows to the chairman's district. There is a certain amount of capital, 8 cents a share, if his company, old-tech, not providing stock options is reporting 8 cents a share, and what we are debating here is whether the high-tech company is reporting 7 cents or 9 cents, let us not forget it is all comparative, and the capital that flows to that stock option-using company is flowing away from the company that does not use stock options.

Finally, I may add that there is one area where FASB has it wrong. They know the have it wrong. And that is the area of expensing research. If you go buy a research result, you buy a patent, that is purchasing an asset. But if you do the research in-house, that is booked as an expense. That is a penalty and there is a reason why we do not have all that corporate power fighting against that penalty. It is not because research is not just as important to this country as executive compensation. It is because executive compensation is more important to those who have the most power in our country.

If we want to start second-guessing what the FASB is doing, we ought to take a look at the genuine penalty they impose on companies who do research in-house. We know why the FASB has imposed that penalty. It is because the accountants do not want to figure out whether a research project has been successful or unsuccessful. So they penalize a company with a successful research project and say every research project will be deemed unsuccessful and we will penalize. So there are penalties in what the FASB does, but they are for research.

I yield back and thank you for the time.

Chairman BAKER. I had to exercise my option. I am sorry.

Mr. Shays, did you have a comment?

Mr. SHAYS. Yes, Mr. Chairman, just to say that I want to state that my position is basically to go with what FASB suggests, unless I see overriding evidence here before any decision has to be made. So my sense is very clearly that expensing makes sense, but I am here to learn and see if I should be changing my opinion.

Thank you.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Inslee?

Mr. INSLEE. Thank you.

I would normally be reluctant to have Congress delve into a FASB issue, but I think it is required here and I cosponsored this bill. I just want to make two points. First, my friend Mr. Sherman referred to letting 1,000 flowers bloom. The problem, though, is that right now a lot of those flowers are blooming in India and China . We would prefer them to bloom here. By this action by FASB, we add to the possibility that there will be a competitive advantage in hiring talent in India and China, where I think this will be treated differently.

We are now in the midst of a real national domestic crisis dealing with job loss. This potential issue could lead to that where we give a competitive advantage to India and China and this is not the moment for doing so.

The second point is that we are doing a lot of research in my district, the First District of Washington, and we are doing lots of research with DNA and the like. I think we ought to be spending our hard-earned dollars in research on DNA, not research on CPAs trying to figure out how many thousand angels can dance on the head of a pin, on trying to figure out a right number for expensing this. Let us focus on research and science, rather than the abstractions that could lead economists to go crazy.

I will yield to Mr. Sherman.

Mr. SHERMAN. I thank the gentleman for yielding.

I would point out that if the FASB changes the rules, whether those stock options are given to an Indian engineer or Chinese engineer or an American engineer, they would all be treated the same way. How things are treated on the Indian stock market is of little relevance because all the companies in high tech are turning to the American capital. So we are talking about rules that will apply to whether it is French companies, Indian companies, American companies doing business wherever, and their use of stock options and other mechanisms to compensate their people.

Mr. INSLEE. Reclaiming my time, the fact is that we are talking about competition between Indian companies and American companies; Indian capital formation and American capital formation. And you have an antiquated view, I believe, of reality in thinking there is not capital growing in China and India. Half the cranes in the world are in China right now building new capital investment and using a lot of Chinese capital. Our entire federal debt is financed with Chinese capital at this moment, according to Mr. Greenspan.

So I think the future is, we have to pay intimate attention to international competition right now to keep jobs in this country. I think this is one issue, although we do not think of it in terms of outsourcing, we ought to start thinking about these terms in every public policy we have.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Bachus, did you have a statement?

Mr. BACHUS. Yes. I thank the Chairman.

I will tell this to the Chairman and the Members, and also to the panel, one reason that we are here today is because we have not been able to reach any middle ground with FASB. They have simply taken a mandatory approach. We are going to require all employee stock options to be expensed. It does not matter whether it is a phantom expense to the company. It does matter whether it is difficult on how to value these expenses. It does not matter that really tech companies, one of the reasons they have been able to flourish, grow and we are at the leading edge of technological development, and that even FASB agrees that is in large order because of employee stock options.

They have made no efforts to find a middle ground. I actually think that what they are doing violates generally accepted accounting principles, because you are going to require companies to expense these stock options when there may never be an expense. These companies, a lot of their innovation is from employees who were promised a share of the company. That is no longer going to be possible. Employee stock options have resulted in large numbers of people having an equity ownership in a company. In fact, companies that give employee stock options, the employees in many of these companies own 10, 15, 20 percent of the company, sometimes 30 percent and more.

I think we are really threatening to take one of the things that makes our companies the most competitive and the most innovative, and slam the brakes on it. Apparently, we are going to do that with a rule that is going to go into effect January 1. I think it could have broad-based negative effects on our country, on our most innovative companies, our fastest growing companies. There are certain things FASB has not been able to answer. They have answered to me in incomplete ways. One is, where do we get the models to accurately say what these expenses will be? They have said there are models available, but those models are not models that are used to value employee stock options. They are models that are intended to simply model stock options in general. There is a big difference in an employee stock option and other stock options.

So I have real concerns. I am going to, for the record and in the interest of time, submit a two-page statement outlining probably 15 or 20 different objections to this. I think there is some middle ground, but I can tell you that what FASB is proposing is not a middle ground. It is a radical departure from not only what we are doing now, but it to me will shock the market and could have broad-based effects on the creation of jobs, productivity, and keeping our country competitive in a world environment. Also, I think it will harm a lot of middle class workers.

With that, I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. McCarthy, did you have a statement?

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman.

I am going to reserve my opinions at this point, because that is what a committee hearing is supposed to be about. So I will offer my statement, and I am looking forward to hearing the testimony. I will say you can see that both sides of the aisle, Republicans and Democrats, need to have as much information as possible because we are split on this. We are trying to find the right solution for all of you. So I look forward to the testimony.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman.

Very briefly, I am not a big believer in throwing the baby out with the bathwater. I do not believe that we should allow the clear financial abuses of some institutions and firms to impinge on the ability of all entrepreneurs, all small businesses, all high-tech businesses including many that I represent, in surviving and growing.

Many firms in my congressional district rely on stock options as the most feasible way of sustaining themselves. I believe that we should proceed very cautiously and not take the financial abuses of some and use them to essentially destroy the ability of so many of these firms to compete and grow, create jobs and expand.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Matheson?

Mr. MATHESON. No opening statement for me. I look forward to hearing from the witnesses. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Ackerman?

Mr. ACKERMAN. I am happy to be here.

Chairman BAKER. We are happy to have you, Mr. Ackerman.

If there is no member wishing to make any additional statements, then at this time I would like to welcome our long-suffering panel to our hearing this morning. We do appreciate your willingness to participate and give us your perspectives.

Let me just do the formalities. To the extent possible, constrain your remarks to a 5-minute statement. Your official statement will certainly be made part of the hearing record. We look forward to hearing your various perspectives.

Our first witness is Miss Karen Kerrigan, chairman of the Small Business Survival Committee. Welcome.

STATEMENT OF KAREN KERRIGAN, CHAIRMAN, SMALL BUSINESS SURVIVAL COMMITTEE

Ms. KERRIGAN. Good morning, Chairman Baker, Ranking Member Kanjorski and members of the subcommittee.

First, let me thank you for inviting the Small Business Survival Committee to present our views on H.R. 3574, the Stock Option Accounting Reform Act, indeed, to endorse and support this piece of legislation which we think is necessary to sustain economic growth, certainly broad-base employee stock options, and innovation in this country.

Again, I am Karen Kerrigan, chair of the Small Business Survival Committee. We are a nonpartisan small business advocacy organization headquartered here in the nation's capital. SBSC works to advance legislation and policies that help to create a favorable and productive environment for small business growth, job creation and entrepreneurship.

In our view, H.R. 3574 is an appropriate response to what seems to be general indifference at the Financial Accounting Standards Board with respect to the business community's concerns about mandatory stock option expensing. The board is about to unveil a stock option expensing rule that would be particularly complex and costly for small businesses.

In our judgment, it would not lead to the sort of financial transparency and accountability sought by FASB, shareholders, and elected leaders or regulators. Instead, broad-based employee stock option plans would suffer, leaving small firms at a competitive disadvantage to larger and more mature entities whose resources allow them to recruit and attract the best and the brightest. This would be a shame, as small businesses are a key source of innovation and job creation in the United States.

I know that committee members are keenly aware of the important role America's small business and entrepreneurial sector plays in job creation, innovation, economic growth and in the overall health and vitality of our economy. They produce 55 percent of innovations; they obtain more patents per sales dollar than large businesses; they employ 38 percent of high-tech workers. Incentives and tools that help small firms add to their innovative capacity and their productivity like stock options are integral to their success and our general economic well being.

Indeed, through the leadership of the small business and entrepreneurial sector, and more specifically the high-tech sector, the concept of employee ownership and participation has enriched our economy and our workforce in a variety of ways. The spread of what is called partner capitalism, as the authors of the book In the Company of Owners describe it, is a good thing as it boots employee productivity, profits and stock returns.

The mandatory stock option expensing rule proposed by FASB in our view is archaic and out of step. It would vastly curtail the capability of small firms to offer stock options as an employee recruitment, retention and incentive tool. It makes little sense to erect barriers and rules that eviscerate these programs, as stock options have allowed millions of America's workers to have ownership in the companies where they work.

While FASB's intention to increase financial recording and transparency is a worthy goal, we are baffled that they would continue down the mandatory expensing of stock options path, or more specifically, untested valuation models to achieve that. I am not an accountant, as many of you will find out probably in the Q and A session of this, yet the proposal does not seem to make accountant sense. There is no true consensus on the identification of a model to place an accurate and reliable number on the so-called costs of employee stock options. Indeed, all indications are that the FASB is going to rely on either the Black-Scholes method or the binomial method, both of which many experts agree produce bad numbers.

As a result, the mandatory expensing of employee stock options will not make financial statements more accurate, reliable and transparent. A recent decision by FASB to reject field-testing of various valuation models is unfortunate. From our perspective, it made sense for FASB to take the time to run valuation tests on a wide sample of companies to determine impact.

H.R. 3574 is a prudent solution which comes at an important time. The proposed legislation incorporates sound and targeted reforms with a reasonable requirement that a study be conducted to understand the economic impact of the mandatory expensing of all employee stock options. The latter is very important, as policymakers must make every effort to review whether proposed policy initiatives weaken or strengthen U.S. job-creating capacity and competitiveness.

SBSC certainly appreciates the measure to protect small businesses and startup companies. The exemption for companies with less than $25 million in revenues and the protection for companies 3 years after the initial public offering strike a reasonable balance.

In essence and most importantly, H.R. 3574 will help preserve broad-based stock option plans and the ability of small firms to offer these plans.

Let me just add as a wrap-up that we are hopeful that this instance or this current controversy serves as an opportunity for FASB to review its standard-setting process. Already, they have reached out to the small business community, specifically to the Small Business Survival Committee, to let us know that they are putting together a small business advisory board and they have asked us for recommendations for people to serve on that board. We have recommended someone to serve in that capacity.

In closing, let me reiterate SBSC's support for H.R. 3574. We encourage Congress to act quickly. With the economy getting back on track, we believe Congress would be taking a prudent step in shielding America's workforce and businesses from the proposed action that would undermine economic growth.

Thank you.

[The prepared statement of Karen Kerrigan can be found on page 82 in the appendix.]

Chairman BAKER. I thank the gentlelady for her statement.

Our next witness is Mr. Mark Heesen, President of the National Venture Capital Association. Welcome, sir.

STATEMENT OF MARK G. HEESEN, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. HEESEN. Thank you. Good morning.

I am Mark Heesen, President of the National Venture Capital Association, which represents 460 venture capital firms in the United States. Venture-backed companies are very important to the U.S. economy as a whole in terms of creating jobs, generating revenue and fostering innovation. In fact, U.S. companies that were originally funded with venture capital now represent 11 percent of annual U.S. GDP and employ over 12 million Americans.

I am testifying today in support of H.R. 3574, as this bill reflects a thoughtful and balanced approach to employee stock option accounting. The bill mitigates to a considerable degree the critical flaws surrounding the impact of expensing on small and emerging growth businesses, an impact that FASB has simply refused to address.

Since the last Senate hearing this past November on this issue and the last meeting of this subcommittee in June, the FASB has made no meaningful progress toward making any distinction between the effects its proposal would have on large publicly traded entities versus small private businesses, despite countless calls to do so and promises from Chairman Herz to members of this committee to do just that.

We fully concur with Congress's reluctance to involve itself in the setting of accounting standards. Yet FASB's exposure draft is expected in a matter of days and frankly we have nowhere else to turn. The voices of our country's emerging growth businesses have gone ignored by FASB. We see an urgent need for checks and balances in our system at this time.

Employee stock options are a critical factor in fueling entrepreneurial innovation and economic growth. For example, the biotechnology industry today simply would not exist without venture capital and without employee stock options. Almost without exception, young venture-financed companies use options to attract the best and the brightest talent when cash is scarce, and cash is always scarce in these companies. Should FASB require stock option expensing, they will seriously harm the economic tool that has given U.S. companies a major competitive advantage over its foreign counterparts.

The mandatory expensing of stock options will place a serious burden on small companies so that most will be forced to curtail their broad-based option programs. Today, just as in 1994 when this issue was last addressed by Congress, an acceptable method for the valuation of employee stock options has not been identified by FASB. Therefore, the option expense number will be perpetually inaccurate, particularly for private companies where it is impossible to measure volatility in mandatory input into the valuation models currently supported by the FASB.

By requiring companies to disclose a highly suspect expense number, the FASB is creating a cost on the income statement that will have a significant long-term impact on a company striving to reach profit levels necessary for an IPO or to become an attractive acquisition target.

Aside from inaccurate financials, a more practical concern is the monetary and human costs that will be required for young companies to undertake the valuation process. These organizations cannot afford the outside expertise required to work through these complex valuation models, nor can they afford the time to do it themselves. But FASB's mandate will force them to address these accounting issues, distracting management, raising expenses, and lengthening the reliance on expensive high-risk capital to the start-up sector.

We believe H.R. 3574 seeks to preserve broad-based employee stock options and addresses serious implications of expensing for emerging businesses. By limiting mandatory expensing to the top five executives, this bill targets executive compensation, while simultaneously preserving the ability of companies to deliver options to rank-and-file workers.

By exempting the expensing requirement for small businesses until 3 years after an IPO, the bill relieves compliance burdens for young companies seeking to go public, and allows the company's stock to settle down from the volatility of an IPO. By setting the volatility at zero for valuation purposes as allowed under current FASB rules, H.R. 3574 removes a key variable that creates highly inaccurate expense figures.

Finally, by requiring the Secretaries of Commerce and Labor to complete a joint study on the economic impact of mandatory expensing, the bill thwarts a rush-to-regulate effort by the FASB and prevents severe unintended consequences for our economy and our international competitiveness.

Should FASB move forward with this current stock option accounting mandate, venture-backed companies will have inaccurate financial statements prepared at a significantly greater cost. Entrepreneurial businesses will be unduly impacted as they do not have the adequate resources to comply. The entrepreneurial energy that now accounts for over 10 percent of the U.S. economy will be drained at a time when our global competitiveness is increasingly challenged by economic conditions overseas.

International convergence of accounting standards such as mandatory expensing will touch Europe and the United States, but not China and India, where we feel accounting standards more supportive of stock options will drive more highly skilled jobs offshore. Today we applaud the congressional leadership for addressing the practical impact of FASB's stock option expensing proposal and we urge passage of H.R. 3574.

Thank you very much.

[The prepared statement of Mark G. Heesen can be found on page 75 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Reginald Reed, who is the manager for software development from Cisco Systems. Welcome, sir.

STATEMENT OF REGINALD REED, MANAGER, SOFTWARE DEVELOPMENT, CISCO SYSTEMS

Mr. REED. Thank you. Good morning. Chairman Baker, Ranking Member Kanjorski, members of the subcommittee, thank you for the opportunity to testify this morning in support of broad-based stock option programs and H.R. 3574, the Stock Option Accounting Reform Act.

My name is Reginald Reed. I am the manager in the software development area for Cisco Systems, Incorporated. I work for Cisco in the Research Triangle Park near Raleigh, North Carolina. I have been with Cisco for 7 years. We are most appreciative, Chairman Baker, for your incredible leadership on this important issue. Thank you for standing up to preserve broad-based employee stock options for the over 10 million U.S. employees who have received them. We need the House and Senate to pass this legislation soon because the future of broad-based employee stock option plans is in jeopardy.

Every day, I see the difference that employee stock options make in the workplace. In my opinion, there is no better way to motivate talented employees. In fact, I had underestimated their power to motivate. Because of Cisco's broad-based employee stock option plan, our customers and shareholders benefit. When something is a positive for employees, customers and shareholders, it is a very powerful tool.

At Cisco, employees are tied to the company's bottom line in large part because of the stock option grants we receive that make us all owners. Employee stock options allow us to better understand how hard work and innovation play a central role in the company's overall success. The sense of ownership created by stock options at Cisco and other companies is part of the driving force behind the advances in information technology that take place throughout the industry.

The Cisco stock option program has helped turn our Research Triangle Park operation into a major engineering hub on the East Coast. At Cisco, I see the benefits of employee stock options everywhere I look. I have five engineers who report directly to me. I see first-hand how stock options make them think and act like owners.

I see the extra mile they go, the extra energy they provide, and how they act like owners.

I also know how stock options incentivize me. As I look at my managers, I see the same dynamic. Our CEO, John Chambers, has put it very well. He has said that the difference between workers who receive employee stock options and those who do not is a lot like the difference between owning a home and renting one. The mindsets are totally different. When you own a home, it is a reflection of you. From the basement to the attic, you want everything to be perfect. When you rent, you just want to make sure that you get the security deposit back.

The 35,000 employees who make up Cisco Systems are owners. We want to make the most innovative products. We want to develop the newest technologies. Employee stock options are an essential part of that commitment that binds us all together. If stock options are expensed, many companies will be forced to cut back on programs that benefit rank-and-file employees, and instead only give them to top executives. If this happens, we will lose much of our ability to attract, retain and motivate dedicated employees.

The call for expensing of employee stock options, as I read it, came about because people were concerned about bad executive behavior. The irony is that these misdirected reforms to expense all stock options will largely impact rank-and-file employees like myself. This is why, Chairman Baker, your legislation addresses those initial concerns so well, while also preserving broad-based employee stock option programs.

A little over a year ago, my wife Julie and I welcomed our first child into our family. The stock options I exercised 5 years ago went towards a down payment for the house that our child calls home. In the future, my goal for stock options are for a good education for my daughter and a more secure retirement.

I am not an accountant. I am not an expert in financial statements or footnotes or the securities laws, but I do know the benefit of stock option plans that are broad-based. Like the millions of other workers in this country who receive employee stock options, I am worried that unelected accounting regulators are going to make a decision that effectively eliminates broad-based employee stock option plans and negatively affects our economy and our country.

We need your help. We need our elected officials in the United States Congress to step in and preserve broad-based employee stock options. That is why on behalf of the employees of Cisco, I ask you to pass H.R. 3574.

Thank you very much for inviting me here today and taking the time to listen to my testimony. I will be pleased to answer any questions that you might have.

[The prepared statement of Reginald Reed can be found on page 113 in the appendix.]

Chairman BAKER. Thank you, Mr. Reed. We appreciate your participation here today.

Our next witness is Professor Robert Merton from the Harvard Business School. Welcome, sir.

STATEMENT OF ROBERT MERTON, HARVARD BUSINESS SCHOOL

Mr. MERTON. Good morning. As you said, I am Robert Merton. I am a professor at the Harvard Business School. I am also a co-founder and the chief science officer of a firm called Integrated Finance Limited.

Mr. Chairman, I thank you and the subcommittee for inviting me to testify on the Stock Option Accounting Reform Act. The focus of my remarks on this bill addresses three points. Compensatory stock options are a real cost to the company and should be an expense. Second, the costs to the firm of these options can be estimated. And third, what are some of the potential public policy issues associated with expensing of these options.

As to the first point, the function of financial accounting is to provide clear, comparable and unbiased information to inform investment decisions. It is a basic principle of accounting that financial statements should record economically significant transactions. Issuing stock options is just such a significant transaction and footnote reporting is not a substitute for recognition on the income statement.

Even if no cash changes hands, issuing stock options to employees incurs a sacrifice of cash, an opportunity cost that needs to be accounted for. Both accounting earnings and labor expenses relative to operating revenues are used by analysts to estimate performance of the firm and to compare efficiency and profit margins among firms. The form in which such compensation is paid by the firm should not determine whether it is expensed or not.

H.R. 3574 holds that only options granted to the CEO and the top four most highly compensated executive officers of the firm should be expensed. That is not consistent with reflecting the entire economic cost of using options to pay for labor services to the firm. Other forms of compensation, including salary, cash bonus, restricted stocks, performance options and other benefits are expensed for all employees, and not just the top five officers of the firm.

As to my second point, the value of these options should be the economic cost to the firm of granting those options, and not the value placed on these options by the employees who receive them. The value of those options can be estimated using market prices or pricing models. Financial institutions value and execute transactions involving all kinds of options and other derivative securities in large volume every day all around the world.

Examples range from convertible bonds, warrants, some with 25-year maturities, and institutions routinely in large size offer over-the-counter securities both customized options and so-called exotic options, the terms of which are far more complex than the kinds of instruments that we are trying to assess and value here.

Like real estate appraisals or other non-traded items, estimates from option pricing models often differ from each other and market prices. Those differences are associated with the simplicity of the model, how much accuracy you really want to get, the data, but they tend to be much better than almost any of the other areas on which you do accounting valuations.

That fact does not imply that it is not possible to value an option with terms that are not precisely traded in the market. Financial statements should strive to be approximately right in reflecting economic reality, rather than precisely wrong. H.R. 3574 holds that if a pricing model is used to determine the fair value of an option, the assumed volatility of the underlying stock shall be zero. It is the case that under that assumption of zero volatility, any pricing model used will give about the same estimate of value.

Thus, in effect H.R. 3574 specifies the option-pricing model to use for expensing. This is not a fair value calculation. No recognized expert would be willing to say so. I would strongly advise anyone who asked me against signing any document that would assert that this is a fair value valuation. I have in mind, among other things, CEOs or CFOs signing Sarbanes-Oxley-type documents. I would strongly urge them, do not sign if you think that this is given as the fair value assessment.

But there is no need for you to take my word for it. I would suggest you ask your staffs to get Black-Scholes model, or a binomial model. I am sure any number of financial firms will give you access to their proprietary option models. Plug in zero volatility and valuate Cisco, General Motors, Intel, General Electric, IBM or any of your other favorite companies using that model with zero volatility, and apply it to their traded options which trade in large volume every day, and see how close it comes. You will discover that the valuations are very different, that the valuations given by zero volatility are dramatically less than the market prices.

Furthermore, you will discover that the firms whose equities are more volatile, the difference between this procedure and the market price will be even larger. Since these are also the firms who are often using large amounts of stock options, this would suggest that this valuation procedure is grossly in error in any assessment of fair value.

You might even ask, and I say this somewhat tongue-in-cheek, because I do not think any firm would do it, whether firms would be willing to issue options to third parties at the price that is being suggested they be valued at for expensing in H.R. 3574. I do not think they will.

Current accounting standards require the estimation of useful economic life for depreciating plant and equipment, or as mentioned earlier, the value of acquired in-process R&D, the cost of employee pensions and other retirement benefits, and even contingent liabilities such as environmental cleanups. These estimates are surely made with error and none of these is traded precisely on the markets. And these estimates can significantly impact reported earnings. FASB sets standards for making these estimates and changes take place as new techniques evolve. Why should the case of setting standards for estimating cost for option expense be singularly different?

My third point, will expensing stock options hurt young businesses? This is an important issue. Many critics of the expensing, as we have heard this morning, are concerned that life will be more difficult for businesses that rely heavily on options to reward their entrepreneurial talent. We all recognize the vitality and wealth that entrepreneurial ventures, particularly those in high tech, bring to the U.S. economy. I, for one, have no objection to policy measures that encourage and assist new ventures.

I do question the policy effectiveness of doing so by essentially creating the benefits to those companies from a deliberate accounting distortion proportional to a company's use of one particular form of employee compensation. Indeed, some forms of incentive compensation, such as restricted stock, performance cash award options, and indexed for performance options, arguably do a better job of aligning executive and shareholder interests than conventional stock options do. Yet current accounting standards hold and require that these and virtually all other compensation alternatives be expensed. The provisions of H.R. 3574 would, in effect, exempt only at-the-money stock options from expensing.

If options are a more efficient means to compensate employees because of incentives, then the superior performance of such firms who use them instead of cash should be demonstrated by the larger revenues generated, not by underreporting the expenses. If option grants really do drive employees to work harder, produce, make the firm worth more, that should manifest itself in higher output of the firm. I would recommend that we not try to adjust for that by understating the actual costs.

On the other public policy issues, I think if you pass an Act, as I understand this, which sets a valuation procedure, it would take an act of Congress to change it, but I am not a lawyer. If this were to pass, it could not be changed other than by act of Congress. That seems pretty static to me, relative to having policy set by a standards board which can evolve with new technology and experience.

The second thing I would point out as a public policy matter is a little more latent. That is, I think that the past accounting treatment of options versus other forms of compensation has stifled innovation and variety in compensation plans. It is no accident that virtually every company in the past that uses significant amounts of stock options always issues at-the-money options, or as we are hearing now, maybe out-of-the-money options. Performance options and others are not issued, even though many believe they are far better. It could well be that the previous accounting treatment, which de facto will be the accounting treatment going forward under this bill, is important in having created that stifling of innovation.

Now, on the matter I have heard allusions to that it is seen as a potential comparative advantage for the U.S. if it were to continue to understate certain operating expenses vis-a-vis Europe or other places that do. I do not think so. I do think it is a comparative advantage for the U.S. to maintain the gold standard for financial accounting and disclosure to investors here and abroad. Options can be a powerful incentive tool, but failing to record a transaction that creates such dramatic effects is economically indefensible and encourages companies to favor options over these alternative compensation methods. It is not the proper role of accounting standards to distort compensation by subsidizing one form of incentive compensation relative to all others.

I thank you.

[The prepared statement of Robert Merton can be found on page 90 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Mr. Arthur Coviello, President and CEO of RSA Security. Welcome, sir.

STATEMENT OF ARTHUR COVIELLO, PRESIDENT AND CEO, RSA SECURITY

Mr. COVIELLO. Thank you, Chairman Baker and thank you, Ranking Member Kanjorski and other members of the subcommittee. My particular thanks once again to you, Chairman Baker, for your outstanding leadership on H.R. 3574.

This is indeed must-pass legislation. Congress and FASB must resolve the issues that bear directly and significantly on issues of accounting, valuation, corporate governance, entrepreneurial capitalism, economic growth and jobs. But by its own admission, FASB deals only with accounting and valuation. I am here to tell you that they have the accounting and valuation fundamentally wrong.

The mandatory expensing standard that FASB intends to put into place will force demonstrably inaccurate and unavailable numbers into the financial statements. Let me give you an example from my own company. I am very proud of the fact that we engineered a successful turnaround last year, generating $39 million in operating cash flow and $14 million in after-tax earnings on a GAAP basis, that is GAAP without expensing stock options. Had we expensed stock options we would have recorded a $21 million loss, a $21 million loss. That is a $36 million swing had we expensed stock options.

Would there be a decrease in any of our assets? No. Would there be an increase in any of our liabilities? No. But there would be a marked change in our price-earnings ratio because we would have a price-earnings ratio with income, whereas we would not with a loss. Now, members, I respectfully ask you, who does this fool? Is it easier to evaluate my company based on the current method or is it easier to evaluate my company based on the expensing of stock options?

Multiply this by thousands of public companies in the tech sector that have the exact same issue. Let me give you another example. Sun Microsystems granted options to its employees in the year 2000 at the height of the tech bubble. Those stock options would have resulted in a $700 million charge to earnings. Those stock options were priced at roughly $60 a share. They are not likely to ever be exercised. As a matter of fact, I suggest it would be highly unlikely that they will ever be exercised. However, a $600 million to $700 million expense would have been recorded.

Warren Buffett who was mentioned a couple of times by the members this morning has said that he would gladly trade some of his yards of carpet from one of his Berkshire Hathaway companies for some of those Silicon Valley stock options. I suggest to you that the employees of Sun would gladly take the carpet for the options that they have at $60 a share.

But let us move on from the issue of accounting and valuation specifically, and the issues that should really pique your interest. That is jobs, the economy, and innovation. The high-tech industry, by many estimates, has been responsible for two-thirds of the productivity growth in the economy since 1995. In terms of job creation, my own subsector of the economy, the software industry, has generated over 900,000 jobs since 1993 to 2002. I have not seen the stats for 2003, but I can tell you that we at RSA added 50 engineering jobs last year as we started to rebound. The balance of trade that the software industry, again a subset of the high-tech industry, generated in 2002 was a favorable balance of trade of $25 billion.

What do stock options have to do with all of these statistics? Well, I think they are a very important element in the incentives that are behind all of this job creation, economic growth, innovation and productivity. Let's compare ourselves to the Europeans. They fundamentally lost jobs in the 1990s. They have no broad-based stock option plans. Let's take a look at our competitors in Asia, the Chinese and the Indians. The Chinese, as part of their five-year plan, have a heavy incentive on issuing employees, engineers that are graduating from their universities at a far greater rate than American universities, they have as part of their 5-year plan a desire to implement significant broad-based stock option plans as an incentive.

The real cost of stock options is already calculated in the dilution of earnings per share. It is already reflected in the calculation. That is a standard that was created well over 20 years ago. Why must it change? If we need to have reform of executive compensation, then let's have reform of executive compensation, but let's not throw the baby out with the bathwater.

Let us talk about investors for a moment. I think the existing reforms that are already in place between Sarbanes-Oxley and some of the reforms on the various stock exchanges have gone a long way. You can no longer re-price stock options. Shareholders have to approve new stock option plans. This Act goes further to require the expensing of the officers's stock options, again I think a very reasonable approach for compensation reform.

But there will be confusion if we expense stock options. There will not be more transparency. In the example I gave you, how would an investor evaluate us based on the investment criteria that all investors use when they make a decision to invest in a company? The price-earnings ratio. I, as a CEO of a company, could not continue to sustain a broad-based stock option program if I had to take that kind of a hit to my P/E ratio because if I needed to go to the capital markets to raise money, to be able to generate more innovative inventions for my firm, I would have to take into consideration my price-earnings ratio. So it would be difficult in terms of my own capital formation. Again, apply my specific example to many, many companies that are not even public.

In 10 years, FASB has come up with hardly a single improvement to this valuation issue. They have been intractable. We are before you today because there is a problem that they seem unwilling to address. Left to its own devices, FASB will substitute an arbitrary value that cannot be ascertained. I respectfully disagree with Professor Merton in that some valuation is better than none at all. I don't think it works, especially when you take into consideration that stock options are already reflected in the dilution of an earnings-per-share calculation.

Against this backdrop, you would think FASB would enthusiastically embrace the stock option coalition's suggestion that FASB go out in to the real world and actually test multiple valuation models before implementing an entirely new standard across the board, the same one they have been arguing for over 10 years.

Let me conclude by giving a more specific example of the impact of a couple of our own employees. One is a person by the name of Leslie Hoffman who was formerly my secretary and now works in our purchasing department. She is a single mom and through the exercise of stock options at RSA Securities she was able to purchase a home and provide for childcare for her son Sebastian. She works very hard at home. She knows the importance of her role in helping to contain costs for the company.

We also have a gentleman by the name of Dave Chabot, who is an engineering manager. Dave is another gentleman who works very hard, late into the nights, who has benefited from stock options, moving out of a condo with his children, purchasing a home and still having enough money to be able to set aside tuition college expenses for his two children. Hopefully, some day they will grow up to be engineers and start up a high-tech company. He also recognizes the value of incentive stock options and being an owner of the firm.

This is not an issue of compensation, as has been suggested by some of my other members of the panel. It is an issue of ownership. It is an issue of building sweat-equity into something that you believe in. This will continue to fuel innovation and jobs and economic growth for the country. Let's not eviscerate such a fine program.

Thank you very much.

[The prepared statement of Arthur W. Coviello can be found on page 51 in the appendix.]

Chairman BAKER. Thank you, sir.

I will start our questions going, professor, directly to Mr. Coviello's examples. Taking the Sun Microsystems $60 exercise question, resulting in a $700 million charge in the year of granting, that subsequently might not later be exercised. If you do not dispute those facts, is implementation of an expensing rule in those conditions fair value reporting?

Mr. MERTON. I will stipulate for the purpose of answering your question that those are the facts. I think it is a little more complicated in terms of how the expensing would actually be done. But for this purpose, I would ask you again on the question of financial accounting, there is an issue of comparability. Imagine that there was a firm just like Sun who chose instead to pay its employees in cash the amount of those options, their value at the time. It then had the employees use that cash to buy the options. How would the accounting treatment have been of that sister company? They would have expensed as labor costs the amount of cash that was paid to the employees. The employees would have bought options with the cash.

As it turned out the options went down and became a lot less valuable. That is very bad for the people who are invested in them, so I am not suggesting in any case that that is a good thing. But in terms of the accounting treatment, the response is, why should that sister firm expense $700 million because it chose to do it that way, when Sun did it its way, it would have no expense. We have to distinguish between what is an expense for our labor and then what we do with the fruits of that labor in terms of investment risk. In this case, in effect, the employees have exchanged the cash compensation for options.

Chairman BAKER. But the examples goes to the underlying point of predicting future values, and there is not, or at least I do not believe there is defended, a particular valuation model that is held up to be accurate in predicting future economic value. That is the core of my concerns about this, is having a snapshot that represents to shareholders and potential investors true economic condition, but that we have one that is a fairly reasonable calculus of true value. You have no concerns about valuation models in the current debate?

Mr. MERTON. In the context of predicting future values, it is a difficult task, but it is a task that has to be undertaken every day. That is what is happening when you see valuations of stocks, when managements make decisions about how to value projects, when underwriters go and decide where to price things. They are always engaged in that. We have lots of references to valuing things that represent uncertain events in the future. So in terms of the value of an instrument as of today that I have conveyed to someone, there is nothing especially unusual about doing that valuation. I do not mean to say it is trivial, but it is not something that, my God, how do we do it?

The fact that conditions change and often come out not as expected is a reality of life that we all face. All the investors in Sun who bought the stock at $60 or who held external options at $60 suffered as a result of that decline. If they knew that was going to happen, they would not have bought the instrument. But I think you can separate what happened afterwards from what the value conferred at the time was.

Chairman BAKER. Certainly, and I understand the difference between risk-taking and the actuarial responsibility to report financial condition accurately. Risk-taking is an art form. To the best extent possible, FASB represents accounting as a science, not as an art. I think the problem is we have a proposed interface of artistic view with scientific expectations. I fear the consequence of that is to further misrepresent, not make more clear, true financial condition.

Let me jump quickly, because I know we are going to have a lot of questions, at least I think we are, from other members as well. Mr. Reed, in your statement with regard to Cisco, can you, and you may not be the appropriate Cisco official to ask this particular question, but in your view what is the likelihood that without the options-granting ability that Cisco engaged in, that Cisco would be the company that it is today, given the talent and resources brought into your corporation as a result of those grants?

Mr. REED. Specifically, in the Research Triangle Park area, there is an excellent example of how we made great strides against IBM, which was a much larger company than Cisco was at the time, to bring in IBM networking into the basically Internet protocols. Talent was basically attracted away from IBM using stock options in the very early days. The movement of that talent has basically allowed Cisco to take over that entire market. So it is definitely very important. It would not be in the same place that we are today.

Chairman BAKER. I thank the gentleman.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Coviello, you are a public corporation being traded?

Mr. COVIELLO. Yes, we are.

Mr. KANJORSKI. Did I hear you say you recorded a profit of $14 million, but if you had expensed your options you would have shown a $26 million loss?

Mr. COVIELLO. $21 million loss.

Mr. KANJORSKI. $21 million loss. It seems to me I am trying to get a handle on this. Four members of the panel are obviously not for expensing stock options, and professor, you are a purist. I am trying to become a realist. I think there are compelling arguments in terms of Mr. Heesen's talking about the use of stock options for purposes of avoiding use of raw capital at the very beginning, which is very expensive and difficult to get. We all recognize that and we certainly do not want to turn off the faucet of venture capital.

I think Ms. Kerrigan makes the point on small businesses. She questions whether it increases transparency and reliability. Quite frankly, I always ask the question, why do we want transparency and reliability? It is basically we are trying to weigh the advantage of having a well-informed investor, and that presupposes a public market. As far as I am concerned, if we were to have a separate rule in terms of stock options for non-publicly traded corporations, I could care less. I am not even worried about the venture capitalists. I think they have sharp enough teeth to do due diligence and they know what the hell the company is really worth and what is the value out there. So they are sort of protected.

I guess I am a little disturbed with Mr. Reed's situation, that they want to go on. So let me ask you this for my own clarification. Would you call the non-expensing of stock options a loophole in accounting? And where did it come from? Was it just an invented figment of someone's accounting imagination that said this is a great way not to show an expense on the balance sheet?

Mr. MERTON. I rarely attribute such a conspiratorial element to it. I think if you would like something of the history of options, I think where in part they may have come from is a clear realization, as we have heard here, that it is important to have the management and employees incentives aligned with the shareholders. So you start out by saying, so why not give them stock.

Mr. KANJORSKI. Yes, that can be done in various ways, though.

Mr. MERTON. I am about to get to that, going one step at a time.

Mr. KANJORSKI. Okay.

Mr. MERTON. I think what was discovered is that sometimes you wanted to give more exposure to the movement of the stock than cash. Let's say I wanted to give a particular member of my company a sensitivity to what the fortunes of the shareholders is, which is equivalent to 10,000 shares of stock. But if the 10,000 shares, if I gave them the shares, were worth $1 million, the problem is that is just too much money.

Mr. KANJORSKI. Right.

Mr. MERTON. So one of the ways you could say to solve that is, give them $10,000 shares of stock and then lend them part of the money. Okay, that would be the next step. The problem there is that if you do that and the stock goes down no fault of their own, they go bankrupt.

Mr. KANJORSKI. More of a problem, as Mr. Coviello pointed out, you do not have the money at the time to make that available. They are giving chits. They would not be able to make the loan.

Mr. MERTON. The loan is fictitious in the sense you are giving them shares and they are giving you a note back, so there is no cash involved.

Mr. KANJORSKI. Okay, and that would be all right if you are not a publicly traded corporation, but if you are publicly traded, that is going to show up on your balance sheet in a very negative way.

Mr. MERTON. I think you were asking me where I think they came from. I think in making that loan no recourse, there was no risk of personal bankruptcy, and that is exactly what an option is. By the way, anyone who knows my background should certainly not think I am opposed to options, either to be used or other tools. But rather, that the question in each of these things that is being raised here, some of it is that there is a connection that somehow says that if options are expensed, we cannot issue them anymore. If options are a good idea, why don't you?

Mr. KANJORSKI. They will survive. Right.

Mr. MERTON. Okay? And explain it. In the case of the public company, the question comes, if your shareholders understand your business, then at least the ones that do will understand that you had those options whether or not you expensed them. So if they did, let's first assume if they did, then now expensing them, what difference does it make? It is the same information. The alternative is that they did not understand it. Once you put it in the earnings, it is going to influence their valuation.

Mr. KANJORSKI. Okay. Let me ask you this, suppose we used a mechanism like profit-sharing contracts, particularly to attract extraordinary talent. Would that show up on the profit-loss statement?

Mr. MERTON. Yes.

Mr. KANJORSKI. How would it show up? Would it show up for the very value of it, because a profit-sharing contract for next year's profit is before——

Mr. MERTON. Well, the realized profit sharing, it would show up there.

Mr. KANJORSKI. Just for that year, but it would not show up for the future profit sharing.

Mr. MERTON. No.

Mr. KANJORSKI. In other words, you are a great scientist and you come to Cisco, and you are not about to go to work and give your brilliance to Cisco without getting some valuation on what you are contributing into equity. They want you so much that they are going to give you a cumulative profit-sharing contract for the next 10 years.

Mr. MERTON. Yes.

Mr. KANJORSKI. The only thing that is ever going to show up on their balance sheet is the actual payment of the profit-sharing plan for the year in place. Isn't that correct?

Mr. MERTON. That is correct.

Mr. KANJORSKI. You are not going to have to indicate or advertise that there is that profit-sharing contract out there, and if you did it would only be done by a footnote.

Mr. MERTON. It would be a disclosure.

Mr. KANJORSKI. What would be the difference of that kind of a construct as compared to the option, other than the stock option has a ready available market? We do not have profit-sharing contracts markets yet, but I am sure the Chicago Board will come up with it.

Mr. MERTON. I think that it goes back to the earlier question from the Chairman. If the options are not owned at all, in other words they are contingent on future labor, that part of their valuation arguably should not be charged until it is earned. But once the options are in effect owned and no longer a condition of employment, then the ownership of that option——

Mr. KANJORSKI. Yes, but that is——

Mr. MERTON. I am sorry to interrupt. I was answering your question that if the future profits are something that I have even if I do not stay, then I think you should expense that or put that on there because that is payment for now. It is not contingent on my future work.

Mr. KANJORSKI. Okay. I would tend, if we are going to be purists, to agree with you. But then I am struck with the cost factor that Mr. Heesen talked about in terms of if I am a little startup company, I really do not need to spend $50,000 or $100,000 or $200,000 trying to figure out this formula on the stock option program. It does not get me anything. It costs me a great deal of money to do that at the precise moment in time that I want to put that $100,000 into research and development or into things that are going to make a viable product. So I see a distinction between Cisco or General Motors or somebody else. It is somewhat like our CRA problem up here in years past. You know, banks have to do CRA. They are great for Citicorp because it costs them $50,000 or $100,000 and they have their accountants make all these reports and everybody knows.

But if the cost is the same thing for mini-corporation that is struggling with $2 million in the back garage trying to come up with a product, they are not about to spend that $100,000 or $200,000 to comply with the accounting rule. Is there some difference that we should be looking at or encouraging the Standards Board to look at between stock option disclosures for publicly traded corporations or when they are going to IPOs or at some stage, for purposes of transparency. I back into this, and the only reason I could give a damn about a company accounts is I want to be able to compare equal things when I am making recommendations to apply my portfolio or if I am assisting someone else, how their money is expended.

Other than that, why do we care? If it is a startup company or a small business, why do we care? I don't care if they even have accounting. If they can get along without carrying on accounting, who cares? If they are making money, they are operating, they are not going to the investor market, they are not borrowing money from the bank, or if they are borrowing money from the bank, their relationship with the bank is of such a nature that it is a character situation and they know that they are a substantial producing company. So what do we care how they keep their books?

Mr. HEESEN. In answer to your question about public versus private, in today's FASB standard, there is a distinction. Today, if you are a private company, you can either disclose or you can value your options under minimum value. That is the FASB pronouncement today. They are talking about basically disallowing minimum value for private companies going forward, so that we would be treated just like a public company. FASB, we have asked for months why suddenly are you making this radical change and we have gotten no answer. So they are actually making it worse for private companies.

Mr. KANJORSKI. Okay. And I am a little sympathetic to that problem, but the testimony that I hear from Ms. Kerrigan, there is now an advisory board for small business. You are going to have an ability to work with this rule or mold a rule or comment on the rule. Aren't we a little premature jumping in here and granting an exemption for this particular area, memorializing it? We are never going to close the door.

I sympathize with both sides, but most of all I am sort of a purist. I think we have accounting for the purposes of real transparency so that everybody can see what is promised out there, what is committed out there, what are the future obligations of the company. I would hate to invest in Cisco and find out that they have $10 billion off-share options out there that I never heard of, and that in reality only 1 percent of the value of the company is returnable to me in a dividend. I would be rather shocked. So I think they have to disclose at some level.

But on the other hand, I find some great sympathy with startup companies in attracting talent and wanting to share ownership with that talent. I just think there has got to be something in the rule management here that allows to accomplish both good purposes. Maybe I should go to the professor.

Mr. HEESEN. Unfortunately, on the committee that you are talking about, that came about as a result of the Senate hearing, FASB small business committee. Now, that was in November. It is now March. They just a couple of weeks ago sent out invitations to put in names for that.

Mr. KANJORSKI. That is very fast, Mr. Heesen. You are not in Washington long enough to know that is very fast.

Mr. HEESEN. The FASB standard is going to come out the end of this month. If you think that they are suddenly going to say, oh, let's stop the train here and we will create this commission and let small business, I think that is unrealistic. I think they are going to move forward and we are going to be part of that.

Mr. KANJORSKI. All right. Do you see anything here?

Mr. MERTON. I certainly say that in the case of costs imposed on companies, particularly smaller companies, I am 100 percent in favor of trying to avoid that. I do not want to impose just to report numbers because, so I endorse that, no question.

In terms of how it is done with private companies, I also share the view that is less important, although it depends on whom the other stakeholders are with that firm. With public companies, it is comparability and as I mentioned before, the ability to sort of let competition decide what is the best way. They should turn it around and ask why should one particular form of compensation be given special treatment.

Mr. KANJORSKI. That goes to your puritanical——

Mr. COVIELLO. Mr. Chairman, may I respond to a couple of these points?

Chairman BAKER. Yes, briefly. We have run over time a little bit.

Mr. COVIELLO. First, I take great exception to the use of the word that this is a loophole that needs to be closed. In the earnings per share, the $14 million of earnings that we had last year, we had 24 cents of earnings per share. Included in that calculation was roughly a 10 percent impact of dilutive stock options. Also, in the footnotes to our financial statements, we disclose every single option and at what price those options were struck. So I do think we calculate the economic effects of stock options already in the financial statements.

You asked earlier, Ranking Member Kanjorski, about why did they do it this way in the first place. Because it makes total logical sense.

Mr. KANJORSKI. Mr. Coviello, we could make that argument and say the reason my company offers Hummers to all my workers is it makes eminent good sense to get to work on time, and then say we do not have to expense them on our books.

Mr. COVIELLO. I am talking about the accounting principles board that came out with the original accounting for stock options. It made a lot of sense then. It still makes sense now in the context that I was describing.

Second, I also want to take exception to something that the professor said about, well, investors that know the company can understand what the impact of the dilutive effects was and work their way through it. Why should you have to be an applied mathematician to understand what the heck all of this stuff means?

Also, we have thousands of shareholders. Having a shareholder base is all about mind-share. It is a lot easier for me to capture mind-share if I do not have to make some convoluted explanation of why I had $14 million of income and all of a sudden it is a $21 million loss. It is a lot easier for me to get mind-share. That will have an impact on my stock price. That will have an impact on my ability to raise money, and that is why it is so important.

Chairman BAKER. The gentleman's time has expired.

Mr. Shays?

Mr. SHAYS. Thank you.

This is a fascinating issue and I think it is an extraordinarily important one. I can feel the intensity that people feel. But I would like to ask each of you first off, if the FASB rules go in, is it your statement that there will be no stock options?

Mr. COVIELLO. I will respond to that. I think it is going to be a period of intense confusion. People will look at all sorts of methods. They will wonder how the street is going to react. The bottom line to answer your question is, I am not entirely sure what the heck we are going to do. It is going to create a tremendous amount of chaos.

But if the end result is that Wall Street in their wisdom decides that it is a big negative to have a huge expense on your books from stock options, then absolutely yes, it will eviscerate broad-based stock options programs and that would be a tragedy.

Mr. HEESEN. From an emerging company vantage point, venture capitalists are smart people. They would have figured out a different way to do things over these last 10 years if they could have come up with something better than a stock option. We do not have a choice in the matter. We will continue to give options, but what happens if we continue to give options? That means we have less money to put into other companies. So instead of funding five startups, we are going to fund three startups. And those companies are going to take longer to go public or be acquired because of the drag of these numbers. So it is going to affect venture capitalists directly. They have religion on this issue.

Mr. SHAYS. Let me hear from the others as well. Yes?

Ms. KERRIGAN. From a small business perspective, I definitely believe they will diminish their use. Small firms are going to take a direct hit to the bottom line from an earnings perspective, number one. Number two, they just simply do not have the resources from a valuation perspective, to hire the type of investment bankers and other type of experts, I believe, to make this happen.

So it is costly. It will be complex from a small business entrepreneurial perspective. I do think they will go by the wayside.

Mr. SHAYS. Thank you.

Mr. Reed?

Mr. REED. In my opinion, and I believe it is the opinion of many engineers that I work with as fellow rank-and-file employees, that as Mr. Coviello mentioned, the way that the street reacts to these changes is going to highly affect what happens. We believe that there is a very good chance that if they were not eliminated altogether, that they would be cut back severely.

Mr. SHAYS. Professor?

Mr. MERTON. We should recall that other than the expense, which we have noted before, there is no cash difference here. It is just a question of whether it is reported. So then the issue is, how is The Street or other investors going to react? Well, I think particularly if it is widespread, they will adjust to it. It is not clear to me that there will be any material impact on valuations.

Whether companies then choose to change their form of which they provide incentive compensation, I think that will vary and I do not know. But I do not think there will be a big effect on value. I think also the fact that investors, particularly sophisticated institutional investors, want to see the expensing, I do not see that as an issue of being punitive about compensation, but it would suggest that is something they want. They do not want to hurt their investments.

Mr. SHAYS. I hear you.

Mr. Coviello, one of the things that I found kind of striking is I had a lot of constituents who called me up because their kids got screwed with stock options. Their companies went down and they still had to pay tax on an option that was not at all attractive anymore or nonexistent. How do you let young people know the potential risk with an option, as well as the potential benefit?

Mr. COVIELLO. There are a couple of issues there. First, I think it helps to prove my point that options are in essence a form of risk capital for the individual who is earning and investing those. I think in the instance you described, what may have happened is employees exercised stock options at a high price, and then held them. During the holding period, the stock price might have gone down precipitously.

We issue a lot of nonqualified stock options. I think most of the stock options are nonqualified. That creates a taxable event as soon as you exercise, which actually has the impact of literally forcing the employee to sell as they exercise because they are going to be taxed at the exercise point value. So in those instances, I find it unfortunate that they did not get better advice. We do try and do a good job with our employees in that regard so that they understand the tax consequences around stock options.

Mr. SHAYS. I am all set.

Thank you, Mr. Chairman.

Chairman BAKER. Yes, Mr. Shays. On reflection, I do believe that was an IRS problem where the person exercised, stock price deteriorated, and employees generally did not sell their options at the higher price.

Mr. SHAYS. Thank you.

Thank you, gentlemen and lady.

Chairman BAKER. Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

This is my first hearing, having been recently assigned to serve on this subcommittee and this is quite an interesting topic to me. I serve as the Ranking Member on the Small Business Committee, so I am very much concerned about the regulatory burden and the effects of this regulation on smaller companies.

Mr. Heesen, from your perspective, would increased compliance costs associated with going public deter many smaller companies from pursuing an IPO?

Mr. HEESEN. You are always going to want an IPO. If you can get into the market, you are going to go there. The question is, every day means something in the IPO market. It could be open one day and closed the next. And it costs money. Every day costs money from a venture capitalist perspective. That means less money going into other companies. So you want that company to go out at the best possible time at the least possible cost. So money does matter.

Ms. VELAZQUEZ. So how will this affect the venture capital industry?

Mr. HEESEN. I think it could have an impact in that fewer companies at the end of the day, fewer innovative companies get funded. The important thing to note here is that we love to talk about our successes, but many venture capital-backed companies fail. We give options to all those people, all those people have options underwater. We hope that we get a couple of companies that hit that IPO mark or get bought out by the Cisco's and Intel's of the world.

Ms. VELAZQUEZ. Far from broad-based expensing proposals, H.R. 3574 will still impose costs on smaller companies. Have you estimated the regulatory burden and compliance costs associated with this legislation?

Mr. HEESEN. Looking at the different valuation models that FASB has talked about. They have said, oh, you can just get these off the shelf and plop them in. We have not been able to verify what FASB has said on that by any means.

If you are a Coca-Cola, you can go out and get an investment bank and do these sorts of things. If you are a small emerging growth company, try even to find someone who is going to do this for you, let alone what the cost is going to be. Just finding a person to do this is going to be extremely difficult.

Ms. VELAZQUEZ. Thank you.

Professor Merton, as with any model, the output is only as good as the data and assumptions that are used. If the assumptions are faulty, you will get faulty valuations regardless of how good the model is. The key assumptions in valuing employee stock options are the risk-free rate, stock volatility, dividends if any, and the life of the option. These are things to estimate because of the many underlying valuables involved. More importantly, they can be manipulated by adjusting any one or a combination of these assumptions. Management can lower the value of the stock options and thus minimize the options's adverse impact on earnings.

What is your view of the potential for manipulation and abuse by corporations seeking to lower their expenses for stock options?

Mr. MERTON. I think the best protection on out and out manipulation is a combination of, first, I think most managements want to do the right thing. I like to think that.

Mr. COVIELLO. Thank you.

[Laughter.]

Mr. MERTON. I want to make that statement because it sometimes sounds like these are a bunch of people we have to keep in a corral because if you just turn your back on them, they are going to go and steal everything. That is not my experience with executives, people who build companies. They care about doing the right thing. That is the first thing.

The second thing is, to the extent that you have public accounting firms that are responsible for this, they have to render opinions. We know that that, too, can sometimes go amok. But the general practice is to do the right thing, and there is a discipline here. There have been laws passed recently to put some more teeth into that if you do fool around with it. So I think deliberate efforts to manipulate, I do not see as a really material thing.

The second thing is that investors, firms get reputations for how they manage their books even now. If you play games with these things, you do get a reputation with investors that can be costly.

Ms. VELAZQUEZ. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Velazquez.

Mr. Sherman?

Mr. SHERMAN. I fear that this bill is going to reduce the total amount of capital available to all of the companies in this country, because our capital is international. Capital has a choice. Are they going to go to the stock market that reports the highest earnings, then they might as well invest in Bangladesh. Or are they going to go to the stock markets and the countries with the toughest rules? Again and again and again, money floods into this country from third world countries and from Europe and from Japan because they want honest earnings, toughest standards.

My fear is that this bill will be the first step in converting GAAP, generally accepted accounting principles, into GAAP, generally adulterated accounting politics. So the first question is, will this bill encourage foreign investors to invest in our stock markets? I have not heard anybody say yes, and clearly again and again they seem to want the toughest standards. But even if the capital in America remains the same, then all this bill does, it does not just help some companies. Every company that gets helped, another company gets hurt. There is so much capital and if you are investing in the new economy, you are taking it away from the old economy.

What this bill does is it turns to those companies that provide health care for all, but do not provide stock options, and it takes capital away from them and shifts it to, say, a company that provides stock options for the top 10 percent. In every other area, especially those of the other party, say that the government should not pick winners and losers. In this one case, we are picking winners and losers and we are doing so on the basis of this, that companies that are most generous to their executives are going to be winners, by government fiat.

I know we are told that some secretaries get options and buy houses, but keep in mind, at least 90 percent of the benefit of these options are going to the top 1 percent or the top 5 percent. More importantly, for every secretary who buys a home because the accounting rules encouraged stock options, there are 1,000 secretaries who lose their health care coverage because the accounting rules fail to encourage providing health care coverage.

We are also told that employee stock ownership is good. I could not agree more. But the plan that creates broad-based employee stock ownership, ESOP, employee stock ownership plans, under those plans you have to recognize, professor you confirm this for me, if you contribute to the ESOP, that is an expense and you have to book the expense. I see the professor is nodding. I think every other accountant in the room is nodding.

So the plan that creates broad-based stock ownership for everybody, in new companies, old companies, big companies, small companies, that gets the tough accounting treatment. But the best system for enriching the very richest people or the most powerful people in America, that is getting favored coverage.

I do want to bring to the subcommittee's attention, and I do have a question after this, that I intend to offer three amendments to the bill should we move to markup. The first is, I should point out that we have a special rule for options granted before December 31, 2004. That ought to be January 3, 2004, because I do not want a lot of companies issuing a lot of stock options for Christmas just to sneak in under whatever rule we provide.

Second, this idea that we are going to assume volatility is zero: if you are going to apply the Black-Scholes method, at least apply the Black-Scholes method. As the professor points out, assuming volatility is zero, that is to say hijacking the method, produces inferior results.

Finally, if we are going to have special rules for companies organized in the United States and Canada, how about Mexico? Either strike Canada from this bill or put in Mexico. America has two neighbors. It has a northern border and a southern border.

Now, the professor commented somewhat adversely on this compromise idea I have, and that is to publish it both ways. Why would it be a disadvantage to let investors decide? Perhaps they want to invest in companies based on one accounting system, and perhaps they think the other. We are preparing these financial statements for investors. Why force them into one or the other?

Could you also comment on whether today's financial statements would allow sophisticated analysts to re-cast the financial statements so that they could compare Coke and Pepsi? That is to say, if you were a stock analyst today, could you calculate the income statement and earnings per share of a company based on the idea that they had expensed all their stock options, and use that number if you thought it was more helpful. There is a question there.

Mr. MERTON. Is that a question to me?

Mr. SHERMAN. Okay.

Mr. MERTON. Starting at the reverse one, you said, couldn't they reproduce this. The answer is yes, in most cases, with enough data, if that was the only thing they had to do, one company.

Mr. SHERMAN. I am saying, could an analyst sit down today with the amount of information published by Pepsi today, and re-cast, assuming Pepsi did not extend stock options, I think they may have changed their mind. There was a while Pepsi did not; Coke did. Could they sit down with Pepsi's or some other company's financial statements and SEC report, and determine what would be the earnings per share for the most recent year if that company had expensed stock options, just a Coca-Cola does?

Mr. MERTON. Yes, they could.

Mr. SHERMAN. They could. So why is it that the analysts are so lazy that they go out and tell their investors, well, this is the earnings per share from Coke, and we could make the Pepsi earnings per share comparable so that you could compare them, but we are no going to bother. Why is it that the market does not embrace either an expense it all earnings-per-share number or expense none of it earnings-per-share number? Why is it instead that the market embraces a whatever the company happens to publish, that is what we will use, even if they are using different systems?

Mr. MERTON. Well, if you will forgive me, why stop there with options? Why not, if you went back to research R&D, why not allow them to do it there? The problem that happens is, yes, in any one case, you can do it.

Mr. SHERMAN. This is the only case where Congress is plotting to overrule the FASB. Considering, excuse me.

Mr. MERTON. What I meant by one case, I did not mean this case. I meant if you want me to calculate today as an analyst for Pepsi for this year, yes I can do it.

Mr. SHERMAN. How long would that take you?

Mr. MERTON. Depending on the day, maybe a couple of hours.

Mr. SHERMAN. Okay.

Mr. MERTON. Depending on how complex.

Mr. SHERMAN. There are a lot of hard-working people on Wall Street. You would think one of them would do it.

Mr. MERTON. But then I would also have to do it for all prior years in order to have comparables through time.

Mr. SHERMAN. Okay.

Mr. MERTON. And then if I am in the business of doing comparables across Coca-Cola and all these other companies, I would have to do it for all these other companies, even ones I do not follow.

Mr. SHERMAN. So obviously, we cannot just have one stock analyst do this. Either somebody is going to do it and publish it and make it available and talk about it, or we can make it easier and tell the companies to publish it both ways and do the work for all those hard-working stock analysts. But we should never have a circumstance where if somebody wants to know what the earnings per share is over time across industries, based on expensing stock options, that they are prohibited by practical considerations from knowing.

If the witnesses in favor of the bill are right, then investors should get their information, too. What would be wrong with requiring companies to publish it both ways, staying away from some of the real small companies that might not have the resources to publish both ways?

Mr. MERTON. I would say just cost.

Mr. SHERMAN. Costs, okay.

Mr. MERTON. The costs of doing that. We have that happen now.

Mr. SHERMAN. And the cost actually argues for the bill because implementing the new FASB standards, should they be adopted, that is the expensive thing. If you had a company that only had five employees, was only going to spend $10,000 to publish their financial statements, such a company could not do it except under the existing system.

I know this FASB formula that they are considering, I cannot imagine that you could implement that for only a few thousand dollars for a company. You need a Black-Scholes study and the whole thing. So we could let small companies use the old system, the system that exists still today, and bigger companies could publish it both ways. What would be the disadvantage there?

If I have time, I will ask anyone else on the panel to comment on that. Anybody have a comment? Okay, I am done.

Chairman BAKER. Being somewhat responsive to the gentleman's observation about the practice being aimed primarily at the benefit of the higher level executives, frankly that is what led me to direct our effort in this vein was to try to identify the problem that started the reform effort in the first place, without inhibiting the growth of small business enterprise, which clearly can be established, I think Professor Merton will even agree, that it does play a role in business formation, without arbitrarily reversing a business practice which has had positive economic consequences.

So I appreciate the gentleman's navigation through the problem. There is movement.

Mr. SHERMAN. If the Chairman would yield, we could perhaps better effectuate that purpose if in addition to saying the top five executives, because I know the number six guy at Disney and he is pretty well off.

Chairman BAKER. I know the top 20 at Fannie Mae and they are really doing well.

Mr. SHERMAN. That, too. Perhaps we would want a system that in addition to saying the top five executives of the average company, said anybody who was getting more than $100,000 worth of stock options in any year would also be put in this rarefied company. Being the top five at a medium-size company is no big shakes compared to being number six at, say, Fannie Mae.

Chairman BAKER. I appreciate the gentleman's perspectives.

You may not have knowledge of this factual circumstance, Professor Merton, and if you don't, I understand, but with regard to the well established company and the view that it may be easier for publicly traded companies to comply with the expensing requirement, I am aware that Coca-Cola recently tried to market some of its options to two investment banks. The investment banks preliminarily interested in that opportunity, ultimately turned it down because their obligation is to hedge against the risk. In trying to place the appropriate hedges against that potential investment, they were unable to achieve a valuation sufficiently accurate to warrant engaging in the transaction. Is that a correct observation about those circumstances? Or do you have the ability to make a comment today on that?

Mr. MERTON. I do not know that specific case. There was a case, in the case of Microsoft, when they moved to restricted stock, where they entered into an arrangement with a large bank to take care of the out-of-the-money options. I think this would have been a parallel type transaction. I do not think that is the most efficient way, with all respect, to accomplish it, but yes, they would have to do some hedges if they are going to hold them primarily and not reissue them. Absolutely. But that does not affect the price.

Chairman BAKER. Oh, no. I was not suggesting that. All I was saying is that in the case of a company as well established as Coca-Cola, who was trying for whatever reason engage in this transaction for some business purpose, unable to reach a conclusion because at the end of the day someone trying to make a future value calculation could not do it sufficiently accurately enough for their risk profile to engage in it. Let me get the more detailed facts and I might just correspond with you on that to get your views about it at a later time.

Mr. Kanjorski, do you have any further questions?

Mr. KANJORSKI. I think that I have heard, and it is just rumor to me, there is some tax advantage to the corporation in offering stock options. Is that correct?

Mr. MERTON. Are you asking me?

Mr. KANJORSKI. Yes.

Mr. MERTON. I am not a tax expert. But you have to stay relative to something, to say that it is a tax advantage.

Mr. KANJORSKI. Yes. I understand they get a deduction for tax purposes on the value of the options offered.

Mr. COVIELLO. If the options are exercised.

Mr. MERTON. Yes. At the time they are exercised, then it becomes a taxable even to the employee.

Mr. KANJORSKI. To both the corporation and the employee at the time of exercise.

Mr. MERTON. Yes.

Mr. SHERMAN. If the gentleman will yield. There are two kinds of stock options. With incentive stock options, the company gets no deduction and the employee does not have to pay any taxes for the most part. But those are very restricted. There are all kinds of rules to qualify. For a nonqualified stock option, the employee gets hit with a tax and the employer gets a tax deduction.

Mr. KANJORSKI. At the time of exercise.

Mr. SHERMAN. Yes.

Mr. KANJORSKI. So by issuing, there is no tax benefit in one current year if they are going to be taken down another year.

Mr. MERTON. No.

Mr. COVIELLO. No.

Mr. KANJORSKI. Mr. Chairman, I do not want to delay this. I think we have had a very fine panel here today. They have certainly brought to my mind a lot of questions that we should further look at. I am tending to lean with my accountant friend here. Why not give the dual option that they have to record it both ways so we can level the playing field. I think ultimately what we are looking for is transparency. Who cares how they do it or how we arrive at it, as long as we get the information, and not every individual investor or every banking house has to do every one of the 17,000 public corporations on their own. Efficiency says have every corporation do it, if that were the case.

I also think that there is some merit on us looking at the impact on startup businesses and particularly venture capital businesses that we would not want to front-load the cost of getting into business or doing business at that precise moment where it would stress the company and more than likely add a burden that may sink them ultimately, even though it could be a successful corporation.

With all that in mind, I ask unanimous consent to submit for the record statements in favor of the Financial Accounting Standards Board's efforts to adopt a mandatory stock options expensing standard, from the Council of Institutional Investors, the AFL-CIO, and the International Brotherhood of Teamsters. Without objection.

[The following information can be found on pages 117, 121 and 123 in the appendix.]

Chairman BAKER. Without objection.

Mr. Kennedy, did you have a comment?

Mr. KENNEDY. I would just like to thank you, Mr. Chairman, for hosting this hearing on this very important topic. As a CPA, I know the complexities of having to deal with stock options, but I also understand the power they have to motivate people. Do earnings become meaningless at the variability from recording stock options, bring earnings up and down so much that it discourages businesses from offering them at all. The incentives that drives in our economy is critical, and this bill is something that I think needs to be given serious consideration. I thank you for hosting this hearing.

Chairman BAKER. I thank the gentleman for his remarks.

Mr. Sherman, did you have any further comments or are you done?

Mr. SHERMAN. Believe it or not, I am done.

Chairman BAKER. Terrific. We have run your balance sheet finally.

I want to express my appreciation to each member of the panel for your insight. It has been very helpful to the committee in its consideration of this matter. We look forward to working with you and other interested parties in the days ahead.

Our meeting stands adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 3, 2004

Statement of Congressman Michael N. Castle

Capital Markets Subcommittee Hearing on
H.R. 3574, The Stock Option Accounting Reform Act

March 3, 2004

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing before the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee today. In recent years, the Financial Services Committee has held a number of hearings that have brought attention to corporate accounting scandals. I commend your continued commitment to corporate accountability. Having recently passed the one year anniversary of the Sarbanes-Oxley Corporate Accountability bill, I believe it is important to remain on track in our mission to reform corporate accounting. A key step in this process is to support an honest accounting standard that would require all employee stock option compensation to be shown as an expense on corporate financial statements.

It has been estimated that, in aggregate, employee stock options now account for 15 percent of all shares outstanding at U.S. publicly traded corporations. In 2000 alone, companies on the Standard & Poor's 500-stock index awarded a staggering $126 billion in stock options - which is more than Ireland's 2002 gross domestic product.

Unfortunately, current rules allow corporations not to count options issued to employees as an expense on corporate income statements. This omission has led to a variety of stock option abuses linked to excessive executive compensation, inflated company earnings, dishonest accounting, and corporate misconduct. In addition, the present system has encouraged earnings manipulation as a means of bolstering stock price to cash in on options. Such dishonest accounting "tricks" have led to corporate scandals such as the Enron debacle and have hurt our nation's economy by damaging investor confidence in financial statements. In order to protect investors, we must fully disclose employee stock options and accurately portray companies' financial status.

In response, the Financial Accounting Standards Board (FASB), which is the governing board that sets accounting principles, has again decided that employee stock options should be considered an expense on corporate financial statements. Although FASB was prevented from setting standards for expensing stock options in 1994, it has since become even more apparent that expensing is necessary. As a Member who is dedicated to closing the loopholes that have hindered investors from accurately analyzing corporate performance, I believe requiring a uniform standard for the expensing of stock options it the right thing to do. Currently, over 480 U.S. companies, including corporate giants such as Coca-Cola, General Motors, General Electric, and Wal-Mart voluntarily expense stock options. Others, however, especially in the high tech industry, have refused to expense until they are required to do so. FASB's decision will require all companies to use the same stock option valuation methodology and will erase the accounting disparities that arise between companies who voluntarily expense and those who do not.

I understand that critics of the FASB requirement are concerned that companies will eliminate broad based stock option plans, thus hurting average workers. As you know, H.R. 3574 would require expensing for only a company's top five corporate officers and delay implementation until the completion of a study by the Secretaries of Commerce and Labor. However, many successful companies that offer broad-based stock option plans to their workforce have already determined that they can expense employee stock options without having to end this form of compensation. Furthermore, a survey conducted by the U.S. Bureau of Labor Statistics found that in 2000, only 1.7 percent of non-executive workers actually received any stock options. Assuming any changes would even take place, most workers would not be affected by the honest accounting.

Companies who voluntarily expense have already begun to demonstrate that it yields more accurate earnings numbers, restores investor confidence, and can be accomplished without eliminating the benefits for rank-and-file employees. While H.R. 3574 would delay the implementation of FASB requirements, I strongly believe we must act now to increase discipline within the system and strengthen investor confidence by ending the special treatment that stock options have enjoyed for decades. Presently, FASB is preparing for a ninety-day public comment period on a draft rule, which will be thoroughly reviewed so as to make necessary modifications. FASB is planning to issue a final standard for the expensing of employee stock options in November.

As a Committee, it has been our goal to bring corporate accountability to our nation's financial system. Any diversion from this course would be a step backward. The omission of any stock option expense in a company's financial statement, combined with the inclusion of this expense in the company's tax return, will only lead to overstated earnings. The only way to level the playing field in corporate America and strengthen the accuracy of financial statements is to require all employee stock option compensation be shown as an expense on corporate financial statements.

March 3, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing on H.R. 3574, the Stock Option Accounting Reform Act

Thank you, Mr. Chairman, for holding this important and timely hearing. The issue of how to account for employee stock options in a company's financial statements is a very significant one, given the many high profile cases of accounting fraud in large publicly traded companies.

As a Member of both the House Committee on Energy and Commerce and the House Financial Services Committee, since 1994 I have been monitoring the Financial Accounting Standards Board (FASB) rule-making process on the accounting of stock options and was supportive of their previous final rule addressing stock options and allowing them to be recorded as an expense on their annual profit and loss statements.

Unfortunately, Mr. Chairman, I have to say I oppose HR 3574, the Stock Option Accounting Reform Act, which we are reviewing this morning. I feel Congress and this Committee should stand by our statement in the Sarbanes-Oxley Act of 2002 and the recent Securities and Exchange Commission (SEC) Policy Statement reaffirming FASB as the nation's accounting standard setter and we should allow them to their job and retain the independence mandated in these matters by Congress itself.

This week, I am circulating a letter to all my colleagues that I received from the Ohio Public Employees Retirement System (OPERS), a 56 billion dollar fund and tenth largest state pension fund in the United States, expressing their support for FASB's actions and opposition to this bill. As Laurie Fiori Hacking, Executive Director of OPERS, states in her letter "FASB has considerable financial expertise and is best suited to consider complex accounting issues. It also has a measured process in place for soliciting public feedback on proposed accounting standards."

U.S. Financial markets remain the envy of the world due to the quality, timeliness and credibility of the financial information and disclosures provided by companies. The result is better allocation of resources and lower overall cost of capital. We here in Congress must ensure that this remains the case by allowing our standard-setter to operate independent of public and private special interests.

I encourage my colleagues to support the position that the role of FASB is to pursue transparency and accuracy in accounting standards, not to choose among competing public policies.

We should not be setting accounting standards on a political basis. Also, the failure to expense option provides false and misleading statements to shareholders, because it does not accurately report the true costs to the company and shareholders, which explains the broad support for stock option expensing by financial experts such as SEC Chairman William Donaldson, Federal Reserve Chairman Alan Greenspan, former Fed Chairman Paul Volcker and Warren Buffet.

Again, thank you Mr. Chairman for calling this important hearing and I look forward to a thorough debate.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 3574, THE STOCK OPTION ACCOUNTING REFORM ACT

WEDNESDAY, MARCH 3, 2004

Mr. Chairman, we meet for the second time in the 108th Congress to study the accounting treatment of stock options. Specifically, we will today examine H.R. 3574, a bill that would unnecessarily interfere with the independence of the Financial Accounting Standards Board.

Without question, stock options have played an important and crucial role in the ongoing success of many American businesses and the creation of wealth for many American households. The accounting treatment of stock options, however, has also caused significant controversy for more than two decades. The decisions of the Financial Accounting Standards Board to revisit this matter last year and issue a draft rule later this month have therefore rekindled a fiery debate.

In the wake of the recent tidal wave of accounting scandals, support for mandatory expensing has increased significantly. A recent survey by Merrill Lynch found that more than 90 percent of institutional investors want stock options expensed. The four largest accounting firms have also now called for the expensing of stock options. Moreover, many respected financial experts have effectively made the case for options expensing, including William Donaldson, William McDonough, Warren Buffett, Alan Greenspan, Paul Volcker, and Joseph Stiglitz.

In addition, nearly 500 companies have adopted or are in the process of adopting fair value expensing of stock options. Respected corporations like Home Depot, General Motors, General Electric, Wal-Mart, Microsoft, and Amazon have all decided to treat stock options as expenses. Several companies headquartered in Pennsylvania have also done the same, including Mellon Financial, Hershey Foods, and First Keystone Corporation in Berwick.

As we proceed today and in the future, I must caution my colleagues about the ongoing need to protect the independence of the Financial Accounting Standards Board. A decade ago, the Congress unfortunately strong-armed this private regulatory body into abandoning its efforts to adopt a rule requiring stock options expensing. We now know that this retreat contributed to the financial storm on Wall Street in 2001 and 2002.

To protect against similar incidents in the future and safeguard the public interest, we incorporated into the Sarbanes-Oxley Act a provision granting an independent funding stream to the Financial Accounting Standards Board. The active consideration of the Stock Option Accounting Reform Act by our panel, in my view, would threaten this recently approved enhanced independence, intervening in the board's ability to make unbiased decisions and disrupting an objective process for reasons other than sound financial reporting.

Other leaders on Capitol Hill have agreed with me about the wisdom of protecting the independence of the Financial Accounting Standards Board. Earlier this year, Senator Shelby and Senator Sarbanes, the two most powerful members of the Senate Banking Committee, asserted their bipartisan opposition to intervening in the activities of the board. Chairman Oxley has also previously said that compromising the independence of the private board that sets the accounting rules "could negatively impact efforts to improve the transparency of financial reports." I wholeheartedly agree. Deciding what should be accounted for and how it should be accounted is the job of the Financial Accounting Standards Board, not the Congress.

Although the board has not yet released its draft rule on the expensing of stock options, I am pleased that the agency is working to address this important issue. Employee stock options are a type of compensation, just like a salary or a bonus. Because compensation is an expense and because expenses influence earnings, employee stock options should be counted against earnings and subtracted from income.

Mandatory stock options expensing will further help investors to make better decisions. Individuals, for example, might have previously made different choices about the stock of AOL Time Warner. In 2001, the failure to account for employee stock options on the company's balance sheets resulted in a profit of $700 million instead of an operating loss of $1.7 billion. Unlike the current system where some businesses expense options and others do not, a mandatory expensing rule would also facilitate comparisons between companies, helping investors to make apples-to-apples evaluations rather than apples-to-oranges assessments.

In closing, Mr. Chairman, our capital markets can remain the strongest in the world only when the rules are clear and credible, corporate activity is transparent, and the data is unbiased and comparable. Stock options are expenses. To strengthen investor confidence and promote the international convergence of corporate reporting standards, the Financial Accounting Standards Board must therefore proceed with diligence, and without political interference, in these matters.

Opening Statement
Rep. Ed Royce (CA-40)
"The Stock Option Accounting Reform Act"
3 March 2004

Chairman Baker, I would like to thank you for holding this timely hearing on the expensing of employee stock options. Mr. Chairman you should be commended for introducing H.R. 3574, The Stock Option Accounting Reform Act.

By all accounts, the Financial Accounting Standards Board ("FASB") soon will require firms to expense the value of employee stock options, based on complex formulas that use subjective estimates to arrive at that value. In other words, companies will have to estimate the value of illiquid derivatives and then subtract that value from net income. In a world where Congress is trying to help investors by mandating transparency in financial statements, it seems to me that FASB is headed down the wrong path.

In addition to the troublesome accounting issues with expensing stock options, there is even a more powerful argument to preserve stock options in their current form. If companies are required to expense stock options the painful reality is that many companies will cease issuing options to rank-and-file employees. These stock options have served two valuable purposes. First, they allow companies to possess a powerful tool for recruitment, retention, and increased performance. Second, they have provided an opportunity for rank-and-file employees to gain real economic profit for their significant contributions to the success of their company.

I look forward to working with Chairman Baker and others to help protect employee stock options. I yield back.

STATEMENT FOR THE RECORD
HEARING ON H.R. 3574, THE STOCK OPTION ACCOUNTING REFORM ACT

Congressman John Shadegg
March 3, 2004

Let me state from the beginning that I am a strong supporter and cosponsor of H.R. 3574, the Stock Option Accounting Reform Act. Ideally, I would prefer to have no expensing requirement for stock options. However I recognize that there is a significant movement towards some form of expensing, and I believe that the limited expensing, coupled with the absolutely necessary study of the economic effects of expensing, contained in H.R. 3574 is an appropriate step.

There are numerous reasons why I oppose requirements for the expensing of stock options, and I associate myself with the comprehensive discussion of the issue contained in the written testimony of Arthur Coviello.

There are two points which deserve special mention. First, requiring the expensing of stock options will stifle the ability of small companies on the cutting edge of innovation to attract and retain the high-quality employees needed to turn concepts into real-world products. Time and again throughout our nation's economic history, and especially during the high tech revolution of the 1990's, small firms that were long on ideas but short on earnings have been able to conceive of, develop, and bring to market new products which have had profound impacts on all aspects of the economy.

To do so, small companies have relied above all on their human capital: on intelligent, motivated, hard-working employees who are able to think outside the box. The primary way that they have been able to attract and retain these individuals is by offering them the opportunity to grow with the company and to share directly in the success of their innovations through stock option grants. By increasing the cost of granting stock options, the playing field will be tilted away from these small firms, and innovation in the marketplace will suffer.

The second and perhaps more critical point is the democracy which broad-based employee stock option plans bring to corporations. Employees who own stock in their company are far more than labor: they are the owners of the company. They share, both financially and psychologically, in its success to a much greater degree than mere numbers on a balance sheet can ever capture. It would be a sad triumph of myopia to decide that the placement of another – and quite frankly not very accurate – number on a corporation's balance sheet is more important than the commitment to the success of that corporation brought by employee ownership.

I commend Chairman Baker for holding this hearing and for introducing H.R. 3574, and I look forward to working with him to enact this legislation into law.

Prepared Statement of Arthur W. Coviello
President and Chief Executive Officer
RSA Security

before the

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

of the

House Committee on Financial Services

Wednesday, March 3, 2004, 10:00 am

Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for inviting me to testify this morning on HR 3574.

My name is Art Coviello and I am President and CEO of RSA Security, a public company headquartered in Bedford, Massachusetts, with 2003 revenues of $259.9 million. As president and CEO, I am responsible for the operations and growth of the company, directing the company's vision, strategy, acquisitions and investments. I am a Certified Public Accountant (CPA) by background.

I am here to tell you that RSA Security supports HR 3574, the Stock Option Accounting Reform Act. Thank you, Chairman Baker, and thank you, Congresswoman Eshoo, for your outstanding leadership on this vital issue.

Executive Summary

What do issues of accounting, valuation, corporate governance, partnership capitalism, competitiveness, economic growth, and job security all have in common? They will all be affected by the Financial Accounting Standards Board's (FASB) proposal to expense stock options, particularly broad-based employee stock option plans. FASB deals with one, or at most two, of these issues – accounting and valuation. By the Board's own admission, the other issues are not relevant to its deliberations. But they are incredibly relevant to my responsibilities as president and CEO of RSA Security and, I believe, to your deliberations here in Congress.

Let's start with the accounting issue. In an ideal world, would we prefer no expensing at all? Absolutely -- because expensing all employee stock options is fundamentally bad accounting. But none of us live in that ideal world. We do live in a world where the Financial Accounting Standards Board (FASB) has every intention to adopt, as soon as possible, a new accounting standard that will require the expensing of all employee stock options based on demonstrably inaccurate and unreliable valuation methods. Let me repeat that – FASB's new standard will require the use of **demonstrably inaccurate and unreliable valuation methods.**

That is where HR 3574 comes into play. HR 3574 is necessary – indeed, its passage is essential -- *because without it:*

- Good accounting will suffer irreparable harm.
- Investors, especially individual investors, will be confused, and all investors' confidence will be damaged.
- Broad-based stock option plans will likely become a thing of the past, because public companies cannot allow their investors to be confused.
- Employment growth, economic growth and US competitiveness will all take a significant step backwards.

HR 3574 is a thoughtful, sensible and pragmatic approach. The solutions it contains are far, far better than the new accounting standard that the Financial Accounting Standards Board (FASB) intends to adopt in the very near future.

Some Background on RSA Security

With over 14,000 customers around the globe, RSA Security (www.rsasecurity.com) provides interoperable solutions for establishing online identities, access rights and privileges for people, applications and devices. Our encryption technology based on the RSA algorithm is the foundation for privacy and confidentiality on the Internet. Because it is embedded in vitually all software and hardware shipped, it is arguably the most ubiquitious technology ever.

Our customers span a wide range of industries, with extensive presence in the financial services, healthcare, pharmaceuticals, biotech, aerospace, telecommunications, manufacturing, utilities and consumer arenas – and, yes, the government market as well. More than 13 million users across thousands of organizations – including more than half of the Fortune 100 – use RSA SecurID authentication products to replace unsafe passwords, protecting users' identities and access to critical data and resources.

RSA Security's Commitment to a Broad-Based Stock Option Plan

RSA Security has just over 1,000 employees worldwide. We believe that every employee should share in the success of the company. Every person who joins the company receives stock options. More than 80% of our employees have received stock options during the past four years. In addition, for the past four years, we project that approximately three-quarters of the options granted were distributed to employees below the officer and director level. We are proud of our commitment to a broad-based employee stock option plan. By giving employees at all levels a chance through equity ownership to share in RSA Security's financial success, our broad-based stock option plan increases productivity and shareholder value.

Why am I so passionate about employee stock options? Because --

- They are a vital tool for public companies to attract and retain skilled workers.
- They motivate employees to strive for excellence.
- They inspire creativity, loyalty, entrepreneurship and hard work.

Stock options are granted to create incentive for future performance. They allow start-up companies that are short on cash to hire talented employees and to preserve scarce capital funds for research and development. Stockholders benefit from companies with broad-based plans because they expect to receive a financial return that is greater than the potential cost they will bear by sharing ownership with employees.

In the remainder of my testimony, I would like to touch upon four central points:

- *First*, the real cost of stock options is potential dilution of existing shareholders' equity interests.
- *Second*, existing option pricing models, including the Black-Scholes model and binomial models, produce inaccurate and misleading information.
- *Third,* FASB's refusal to conduct comprehensive field testing of multiple valuation methods is indefensible and incomprehensible. Why do these guardians of accounting persist in not taking into account an entire industry – high-technology – as they have with oil and gas?
- *Fourth,* FASB's decision to require the expensing of all employee stock options will destroy broad-based stock option plans and the productivity, innovation, jobs and economic growth they generate.

The Real Cost of Stock Options is Potential Dilution of Existing Shareholders' Equity Interests

The issuance of stock options does not result in a corporate level cost that impacts net income. When an option is issued, there is no outflow or consumption of corporate assets and no decline in the value of corporate assets. Nor is there the creation of a liability representing actual or expected cash outflows. In fact, to the extent options are ultimately exercised, corporate assets are *increased* by the amount of cash that the employee must pay to exercise the option. That is why the original creators' of the standards reflected the dilutive effects of stock options in a thoughtful way in the calcluation of earnings per share. What has changed?

In a seminal work on employee stock options published a little over a year ago, Rutgers University Professors Joseph Blasi and Douglas Kruse and *Business Week* Senior Editor Aaron Bernstein prove, through clear empirical evidence, that, contrary to the claims made by mandatory expensing advocates, employee stock options for everyone except perhaps the highest level executives (something explicitly recognized by HR 3574) are not compensation from an economic standpoint.

According to Professors Blasi and Kruse, "[t]here are only three significant studies of stock options plans that include most or all employees."[1] Indeed, all of these studies are quite recent. Drs. Blasi and Kruse, together with James Sesil of Rutgers University and Maya Kroumova of the New York Institute of Technology, published a study in 2000 that examined 490 companies, in a variety of industries that granted stock options to most or all of their employees. These companies had average sales of $3 billion and had an average of 14,000 workers. That same group conducted a follow-up study of 229 "knowledge industry" companies out of the original sample in 2002. The third study was conducted in 2001 by three professors at the University of Pennsylvania's Wharton School of Business. This study looked at 217 high-tech firms with a median market capitalization of $1.6 billion in 1999.

Based on these studies, Professors Blasi and Kruse conclude:

> From the standpoint of employees, partnership capitalism offers the prospect of significant capital gains. There is a widespread notion in the United States today that employee stock options are just another form of compensation, like salaries and benefits. Many experts made this point repeatedly during the national debate on stock options that arose after the failure of Enron in early 2002.

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1 *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at 170.

* * * *

We believe this view fundamentally misunderstands the nature of employee ownership in general and stock options in particular, at least regarding average employees. **Far from being compensation for labor performed, options are instead a form of capital income.** They represent risk sharing based on joint property ownership. Options turn employees into economic partners in the enterprise. As such, they stand to share in the stock appreciation that they help to bring about. Essentially, options offers employees a way to become shareholders by spending their human capital instead of their cash. They're still employees and they still get paid their regular wages and benefits. But options provide an additional dimension to their employment relationship, allowing workers to participate in both the risks and the rewards of property ownership.

* * * *

There's substantial economic evidence that options bring workers capital rather than labor income....[T]he earnings workers get from options comes on top of their regular market wage. It's true that some high-tech firms, the ones that engage in wage substitution, do effectively require workers to pony up their own money to become property owners. These firms basically get employees to buy their options with a part of their salary. But this isn't a necessary feature of employee options, or a usual one.

* * * *

Several studies demonstrate this. For example, the point came though clearly in the study of the 490 non-Internet firms with broad-based option plans. On average, they paid their employees about 8 percent more than all other public companies between 1985 and 1987, when most of them set up their option plans. A decade later, they still paid about 8 percent more, excluding the money workers got from options. **In other words, these employees got option income on top of the same pay hikes everyone else in the United States had received over the decade**." [2]

Thus, substantial empirical economic evidence now exists to support the conclusion that employee stock options are not necessarily a form of compensation.

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[2] *In the Company of Owners:* at 214-15 (emphasis added).

Based on this and other evidence, Blasi recently stated: "It would be a sorry conclusion . . . if the result of two years of horrible scandals in American corporations and an unprecedented public demand for corporate reform is that the accountants persuade us to eliminate broad-based ownership for technology companies and other companies..." [3]

Existing Option Pricing Models Generate Inaccurate And Misleading Information

The FASB appears to presume that existing option pricing models can reliably measure the value of something they were never intended to value. That presumption is fatally flawed.

Current option pricing models – such as the Black-Scholes model or a binomial method – were designed to value short term, freely-tradable stock options. They were not designed to value employee stock options. Many of the unique aspects of employee stock options cannot be reliably addressed by option pricing models designed specifically for other use.

For example, existing models do not properly account for the fact that employee options generally have a long life, vest over time, are not freely tradable, are subject to forfeiture, and may be subject to external and internal company policy with respect to timing of exercise (such as insider trading restrictions).

Moreover, the required estimate of stock volatility, which generally has one of the largest impacts on the valuation model, requires the company to predict the future – and it is inevitable that any estimate will be wildly wrong far more often than it will be even close to right. While existing option pricing models work well to value what they were intended to value – freely tradable, exchange-based options – simply put, they cannot reliably or meaningfully measure the value of employee stock options – or, by definition, be used to estimate any corporate level expense associated with their issuance. Indeed, current option pricing models require a prediction of employee behavior, thereby making the models even more unreliable in the context of employee stock options.

The FASB will apparently push companies toward using either the Black-Scholes model or a binomial method. Since there is greater familiarity at this point with the problems with Black-Scholes, let me spend a moment on what is known as a binomial model.

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[3] Schwanhausser, "Stock Options Benefited Workers," *The San Jose Mercury News*, January 9, 2003.

Binomial models require the use of "binomial trees." These are equivalent to a series of decision trees that are used to predict possible future events. Thus, binomial models permit the modeling of behavior over time, thereby allowing the inputs used in the model to change during the life of the option. Black-Scholes, on the other hand, uses a specific and constant number throughout the life of the options. For example, under Black-Scholes, once an assumption is made about volatility, that assumed number remains constant over the term of the option. Under a binomial model, multiple assumptions could be made about volatility, so that the volatility estimate could change over the term of the option. Unfortunately, the volatility estimate, whether it changes or not, is still a guess. A binomial model, while more complicated than Black-Scholes, still suffers from the same problems.

According to binomial theory, the more decision trees that are used, the more precise the answer. *The problem is that the more trees that are used, the closer the binomial estimate becomes to the Black-Scholes estimate.* As a result, although the answer derived from a binomial model at any given time will likely differ from the answer derived under Black-Scholes, it will not be a "better" number – it will just be different. And if you follow binomial theory and use a significant number of binomial trees, you are back to the Black-Scholes number that is widely discredited.

The inadequacies of those methods were recently described by SEC Commissioner Paul Atkins in this way:

> "The only positive comment I have heard about Black-Scholes is that everyone seems to understand how to implement vs. the binomial method – but let me be the first to admit that I don't understand the intricacies of the binomial method, and much less some of the ins and outs of Black-Scholes. It's complicated, and as far as the binomial method goes, it has lots of data points. It will take a lot of efforts and expense by companies to implement and it ultimately produces results that are strikingly similar to Black-Scholes. ***Accounting professionals and FASB readily acknowledge that both of these methods are not perfect and frankly are far from it.***" [4]

The bottom line on valuation is this. It is not an improvement in financial reporting to "***substitute an arbitrary value when the actual value cannot be ascertained. Doing so impairs the credibility and trustworthiness of the***

[4] Remarks of SEC Commissioner Paul Atkins, AEI Conference, January 8, 2004; emphasis added.

financial statement, and certainly does not meet the accounting test of reliability—i.e., 'faithfully representing what it purports to represent.'" [5]

Attached to my statement is a sample of comments by accounting, financial and other experts alike that clearly demonstrate the consensus view: Black-Scholes or binomial models cannot and should not be used to value employee stock options. I would respectfully request that this attachment be made a part of the subcommittee's record.

FASB's Refusal to Conduct Field Testing of Multiple Valuation Methods is Indefensible

RSA Security is a member of the International Employee Stock Options Coalition. On January 22, 2004, the Coalition submitted a letter to the FASB urging the FASB to conduct comprehensive field testing of multiple models for valuing employee stock options before proceeding any further with its pending project on stock options. Given the widespread recognition that an accurate and reliable method for valuing employee stock options does not exist, the Coalition reasonsed that that investors, issuers and all stakeholders in the financial reporting system would be well-served by such testing. A copy of the Coalition's letter is attached to my testimony, and I respectfully request that it be made a part of the record.

A number of the coalition's members expressed an eagerness to participate in field testing, and to do so quickly. Indeed, there is FASB precedent for such testing, and at least one prominent organization has urged that FASB conduct field testing with respect to standard-setting generally. Coalition companies told the FASB that they were ready to assist the FASB expeditiously, in any and all ways, in the development, implementation and analysis of the field tests.

In my view, significant field testing of multiple valuation proposals with the open participation of broad industry groups, including technology companies, auditing firms and valuation consultants, would serve investors well and could help mitigate the growing controversy surrounding valuation. The Coalition suggested to the FASB that at least 100 companies across numerous industry segments, as well as the Big 4 accounting firms and several valuation consultants, test multiple methods.

To date, most companies have applied the Black-Scholes method only in their footnote disclosures. As noted, it now appears that FASB will recommend not only the Black-Scholes method but also a binomial or similar method. There

[5] (Kevin Hassett and Peter Wallison, The Economic and Legal Consequences of Requiring the Expensing of Employee Stock Options Without Specifying the Valuation Method, AEI Conference, January 8, 2004, at 8; emphasis added)

is no body of knowledge from footnote disclosures on these other methods, however, in terms of the assumptions companies would make and other key factors. Surely field testing makes sense under these circumstances in order to safeguard the integrity of financial statements.

Inexplicably, FASB made clear at a recent Board meeting that no such field testing will occur. I see no valid policy reason not to conduct such testing – indeed, such testing seems to me to be most appropriate under the circumstances surrounding FASB's stock options project. Whether one supports expensing or opposes expensing, it is undeniable that the valuation issue is complex, contentious and controversial. Why not take the time to get this right?

Mandatory Expensing Of All Employee Stock Options Will Eliminate Broad-Based Plans

HR 3574 would go a long way toward preserving broad-based stock option plans. Why is this so important? Because as Blasi, Kruse and Bernstein conclude in their recent book:

> ...investors and employees alike would gain if companies turned employees into corporate partners by granting stock options to most of the workforce. Most U.S. corporations would be better run, and in the long run more profitable, if America pursued this approach. We say this because unlike the case with executive options, there's compelling evidence that broad-based employee ownership does in fact produce more value for shareholders.[6]

We view the continued availability of broad-based employee stock option plans as essential to the U.S. economy. Any action that would chill or eliminate the use of broad-based employee stock option plans should be avoided, and we believe that any movement toward a mandatory expensing standard will most certainly result in the elimination of broad-based employee stock option plans.

Broad-Based Stock Option Plans are Vital to Enhancing Productivity and Growing the Economy

Professors Blasi and Kruse looked comprehensively at employee ownership programs over the past 25 years. They call employee ownership "partnership capitalism." They concluded that investors came out ahead if their company adopted key elements of partnership capitalism. Just listen to some of their key findings:

[6] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at xi.

- On average, shareholder returns were boosted by 2%.
- Productivity improved 4%.
- Return on equity increased 14%.
- Return on assets increased 12%.
- Profit margins increased 11%. [7]

And there's more. A study published in 2000 of 490 public companies that offered stock options to most or all of their employees found that, compared to public companies without broad-based option plans, the broad-based option companies' average productivity grew 6% faster from the mid-80's to the mid-90's than companies with no employee option plans. Their return on assets also increased 16% more than all public companies, and their average annual stock returns improved by 23% versus 18% for all non-option public companies. [8]

These are some of the concrete, tangible benefits of the partnership capitalism that HR 3574 is committed to preserving and protecting.

Conclusion

Mandatory expensing of all employee stock options represents a solution in search of a problem. As SEC Commissioner Paul Atkins said at a conference less than two months ago:

> "What is the problem that people are trying to solve? And does the FASB direction fix the problem? ***I'm not sure that the presented fix doesn't create more problems.***" [9]

Commissioner Atkins went on to say:

> "I...fear that this change is coming about not simply to improve accountability or to provide more reliable financial information to investors. ***My fear is that this change is coming about as part of a basic horse trade in order to facilitate international convergence with other***

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[7] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at 153-157.

[8] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003).

[9] Atkins remarks.

> ***accounting standards.*** Convergence of accounting standards is of course a laudable goal, and I think my colleagues at the commission have said the same – that it's something to strive for. ***But in an effort to reach this goal we cannot sacrifice the integrity and reliability of financial statements.***" [10]

In my judgment, the mandatory expensing of all employee stock options is without any clear or generally accepted accounting rationale. It is a perverse investor guarantee – it will ensure that investors receive, on a regular basis, inaccurate financial information that is highly subjective and easily manipulated -- Information that will need to be poised and explained. Furthermore, mandatory expening of all employee stock options will destroy broad-based plans as we know them and the productivity, innovation and economic growth they generate. "Partnership capitalism" in the form of broad-based stock option plans should be nurtured, not neutered.

I urge the adoption of HR 3574.

Thank you for the opportunity to testify today, and I look forward to answering the subcommittee's questions.

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[10] Atkins' Remarks; emphasis added. Two highly respected economists have reached the same conclusion:

> "[T]he establishment of new accounting rules for expensing options would likely do more harm than good." (Charles W. Calomiris and R. Glenn Hubbard, Options Pricing and Accounting Practice, Preliminary Paper Presented at AEI Conference, January 8, 2004, at 2).

There is Widespread Opposition to Expensing All Employee Stock Options

Quote Sheet
July 2003-January 2004

"[SEC Commissioner Paul] Atkins, the first SEC member to align himself openly with critics of mandatory expensing, said he was not trying to tell the Financial Accounting Standards Board what to do and was only expressing his own opinion, not that of the entire SEC. But at a conference on stock options expensing, he said he feared the Connecticut-based FASB was moving towards requiring options expensing for political reasons, not accounting ones."

> *"SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.*

"Putting a fair value on something as complicated as long term stock options is almost an impossible task."

> *Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.*

"I'm not sure that the presented fix doesn't create more problems than it actually solves."

> *Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.*

"[AEI Visiting Scholar and Columbia University Finance and Economics Professor Charles] Calomiris also said that mandating stock option expensing will not help investors value a company, and may cause confusion, or "noise," for some unsophisticated investors."

> *Phil McCarty, "FASB Option Expensing Proposal Draws Critics At AEI Panel," Dow Jones, January 8, 2004.*

"Peter Wallison, a resident fellow at AEI and a co-director of the public policy research group's program on financial market deregulation, asked if it makes sense to require the expensing of stock options when no one knows how to value the options. While he admits the options do have some value, Wallison concluded that FASB should defer requiring expensing of stock options "until a workable model is found."

> *Phil McCarty, "FASB Option Expensing Proposal Draws Critics At AEI Panel," Dow Jones, January 8, 2004.*

"FASB 'should not be concerned with corporate governance issues,' Atkins said, nor should they 'be in the business of dictating what kind of compensation' a company offers its employees. He also fears that the accounting change 'is part of a horse trade to facilitate convergence' with international accounting standards."

Teri Rucker, "SEC Commissioner Sees Problems With Stock-Options Plan," National Journal's Technology Daily, January 8, 2004.

"I have yet to meet anybody who suggests that Black-Scholes is a good or even fairly good indicator of the value of long-term compensation options--especially those in broad-based stock option plans,"

Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "Atkins Expresses Concern Over Mandating Stock Option Expensing, Cites Valuation Issue," BNA, January 12, 2004.

"Opponents of mandatory expensing of stock options -- contracts to buy or sell shares of stock at a set price in the future -- say they give employees a stake in making a company a success. Mandatory expensing will make firms stop giving them out, said Jeffrey Peck, a lobbyist for a coalition opposing FASB rules."

Kathleen Day, "Senators Resist Blocking FASB; Accounting Board Close to Ruling on Expensing Stock Options," The Washington Post, January 9, 2004.

"Atkins also expressed concern that FASB was trying to make U.S. accounting standards converge with international standards that are also moving toward mandatory options expensing. While convergence is a laudable goal, he reportedly added, 'in an effort to reach this goal we cannot sacrifice the integrity and reliability of our financial statements.'"

Stephen Taub, "SEC Commissioner Opposes Expensing Options," CFO.com, January 12, 2004.

"Later, in a face-to-face conversation, she pressed Dean to agree that corporations should treat stock options as expenses on their books, and once again he differed with her, explaining that he had learned that options were vital for start-up ventures in such places as Silicon Valley."

David S. Broder, "The Politics Of 'Holy Moly' In Iowa [Column]," The Washington Post, January 11, 2004.

"First, it has become clear that stock option expensing will not accomplish its intended goal of better accounting or corporate governance. More and more, experts are starting to agree that expensing under current models does not create greater accounting accuracy, transparency, or reliability. Second, the fact that there will be negative effects on jobs, competition, and productivity -- factors not initially considered -- is now at the forefront of the minds of most Americans. And third, we're seeing more government, business, and economic leaders, and shareholders begin to realize that the decision to expense cannot be made in isolation. It is part of a much larger equation with very serious downside potential if improperly implemented."

> *John Chambers, CEO, Cisco Systems Inc., quoted in "Stock Options Inspire Innovation," Business Week, December 22, 2003.*

"Not all companies are resigned. A powerful Silicon Valley contingent that stands to take the biggest hit to earnings if expensing becomes a reality -- including Intel (INTC) Corp. and Sun Microsystems (SUNW) Inc. -- is stepping up lobbying against expensing, saying it will stifle innovation and threaten the survival of young companies. 'The economic harm of stock-option expensing cannot be overstated,' Intel CEO Craig R. Barrett told a House subcommittee in June. 'At stake is the future strength and vitality of the American economy.'"

> *Louis Lavelle, "Expensing is Forcing Companies to Rethink Employee Pay Perks," Business Week, December 1, 2003.*

"What the change in the way options are handled would most likely do is to keep corporations from granting options to employees further down the corporate ladder. That would be a colossal problem for smaller corporations and for start-ups that, short on cash, use options to entice talented workers into the fold."

> *Editorial, "New Stock Options Rules Just Worthless Change," The Republican, November 20, 2003.*

"[Expensing stock options is] the wrong answer to the right question, and the Financial Accounting Standards Board has got to know that."

> *Editorial, "New Stock Options Rules Just Worthless Change," The Republican, November 20, 2003.*

"'Without the ability for small businesses to attract ... talented employees (with stock options), start-up businesses will be hurt, and our efforts to diversify our economy in Nevada will be hurt,' said Ensign, who is chairman of the Senate Republican High Tech Task Force."

Senator John Ensign, as quoted by Tony Batt, "Stock Options Not An Expense Under Legislation Supported by Nevada Senators," Las Vegas Review-Journal/Knight Ridder, November 20, 2003.

"'I have to say in this case FASB's green eyeshades have turned into blinders,' Boxer said."

Senator Barbara Boxer, as quoted by Tony Batt, "Stock Options Not An Expense Under Legislation Supported by Nevada Senators," Las Vegas Review-Journal/Knight Ridder, November 20, 2003.

"[Senator] Enzi added, 'It was evident that FASB is not listening to small businesses and not taking their concerns seriously.' Small business groups complain any mandatory stock option expensing will be too expensive and result in them not granting options to workers."

Rob Wells, "U.S. Stock Option Expense Bill Has Bipartisan Backing," Dow Jones International News, November 19, 2003.

"A bipartisan Senate bill that would require companies to expense the stock options awarded to their top five executives, but not those granted to rank-and-file workers, represents a welcome contribution to the rancorous accounting debate on stock options."

Editorial, "Spotlight on Exec Options; Senate Bill's Intent is Sound: Curb Executive Compensation," San Jose Mercury News, November 19, 2003.

"Employee stock options are yielding jackpots again, re- energizing high-tech workers who have been able to cash in on the recent run-up in their employers' stocks. The revival is vindicating stock options as an employee incentive tool..."

Michael Liedtke, "Bouncing Back; Employees Find Stock Options Becoming Attractive Incentive," Associated Press, November 14, 2003.

"In particular, many computer, software and semiconductor makers say FASB's proposed rule would force them to cut profits and abandon the use of options. 'The adoption of this proposal may place U.S. small business at a competitive disadvantage with overseas companies that will not be bound by the standards,' Enzi said."

Donna Block, "Enzi: FASB Must Protect Startups," Daily Deal, November 14, 2003.

"Financial Accounting Standards Board Chairman Robert Herz assured a Congressional panel Wednesday that the rulemaking board will consider the effect that requiring stock-option expensing will have on small businesses."

Phil McCarty, "FASB Will Consider Small Cos In Stock-Option Standard," Dow Jones Newswires, November 13, 2003.

"'I'm hoping small businesses don't have to wage an 11th-hour campaign to get FASB to listen,' Sen. Mike Enzi (R-Wyo.) told Robert H. Herz, chairman of the Financial Accounting Standards Board. 'It seems you spend five times as much time speaking as you do listening. The listening is the part small businesses need more of.'"

> *Steven Gray, "Senator Urges Caution On Accounting Reform; Hearing Focuses on Fears of Small Firms," The Washington Post, November 13, 2003.*

"'I've heard from Intel ... and there's a good case,' Snow said. 'There can't be much argument that options, properly used, are an important component of what drives enterprise and what helps retain employees and motivate them.'"

> *Treasury Secretary John Snow, "U.S. Treasury's Snow - stock options key US pay tool," Reuters News, November 12, 2003.*

"But mandatory expensing of options would kill most broad-based plans. The companies that sponsor them would simply be unable to withstand the hit to earnings-and to stock prices. And neither is warranted because stock options might never be exercised and can't be accurately valued."

> *Marc J. Lane, "Why Options Expensing Rule Would be a Costly Mistake," Crain's Chicago Business, November 10, 2003.*

"Jeff Peck, a lobbyist for the Coalition to Preserve and Protect Stock Options, praised the Enzi proposal 'as a marriage of accounting principles and political reality.' A 'regulatory basis' exists for crafting different rules for top executives, he said, noting that executives have different Securities and Exchange Commission reporting requirements from others in the company."

> *Teri Rucker and William New, "Compromise Plan For Stock Options Garners Interest On Hill," National Journal's Congress Daily, October 31, 2003.*

"[Dell Inc. CEO Michael Dell] also said the move [to expense options] will make it harder for growing companies to attract entrepreneurial employees 'who are willing to take significant risks' by trading upfront compensation for the potential of stock-market gains, and he added that it could hurt job-creation."

> *Bob Sechler, "DELL CEO: Stock-Option Expensing May Hurt Job Creation," Dow Jones Newswires, October 30, 2003.*

"But Joseph Blasi, a Rutgers University professor, warns that cutting back options for rank-and-file workers while insulating top managers and executives 'amounts to an economic atrocity against normal working people.' He hopes more companies like Intel and Cisco Systems will try to win over shareholder support for broad-based plans rather than back down without a fight."

> *Mark Schwanhausser, "Tech firms cut back on options, survey says: Companies Tighten Eligibility, Plans," San Jose Mercury News, October 20, 2003.*

"Driven by heated political rhetoric and hysterical press coverage, a myth has arisen that the decline in equity prices of the late 1990s was caused by option-happy corporate executives. Unfortunately for myth-mongers, the story has been soundly rejected by financial scholars. While options are difficult to value precisely, numerous recent academic studies have been unable to find any evidence that the market misprices firms that rely on them more heavily. There is no crisis."

> *Kevin Hassett, "A Level Paying Field [Op-Ed]," The Wall Street Journal, October 20, 2003.*

"A year ago, the Mercury News' editorial board called for the expensing of options, based, in part, on the assumption that an accurate valuation method could be found. That turns out to be a work in progress. Further, it's clearer now that the abuses uncovered in recent years won't be solved by expensing. Finally, the industry's economic policy argument must be fully studied."

> *Editorial, "The Best Option," San Jose Mercury News, September 29, 2003.*

"Stock options are not inherently flawed...and are actually a very good device, if properly structured."

> *Robert J. Stuckler, Vedder, Price, Kaufman & Kammholz , as quoted by Ameet Sachdev, "Lawyers Help Executives Win Big Bucks from Major Corporations," Chicago Tribune, September 14, 2003.*

"The trouble is that while a change in the rules may, within the context of a "flawed" conceptual framework, appear coherent and desirable to IASB technical experts, we would not expect them necessarily to be quite so aware of unintended consequences - such as sudden widespread falls in corporate pre-tax profits, redundancies and the closure of some all-employee share schemes - as I fear will occur in the wake of the IASB's imminent standard on accounting for share-based payment (the profit and loss account expensing of stock options)."

> *Malcolm Hurlston, Chairman, Employee Share Ownership Centre, "Standards Board Must Be Checked," Financial Times, September 12, 2003.*

"You can't get through all the way to expensing unless you find a credible, acceptable way to value stock options, and that hasn't yet been put forward."

Jeff Peck, International Employee Stock Options Coalition, quoted in "Markets; Accounting Board Delays Changes in Options Rules," Los Angeles Times, September 11, 2003.

"Following his speech, Dean answered questions from the media in which he said he would not favor expensing stock options if at least 65 percent of the options were distributed widely throughout a company."

Dana Hull, "Dean Pans Bush in S.J. Speech," San Jose Mercury News, September 8, 2003.

"The problem with expensing options is that it's like expensing a guess."

Sonia Arrison, Director of Technology Studies, The Pacific Research Institute, "Government's Hand in Our Investments [Op-Ed]," San Francisco Chronicle, September 2, 2003.

"I think that people are beginning to take a step back and look at the bigger picture much more accurately...I'd personally be...surprised if they don't find a middle ground."

John Chambers, CEO, Cisco Systems Inc., quoted in "Compromise Possible In Debate Over Expensing Options," San Jose Mercury News, August 12, 2003.

"Of course, options aren't the perfect compensation solution for every company. Whether to issue them is a business decision — like a decision to build a new plant or expand a sales force or launch an ad campaign. It is, therefore, a decision best left up to businesses themselves, not bureaucrats. If Congress fails to stop the accounting board, it will be sacrificing the country's economy to satisfy the green-eyeshade types."

James Glassman, Resident Fellow, The American Enterprise Institute, "Stock Options Showdown Will Affect Future of U.S. Economy [Op-Ed]," USA Today, July 31, 2003.

"Remember, though, that one size doesn't fit all in this case. Just because Microsoft has shifted to using restricted stock doesn't mean that everyone else should follow. Companies have many choices when they set up compensation plans -- bonuses tied to personal or corporate performance, stock options, restricted stock -- and they should use a mix of all of these methods as needed."

Editorial, "Microsoft's Bold New Pay Plan," Business Week, July 21, 2003.

"Although stock and options obviously have value, calculating that value involves the kind of guesswork that only undermines the credibility of a company's income statement."

> *Steven Pearlstein, "Corporate Reform Could Go Too Far [Column]," The Washington Post, July 18, 2003.*

"In other words, stock options aren't evil...management's willingness to accept stock options sends a signal. It tells shareholders that management thinks the company's stock will go up."

> *Paul Kedrosky, "The Desirable Option [Op-Ed]," National Post's Financial Post, July 12, 2003.*

"We've never thought expensing for options is the silver reform bullet that some believe."

> *Editorial, "Better Shareholder Options," The Wall Street Journal, July 10, 2003.*

January 18, 2004

The International Employee Stock Options Coalition

January 22, 2004

Mr. Robert Herz
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Norwalk, Connecticut 06856-5116

Dear Mr. Herz:

On behalf of millions of U.S. employees and investors, the members of the International Employee Stock Options Coalition (IESOC)[i] urge the Financial Accounting Standards Board (FASB) to conduct comprehensive field testing of multiple models for valuing employee stock options before proceeding any further with its pending project on stock options. Given the widespread recognition that an accurate and reliable method for valuing employee stock options does not exist, we respectfully suggest that investors, issuers and all stakeholders in the financial reporting system would be well-served by such testing.

Many coalition members are eager to participate in field testing, and to do so quickly. Indeed, there is FASB precedent for such testing, and at least one prominent organization has urged that FASB conduct field testing with respect to standard-setting generally. The IESOC stands ready to assist the FASB expeditiously, in any and all ways, in the development, implementation and analysis of the field tests.

Significant field testing of multiple valuation proposals with the open participation of broad industry groups, including technology companies, auditing firms and valuation consultants, would serve investors well and could help mitigate the growing controversy surrounding valuation. We suggest that at least 100 companies across numerous industry segments, as well as the Big 4 accounting firms and several valuation consultants, test multiple methods.

To date, most companies have applied the Black-Scholes method only in their footnote disclosures. It now appears that FASB will recommend not only the Black-Scholes method but also a binomial or similar method. There is no body of knowledge from footnote disclosures on these other methods, however, in terms of the assumptions companies would make and other key factors. Surely field testing makes sense under these circumstances in order to safeguard the integrity of financial statements.

A recent American Enterprise Institute conference underscored the need for field testing. Highly regarded finance, economic and accounting experts, including SEC Commissioner Paul Atkins, Glenn Hubbard, the former Chairman of President George W. Bush's Council of Economic Advisors, and Kevin Hassett, AEI's Director of Economic Policy Studies, identified, among other things, fundamental problems with existing valuation methods. Their comments, a summary of which is attached, provide further evidence that comprehensive field testing is warranted.

Background

The IESOC believes that broad-based employee stock option plans are integral to the formation and growth of high technology, biotechnology and other companies and that the current accounting treatment for stock options should be continued. In our view, stock options do not constitute an expense as no cash payment or outflow of corporate assets is made. The cost of stock options is borne by stockholders through potential dilution, and this expense is already accounted for, and disclosed to investors, in diluted earnings per share.

We agree that there should be greater visibility to stock options and, to that end, many of our member companies have proactively expanded their quarterly and annual stock option disclosures to provide further information to investors.

Latest reports indicate that FASB will require companies to expense all employee stock options pursuant to an existing option pricing model, i.e., the Black-Scholes model, or a binomial or similar model. Experts from numerous fields, expensing advocates and opponents alike, and numerous commentators have raised concerns that these models are highly inaccurate and unreliable when used to value employee stock options, as opposed to freely tradeable options.

The IESOC agrees. The Black-Scholes model, binomial methods, and Monte Carlo modeling all fail the tests of reliability, comparability and consistency. These existing methods simply do not produce credible, transparent, consistent, comparable and unbiased financial information. More specifically, under existing models:

- Consistency and comparability will be at risk. The need to make subjective determinations of the variables used in stock option valuation models will lead to a reduction in existing levels of comparability and consistency in financial reporting across companies and industries.

- To date, accurate valuation of employee stock options has proven to be an impossible task. Valuing stock options granted by high technology and biotechnology companies is particularly complex because estimating certain valuation variables is highly subjective and impacted by factors out of management's control.

- None of the existing valuation models is currently adequate for valuing employee stock options. We believe that the models under consideration by FASB fail to adequately incorporate factors unique to employee stock options and could subsequently compromise the reliability, integrity and comparability of financial reporting, as well as open the door to manipulation.

When one couples issues of volatility, expected holding periods, early exercise, forfeitures, risk free rates of return and trading blackout periods with common issues of the lack of a market, vesting requirements and non-transferability, it becomes crystal clear that there will be significant issues of accuracy and reliability within a company's financial statements as well as consistency and comparability across companies and industries.

While we continue to oppose in the strongest terms the expensing of all employee stock options, we recognize that FASB also continues to press forward. If the Board ultimately proposes mandatory expensing of all options on the face of the income statement, we believe it has an obligation – ***before*** adopting a new accounting standard – to consider multiple valuation methods, test them, and evaluate their accuracy and reliability.

There is FASB Precedent For Field Testing

FASB recently conducted field testing in connection with its project on business combinations (purchase/pooling). The purpose of such field testing was "to determine whether the approach that the Board is pursuing for accounting for goodwill that arises in conjunction with a purchase business combination is operational." [ii] A 1999 memorandum prepared for members of FASB's Financial Accounting Standards Advisory Council discusses the key issue of goodwill amortization, and refers to the results of FASB's field testing. Indeed, field testing "confirmed the Board's concerns about the operationality of the proposed approach, the opportunities for gamesmanship the approach would have provided, and the lack of rigor in impairment testing." [iii] As a result, the Board changed its approach to amortization.

Records also indicate that the FASB conducted field testing in connection with its proposed standards for financial statements of not-for-profit organizations and accounting for contributions in 1994. In addition, FASB conducted field testing in connection with FAS 133 in 1996. [iv]

Field testing is the only prudent way to proceed on the stock options project:

- As before, the Board ought to determine whether its approach on valuation is "operational."
- As before, the Board ought to determine whether its approach on valuation will create "opportunities for gamesmanship."
- And, as before, the Board ought to determine whether its approach is sufficiently rigorous.

Others Have Supported Field Testing Generally

The Association for Investment Management and Research (AIMR) – an expensing advocate – has urged FASB to conduct field testing generally as part of the standard-setting process. In AIMR's words:

> "AIMR's Financial Accounting Policy Committee has on several occasions communicated directly to the FASB in support of field testing in the standards-setting process. ***Field tests can be enormously helpful in identifying implementation problems that neither preparers nor users of financial statements could have anticipated at the conceptual level.*** " [v]

If there were ever a project for FASB to follow AIMR's recommendation, the stock options project must surely be it.

FASB's "Cost-Benefit" Analysis is Inadequate

In September 2003, press reports indicated that FASB had decided to conduct "road testing" of actual valuation models. These media accounts reported that a number of companies "pledged cooperation in taking part in a 'road test' of the accounting standard before FASB formally issues" a new standard.[vi] Numerous companies volunteered to participate in such testing. It was widely understood that actual models would be tested for accuracy and reliability.

FASB has replaced the kind of field testing we recommend here with a cost-benefit kind of analysis that will not impart any relevant or material information about the accuracy and reliability of valuation methods. FASB has told companies that volunteered to participate in field testing that it will instead ask them to assess the out-of-pocket costs that they will incur as a result of attempting to comply with the new standard. FASB has communicated that it does not intend to actually test valuation models. In FASB's words:

> "In particular, the Board seeks to assess and understand the costs, in qualitative terms, that would be required to design and implement a lattice option-pricing model.... ***The scope of the Program does not include testing of lattice option pricing models....*** " [vii]

The field testing program that we recommend is fundamentally different and considerably broader than FASB's ongoing "cost benefit" analysis. Such a broader program – consistent with what appeared to be FASB's original intent – is necessary for any number of reasons, not the least of which is the substantial controversy surrounding valuation.

Suggested Parameters for Field Testing Multiple Valuation Methods

As noted above, we believe that mandatory expensing of employee stock options using currently available valuation models compromises the core financial accounting objectives of comparability, reliability, trustworthiness and consistency. In our view, field testing should include elements that will produce data enabling reasonable judgments about whether expensing stock options enhances or erodes these core objectives.

In order to judge the impact of expensing on comparability, we recommend that field testing include several different industries and multiple companies within each industry. In addition, companies should be chosen that have markedly different levels of stock option usage. By carefully chosing the participants for field testing, FASB can obtain sufficient data bearing on comparability.

Field testing should also require participants to produce a variety of different estimates of their putative stock options "expense" using different valuation models and different inputs for each model for several prior reporting periods. Such data can be used to judge the year-to-year consistency of using a valuation model to determine the alleged "expense" and its impact on the reliability of financial statements.

Such data could also reveal the degree to which changes in the assumptions and inputs skew the outcomes of the various models. This data would allow FASB to assess the degree of trustworthiness (or untrustworthiness) of available valuation models.

We hope that FASB will consider these suggestions in designing field tests, and we would welcome the opportunity to provide further details on suggested methodology and approach.

Conclusion

Those who want to require the expensing of all employee stock options have the burden of demonstrating that such a new accounting standard would enhance the reliability, comparability and consistency of financial statements. Field testing of multiple valuation models across companies and industries is critical. The views of valuation consultants and auditors also are essential to determine the "workability" of any proposal.

The IESOC calls upon FASB to attempt to address the fatal shortcomings of existing option pricing models or develop a new model before mandating inclusion of materially inaccurate numbers on the face of financial statements. FASB should field test multiple models through footnote disclosure until it can be determined whether they do, in fact, "work." Coalition member companies would be pleased to work constructively with the Board in identifying the models to be tested, developing the methodology, identifying companies and industries, and analyzing the resulting data.

Sincerely,

Rick White

Rick White
President

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[i] The IESOC supports broad-based employee stock option plans. It is comprised of trade associations and companies representing a diverse range of industries, including high technology, biotechnology, manufacturing and service companies, in the U.S. and abroad.
[ii] "Business Combinations," Financial Accounting Standards Advisory Council, October 1998, at 1.
[iii] "Business Combinations," Financial Accounting Standards Advisory Council, January 1999, at 3.
[iv] Testimony of FASB Board Member Leslie Seidman before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce, July 22, 2003, p. 8.
[v] See http://accounting.rutgers.edu/raw/aicpa/dbase/d-18d.htm.
[vi] Steve Burkholder, "Several Members of FASB Advisory Panel Praise Proposed Rules on Stock Options," BNA Tax, Budget and Accounting, September 26, 2003, G-9.
[vii] Memorandum from Mike Tovey to FASB Field Visit Program Participants, November 7, 2003, at 1 (emphasis added).

Hearing of the House of Representatives Capital Markets Subcommittee

on

HR 3574

Wednesday, March 3, 2004

Written Testimony of Mark Heesen
President, National Venture Capital Association

Good morning. I am Mark Heesen, president of the National Venture Capital Association (NVCA), which represents 460 venture capital firms in the United States. As you know, venture capital is the investment of equity money to support the creation and development of new businesses. Venture capital backed companies are very important to the U.S. economy in terms of creating jobs, generating revenue and fostering innovation. Many people argue that this segment of the economy, the entrepreneurial segment, is the real growth engine for the U.S. in terms of global competitiveness. U.S. companies originally funded with venture capital now represent 11% of annual GDP and employ over 12 million Americans.

I am here today because our country's small, start-up companies are being threatened by the Financial Accounting Standards Board's (FASB) quest to unilaterally mandate the expensing of employee stock options. The NVCA has a long history of working with FASB on the issue of stock options and our opposition to mandatory expensing is well known. I am testifying today in support of HR 3574 as this bill reflects a thoughtful and balanced approach to employee stock option accounting. The bill mitigates to a considerable degree the critical flaws surrounding the impact of expensing on small and emerging growth businesses, an impact that the FASB has refused to address.

Within the last year, the FASB has demonstrated an increasing disregard for the effects of its stock option accounting proposal on small businesses. This position is a stark contrast to FASB's stance in 1995 when it issued the current rule, FAS 123 in which exceptions were made for private companies. Despite countless calls from these small companies to make distinctions between themselves and large, publicly traded entities, the FASB has made no meaningful progress in this area. Promises from FASB Chairman Robert Herz made at the last Senate hearing in November on this issue and at the last meeting of this sub-committee have gone unmet.

In June, Chairman Herz noted several times that the FASB would address the small business issue. In response to Representative Kanjorski's question whether FASB is "able to establish a rule for accounting purposes that will cause greater transparency for the investing public and not interfere with or in some way compromise the growth of the economy of start-up and high-tech companies," Chairman Herz replied, "...in terms of the private companies, start-ups, we are going to look at that separately, apart from the large public companies."

In response to Representative Emmanuel's question as to whether anybody has looked at the difference of how you would expense stock options for a big public company versus an early stage company, Chairman Herz replied, "It is a question we intend to look at. Because certainly, if nothing else, the valuation issues when you don't have publicly traded stock become of another realm on valuing an option. ...So when you have a private company, a start-up, even if it is pre-IPO I think that is a real issue."

Despite the Chairman's assurances, the only visible effort the FASB has put forth was the announcement, in direct response to the November 2003 Senate hearing, that a small business advisory group will be created. However, this group has yet to be formed and is unlikely to be functional in time to contribute to the current debate.

We fully concur with Congress' reluctance to involve itself in the setting of accounting standards. Yet, with FASB's exposure draft expected in a matter of days, we have nowhere else to turn. In this instance, private companies are in a unique situation with little recourse. While public companies can look to the SEC for additional guidance on many issues, private companies do not fall under SEC purview. However, venture-backed start-ups generally report their financials under GAAP simply because they often do expect to one day move through an initial public offering or become acquired by a public company. Because both of those scenarios require GAAP reporting, venture-backed companies find themselves falling under FASB's domain, without having sufficient input into the discussions of the impact of FASB pronouncements on emerging growth enterprises. In fact, the voices of our country's emerging growth businesses have gone ignored by the FASB. We see an urgent need for checks and balances in our system at this time.

Employee stock options are a critical factor in fueling entrepreneurial innovation and economic growth. For example, the biotechnology industry simply would not exist today without venture capital and employee stock options. Almost without exception, young, growth oriented companies use options to attract the best and brightest talent when cash is scarce.

Employee stock options foster the American entrepreneurial spirit at all levels of organization, with an estimated 10 million workers holding these incentives. Should the FASB require stock option expensing, they will seriously harm an economic tool that has given U.S companies a competitive advantage over our foreign counterparts.

The mandatory expensing of stock options will place a serious burden on small companies so that most will be forced to curtail their broad-based option programs. Today, just as in 1994 when Congress addressed this issue, an acceptable method for the valuation of employee stock options has not been identified by the FASB. Therefore, the option expense number will be perpetually inaccurate, particularly for private companies where it is impossible to measure volatility, a mandatory input into the valuation models currently supported by the FASB. From a formulaic perspective, if one uses the "wrong" volatility there will be a meaningful distortion of the value of the stock option. FASB is familiar with this issue. In promulgating the current stock options rules contained in Statement No. 123, FASB determined that measuring volatility for private companies was too difficult. The FASB stated:

"An emerging entity whose stock is not yet publicly traded may offer stock options to its employees. In concept, those options also should be measured at fair value at the grant date. However, the Board recognizes that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. The Board therefore decided to permit a nonpublic entity to omit expected volatility in determining a value for its options. The result is that a nonpublic entity may use the *minimum value* method . . .." Basis for conclusions ¶ 174. (The minimum value method allows the volatility input to be set at zero.)

While there have been no material changes in the theory of option pricing since 1994, and estimating the volatility of a stock that does not trade has not become any more feasible, the FASB has chosen to reverse their previous conclusion and move forward with a mandate that requires private companies to derive a volatility number. By requiring companies to disclose a highly-suspect option expense number, the FASB is creating a cost on the income statement that will have a significant, long term impact on an organization striving to reach profit levels necessary for an IPO or to become an attractive acquisition target.

Aside from inaccurate financials, a more practical concern is the monetary and human cost that will be required for young companies to undertake the valuation process. These organizations cannot afford the outside expertise required to work through complex valuation models nor can they afford to spend the time to do this themselves. In this regard, we have raised another series of questions: How often do we calculate the value of stock options? Public companies work on a quarterly basis. Private companies do not. They focus on results month-to-month. Should small companies hire experts to come in each month to derive the value of newly granted stock options are each month? Who will do this work? What will they charge and from what strategic area will cash be redirected? Who has the liability if there is a mistake? FASB's mandate will force small companies to address these accounting issues, distracting management, raising expenses and lowering the bottom line.

Finally, implementing mandatory stock option expensing imposes a financial reporting credibility cost that heavily impacts small companies. Public company analysts have said that they will "look through" numbers impacted by stock option expensing to a companies' underlying financials. Yet, over 50% of the NASDAQ companies and virtually ALL private companies do not have analyst coverage. Who is going to look through their numbers? By placing this accounting burden on young companies, FASB is needlessly raising costs, lowering profits and lengthening the reliance on expensive, high risk capital to the start-up sector.

We believe HR 3574 seeks to preserve broad-based employee stock option plans and addresses the serious implications of expensing for emerging businesses. By limiting mandatory expensing to the top five executives, HR3574 targets executive compensation while simultaneously preserving the ability of companies to deliver option plans to rank and file workers. By exempting the expensing requirement for small businesses until three years after an initial public offering, the Bill relieves the compliance burden from young companies seeking to go public and allows a company stock to settle down from the volatility of the IPO. By setting the volatility at zero for valuation purposes as allowed under current FASB rules, HR 3574 removes a key variable that creates a highly inaccurate expense figure. Finally, by requiring the Secretaries of Commerce and Labor to complete a joint study on the economic impact of mandatory expensing, the Bill thwarts a "rush to regulate" effort by the FASB and prevents severe, unintended consequences for our economy and our international competitiveness.

Should the FASB move forward with its current stock option accounting mandate, all companies will have inaccurate financial statements, prepared at significantly greater cost. Yet, entrepreneurial businesses will be unduly impacted, as they do not have adequate resources to comply. The entrepreneurial energy that now accounts for over 10% of the U.S. economy will be drained at a time when our global competitiveness is increasingly challenged by growing economies overseas. International convergence of accounting standards such as mandatory expensing will touch the US and Europe, not China and India where, we fear, accounting standards more supportive of stock options will drive more highly skilled jobs offshore. Today, we applaud the Congressional leadership for addressing the practical impact of FASB's stock option expensing proposal. We urge the passage of HR 3574 as it seeks to achieve consensus while upholding the financial integrity and enhanced transparency sought by all.

Thank you for the opportunity to express NVCA's views on these vital issues.

Small Business SURVIVAL Committee

Prepared Statement of Karen Kerrigan
Chairman
Small Business Survival Committee

On

The Stock Option Accounting Reform Act, H.R. 3574

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
of the
U.S. House Committee on Financial Services
Richard H. Baker, Chairman
Ranking Member, Paul E. Kanjorski

March 3, 2004

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Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, thank you for the opportunity to testify this morning on behalf of H.R. 3574, the Stock Option Accounting Reform Act.

I am Karen Kerrigan, Chair of the Small Business Survival Committee (SBSC), a nonpartisan small business advocacy organization headquartered in the nation's capitol. SBSC works to advance legislation and policies that help to create a favorable and productive environment for small business growth, job creation and entrepreneurship.

H.R. 3574, the Stock Option Accounting Reform Act, is the kind of legislation that will help to maintain and enhance a dynamic environment for small business competitiveness and economic growth. SBSC applauds your leadership, Chairman Baker, as well as the leadership and support of the many bill co-sponsors on the Subcommittee. We urge the House to pass this important legislation as quickly as possible.

H.R. 3574 is an appropriate response to what seems to be general indifference at the Financial Accounting Standards Board (FASB) with respect to the business community's concerns about mandatory stock option expensing. The Board is about to unveil a stock option expensing rule that would be particularly complex and costly for small businesses. SBSC opposes the proposed rule.

In our judgment, it would not lead to the sort of financial transparency expected by shareholders, small businesses and their workforce, nor our elected leaders and regulators. Instead, broad-based employee stock option plans would suffer, leaving small firms at a competitive disadvantage to larger and more mature entities whose resources allow them to recruit and attract the best and the brightest. This would be a shame as small businesses are a key source of innovation and job creation in the United States.

According to the Small Business Administration (SBA), small businesses produce 55% of innovations. They obtain more patents per sales dollar than large businesses. They employ 38 percent of high-tech workers. A healthy and dynamic entrepreneurial sector is critical to robust job creation, maintaining economic growth and our edge in the global marketplace. Incentives and tools that help small firms add to their innovative capacity, like stock options, are integral to their success and our general economic well being.

Indeed, through the leadership of the small business and entrepreneurial sector, and more specifically the tech sector, the concept of employee ownership and participation has enriched our economy and our workforce in a variety of ways. The spread of "partnership capitalism" – as Joseph Blasi, Douglas Kruse and Aaron Bernstein refer to the concept in their book, In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them -- is a good thing, as it boosts employee productivity, profits and stock returns.

The mandatory stock option expensing rule proposed by FASB, by contrast, is archaic and out-of-step. It would vastly curtail the capability of small firms to offer stock options as an employee recruitment, retention and incentive tool. Employee wealth diffusion would endure a major setback as stock options would again be concentrated in the hands of a few.

As noted above, smaller firms in particular have been able to attract and keep highly skilled employees because of their ability to offer stock options to their workforce. It makes little sense to erect barriers and rules that eviscerate these programs as stock options have allowed millions of America's workers to hold ownership in the companies where they work.

While FASB's intention to increase financial reporting and transparency is a worthy goal, we are baffled that they would continue down the mandatory expensing of stock options path to achieve it. I am not an accountant, yet the proposal does not seem to make accounting sense.

First, there is no true consensus on the identification of a model to place an accurate and reliable number on the so-called "cost" of employee stock options. Indeed, all indications are that the FASB is going to rely on either the Black-Scholes method or the binomial method – both of which many experts agree produce bad numbers. In sum, no method currently exists to value employee stock options accurately and reliably. As a result, the mandatory expensing of employee stock options will not make financial statements more accurate, reliable and transparent.

A recent decision by FASB to reject "field testing" of various valuation models is unfortunate, but not surprising. Though I have not attended any of their Board Meetings, my general observation is that the Board is engaged in a race to get this issue "done." From our perspective, it made sense for FASB to take the time to run valuation tests on a wide sample of companies. FASB says it spoke with 18 companies about the costs associated with implementing the proposed standard, but this is hardly representative of the size and diversity of approximately 14,000 public companies.

Second, the "cost" of stock options appears to be quite clear. Economist Alan Reynolds noted this in a 2002 report for the Institute for Policy Innovation. When an option is exercised, Reynolds noted, "the company will often purchase the required stock on the open market – a stock 'buyback.' Using earnings to buy back shares keeps the number of outstanding shares unchanged, but it obviously *does* result in lower reported earnings. The only alternative is to issue more shares—

'dilution'—which also clearly reduces earnings *per share.* Does the cost of buybacks or dilution show up in company earnings? Of course it does."

H.R. 3574 is a prudent solution, which comes at an ideal time. The proposed legislation incorporates sound and targeted reforms with a reasonable requirement that a study be conducted to understand the economic impact of the mandatory expensing of all employee stock options. The latter is very important as policymakers must make every effort to review whether proposed policies and initiatives weaken or strengthen U.S. job creating capacity and competitiveness.

FASB readily concedes that it does not consider the economic consequences of their decisions. I believe a comprehensive study will indeed confirm, and most definitely advance, what we already know about the wide-ranging benefits of employee stock option plans.

SBSC certainly appreciates the lengths to which the legislation goes to protect small businesses and start-up companies. The exemption for companies with less than $25 million in revenues and the protection for companies three years after their initial public offering strike a reasonable balance. In essence, H.R. 3574 will help preserve broad-based stock option plans and the ability of small firms to offer these plans.

FASB contends that its "independence" shields it from Congressional action, yet the economic consequences of the proposed rule are far too

great for Congress to stand by and observe. SBSC is hopeful that this instance serves as an opportunity for FASB to review its standards setting process. Already, FASB has reached out to the small business community, and the Small Business Survival Committee (SBSC) specifically, with an announcement that they are developing a Small Business Advisory Board to act as a resource for future proposals. SBSC cheerfully submitted our recommendation of an individual, as requested, to serve on this new FASB entity.

In closing, I reiterate SBSC's strong support for H.R. 3574, The Stock Option Accounting Reform Act. We encourage Congress to act quickly on the legislation. With the economy getting back on a strong path, Congress would be taking a prudent step in shielding America's workforce and small businesses from a proposed action that would undermine economic growth.

Thank you again for your leadership Chairman Baker, and for providing SBSC with the opportunity to testify today. I look forward to your questions.

Karen Kerrigan
BIO

Ms. Kerrigan founded the Small Business Survival Committee (SBSC) in 1994, a prominent and respected small business advocacy organization with more than 70,000 members nationwide (www.sbsc.org). She now serves as the group's Chairman.

Karen Kerrigan is also President and CEO of Women Entrepreneurs Inc. (WE Inc.), a nonprofit business association helping women business owners succeed through educational programs, networking and advocacy. In 2003, she was appointed to serve on the National Women's Business Council (www.nwbc.gov). Kerrigan also serves on the Taxpayers Advocacy Panel, a federally appointed panel made up of 100 citizens who work to improve the Internal Revenue Service by listening to taxpayers and making recommendations based on taxpayer ideas and feedback.

As a well-known small business advocate, Kerrigan has developed important relationships with key individuals in media, government and the private sector that have led to substantive reforms and initiatives to help America's entrepreneurial sector. Kerrigan testifies often before Congress on issues that impact America's entrepreneurial sector. She has appeared before various U.S. Congressional Committees including House Ways and Means, Education and the Workforce, Small Business, Government Reform and the Senate Commerce, Small Business and Judiciary Committees, as well as commissions at the federal and state level.

Ms. Kerrigan meets regularly with delegations from around the world that wish to learn about public policy recommendations that would enhance and sustain entrepreneurial activity. She recently visited Jerusalem in December 2003, where she met with women business leaders and owners to help them establish an organizational and advocacy presence in the region. While there, she also participated in a video conference with nearly 100 Syrian women business leaders assembled in Damascus.

Her commentary, analysis and written work have appeared in *Investor's Business Daily*, *The Wall Street Journal*, *The Washington Times*, *The Houston Chronicle*, *San Jose Mercury News*, *The Union Leader*, *The New York Post*, and scores of other prominent newspapers and magazines throughout the country. Since 1995, she has written a regular column for the *American City Business Journals* - an influential network of weekly business newspapers in 40 major markets. She has appeared on various television programs and networks such as ABC's Nightline, The McLaughlin Group, CNN, CNN-fn, CNBC, C-SPAN, MSNBC, Fox News Television, various PBS shows and independent cable news programs. She has been a guest on hundreds of radio talk shows and has served as a guest host for both TV and radio as well.

Fortune Small Business named Ms. Kerrigan to its *Power 30* list of key advocates in Washington, D.C. in its September 2000 publication. In 1995, *National Journal* named Ms. Kerrigan to its short list of "K Street" activists less than 40 years of age (which she is no more) most likely to have an impact on Capitol Hill. *Campaigns and Elections Magazine* named her as one of its "Rising Stars in Politics" in its April 1996 issue. She serves on the board of BIPAC and chairs the Coalition for Patient Choice and the HSA Coalition, formerly the Archer MSA Coalition.

Ms. Kerrigan is a native of New York, and holds a BA degree in Political Science from the State University of New York College at Cortland. She resides in Oakton, VA.

Summary of the Testimony of Robert C. Merton
H.R. 3574: Stock Option Accounting Reform Act
March 3, 2004

This testimony takes issue with a number of the central propositions of the proposed Stock Option Accounting Reform Act:

I. Compensatory Stock Options are a real cost to the company and should be an expense

It is a basic principle of accounting that financial statements should record economically significant transactions. Issuing stock options is just such a significant transaction and footnote reporting is not a substitute for recognition on the income statement. Even if no cash changes hands, issuing stock options to employees incurs a sacrifice of cash, an opportunity cost that needs to be accounted for. Both accounting earnings and labor expenses relative to operating revenues are used by analysts to estimate performance of the firm and to compare efficiency and profit margins among firms. The form in which such compensation is paid by the firm should not determine whether it is expensed or not. H.R. 3574 holds that only options granted to the CEO and the top four most highly compensated executive officers of the firm should be expensed. That is not consistent with reflecting the entire economic cost of using options for paying for labor services to the firm. Other forms of compensation including salary, cash bonus and benefits are expensed for *all* employees and not just the top five officers of the firm.

II. The Cost to the Firm of Compensatory Options can be estimated

The value of compensatory options should be the economic cost to the firm of granting those options and *not* the value placed on these options by the employees who receive them. The value of those options can be estimated, using market prices or pricing models.

Financial institutions value and execute transactions involving all kinds of options and other derivative securities in large volume every day all around the world. There are many listed options traded on exchanges. There are convertible bonds and warrants underwritten and traded with long maturities (e.g. 25 years). Institutions offer in the over-the-counter (OTC) market customized and "exotic" options in which the latter contain complex terms. Over the past 30 years, these institutions have developed sophisticated pricing models that they use both to price and to manage the risk of options and other derivative securities.

A recommendation submitted to FASB for expensing compensatory stock options that I co-authored requires only the estimation of 90-day options values for vested options in standard type option plans. 90-day options are traded in the market for many publicly traded companies. Furthermore, many of the special terms in compensatory options that are believed to make their valuation difficult have little effect on the value of a 90-day option.

Estimates from option pricing models often differ from market prices, sometimes significantly. That fact does not imply that it is not possible to value an option with terms that are not precisely traded in the market. Financial statements should strive to be approximately right in reflecting economic reality rather than precisely wrong. H.R. 3574 holds that if a pricing model is used to determine the fair value of an option, the assumed volatility of the underlying stock shall be zero. It is the case that under the assumption of zero volatility, any pricing model used will give about the same estimate of value. Thus, in effect, H.R. 3574 specifies the option-pricing model to use for expensing. This option valuation model is seriously flawed as an estimator of fair value. It is universally accepted that a large part of an option's value is the result of the volatility of the underlying stock price. But there are no real-world traded stocks whose volatility is zero and furthermore, technology firms which issue large amounts of options tend to have above-average levels of volatility. Thus the *mandated* approach of H.R. 3574 will uniformly undervalue all options and for at-the-money options it will uniformly undervalue the options by a large amount. This one provision will *de facto* preserve the current and past practice of not expensing options issued at or out of the money.

Current accounting standards require the estimation of useful economic life for depreciating plant and equipment; the costs of employee pension and other retirement benefits; and even contingent liabilities such as environmental cleanups. These estimates are surely made with error and none of these is traded precisely in the markets. And these estimates can significantly impact reported earnings. FASB sets standards for making these estimates and changes take place as new techniques evolve. Why should the case of setting standards for estimating stock option expense be singularly different?

III. Will Expensing stock options hurt young businesses?

Many critics of expensing argue it will make life more difficult for the businesses that rely heavily on options to reward their entrepreneurial talent. We all recognize the vitality and wealth that entrepreneurial ventures, particularly those in the high-tech sector, bring to the U.S. economy, and I for one have no objection to policy measures that encourage and assist new ventures.

But I do question the policy effectiveness of doing so by essentially creating the benefits from a deliberate accounting distortion proportional to companies' use of one particular form of employee compensation. Indeed, some forms of incentive compensation, such as restricted stock, performance cash awards, and indexed or performance options, arguably do a better job of aligning executive and shareholder interests than conventional stock options do. Yet current accounting standards require that these, and virtually all other compensation alternatives, be expensed. The provisions of H.R. 3574 would in effect exempt only at-the-money stock options from expensing.

I find it rather difficult to accept the prospect that the financial accounting treatment of expensing options will have a profound effect on this Nation's economic prosperity. However, if such were the case, one less distorting approach than the valuation proposal in H.R. 3574 for delivering an accounting subsidy to entrepreneurial ventures would simply be to allow them to defer a percentage of their total employee compensation for some number of years. That way, companies could get the supposed accounting benefits from not having to report a portion of their compensation costs no matter what form that compensation might take.

Options can be a powerful incentive tool. But failing to record a transaction that creates such dramatic effects is economically indefensible and encourages companies to favor options over alternative compensation methods. It is not the proper role of accounting standards to distort compensation by subsidizing one form of incentive compensation relative to all others.

Stock options are not recorded as an expense on companies' books. But the arguments for this special treatment don't stand up. Let's end the charade.

For the Last Time: Stock Options Are an Expense

by Zvi Bodie, Robert S. Kaplan, and Robert C. Merton

THE TIME HAS COME to end the debate on accounting for stock options; the controversy has been going on far too long. In fact, the rule governing the reporting of executive stock options dates back to 1972, when the Accounting Principles Board, the predecessor to the Financial Accounting Standards Board (FASB), issued APB 25. The rule specified that the cost of options at the grant date should be measured by their intrinsic value – the difference between the current fair market value of the stock and the exercise price of the option. Under this method, no cost was assigned to options when their exercise price was set at the current market price.

The rationale for the rule was fairly simple: Because no cash changes hands when the grant is made, issuing a stock option is not an economically significant transaction. That's what many thought at the time. What's more, little theory or practice was available in 1972 to guide companies in determining the value of such untraded financial instruments.

APB 25 was obsolete within a year. The publication in 1973 of the Black-Scholes formula triggered a huge boom in markets for publicly traded options, a movement reinforced by the opening, also in 1973, of the Chicago Board Options Exchange. It was surely no coincidence that the growth of the traded options markets was mirrored by an increasing use of share option grants in executive and employee compensation. The National Center for Employee Ownership estimates that nearly 10 million employees received stock options in 2000; fewer than 1 million did in 1990. It soon became clear in both theory and practice that options of any kind were worth far more than the intrinsic value defined by APB 25.

FASB initiated a review of stock option accounting in 1984 and, after more than a decade of heated controversy, finally issued SFAS 123 in October 1995. It recommended – but did not require – companies to report the cost of options granted and to determine their fair market value using option-pricing models. The new standard was a compromise, reflecting intense lobbying by businesspeople and politicians against mandatory reporting. They argued that executive stock options were one of the defining components in America's extraordinary economic renaissance, so any attempt to change the accounting rules for them was an attack on America's hugely successful model for creating new businesses. Inevitably, most companies chose to ignore the recommendation that they opposed so vehemently and continued to record only the intrinsic value at grant date, typically zero, of their stock option grants.

Subsequently, the extraordinary boom in share prices made critics of option expensing look like spoilsports. But since the crash, the debate has returned with a vengeance. The spate of corporate accounting scandals in particular has revealed just how unreal a picture of their economic performance many companies have been painting in their financial statements. Increasingly, investors and regulators have come to recognize that option-based compensation is a major distorting factor. Had AOL Time Warner in 2001, for example, reported employee stock option expenses as recommended by SFAS 123, it would have shown an operating loss of about $1.7 billion rather than the $700 million in operating income it actually reported.

We believe that the case for expensing options is overwhelming, and in the following pages we examine and dismiss the principal claims put forward by those who continue to oppose it. We demonstrate that, contrary to these experts' arguments, stock option grants have real cash-flow implications that need to be reported, that the way to quantify those implications is available, that footnote disclosure is not an acceptable substitute for reporting the transaction in the income statement and balance sheet, and that full recognition of option costs need not emasculate the incentives of entrepreneurial ventures. We then discuss just how firms might go about reporting the cost of options on their income statements and balance sheets.

FALLACY 1: Stock Options Do Not Represent a Real Cost

It is a basic principle of accounting that financial statements should record economically significant transactions. No one doubts that traded options meet that criterion; billions of dollars' worth are bought and sold every day, either in the over-the-counter market or on exchanges. For many people, though, company stock option grants are a different story. These transactions are not economically significant, the argument goes, because no cash changes hands. As former American Express CEO Harvey Golub put it in an August 8, 2002, *Wall Street Journal* article, stock option grants "are never a cost to the company and, therefore, should never be recorded as a cost on the income statement."

That position defies economic logic, not to mention common sense, in several respects. For a start, transfers of value do not have to involve transfers of cash. While a transaction involving a cash receipt or payment is sufficient to generate a recordable transaction, it is not necessary. Events such as exchanging stock for assets, signing a lease, providing future pension or vacation benefits for current-period employment, or acquiring materials on credit all trigger accounting transactions because they involve transfers of value, even though no cash changes hands at the time the transaction occurs.

Even if no cash changes hands, issuing stock options to employees incurs a sacrifice of cash, an opportunity cost, which needs to be accounted for. If a company were to grant stock, rather than options, to employees, everyone would agree that the company's cost for this transaction would be the cash it otherwise would have received if it had sold the shares at the current market price to investors. It is exactly the same with stock options. When a company grants options to employees, it forgoes the opportunity to receive cash from underwriters who could take these same options and sell them in a competitive options market to investors. Warren Buffett made this point graphically in an April 9, 2002, *Washington Post* column when he stated: "Berkshire [Hathaway] will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America." Granting options to employees rather than selling them to suppliers or investors via underwriters involves an actual loss of cash to the firm.

It can, of course, be more reasonably argued that the cash forgone by issuing options to employees, rather than selling them to investors, is offset by the cash the company conserves by paying its employees less cash. As two widely respected economists, Burton G. Malkiel and William J. Baumol, noted in an April 4, 2002, *Wall Street Journal* article: "A new, entrepreneurial firm may not be able to provide the cash compensation needed to attract outstanding workers. Instead, it can offer stock options." But Malkiel and Baumol, unfortunately, do not follow their observation to its logical conclusion. For if the cost of stock options is not universally incorporated into the measurement of net income, companies that grant options will underreport compensation costs, and it won't be possible to compare their profitability, productivity, and return-on-capital measures with those of economically equivalent companies that have merely structured their compensation system in a different way. The following hypothetical illustration shows how that can happen.

Imagine two companies, KapCorp and MerBod, competing in exactly the same line of business. The two differ only in the structure of their employee compensation packages. KapCorp pays its workers $400,000 in total

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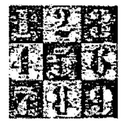
compensation in the form of cash during the year. At the beginning of the year, it also issues, through an underwriting, $100,000 worth of options in the capital market, which cannot be exercised for one year, and it requires its employees to use 25% of their compensation to buy the newly issued options. The net cash outflow to KapCorp is $300,000 ($400,000 in compensation expense less $100,000 from the sale of the options).

MerBod's approach is only slightly different. It pays its workers $300,000 in cash and issues them directly $100,000 worth of options at the start of the year (with the same one-year exercise restriction). Economically, the two positions are identical. Each company has paid a total of $400,000 in compensation, each has issued $100,000 worth of options, and for each the net cash outflow totals $300,000 after the cash received from issuing the options is subtracted from the cash spent on compensation. Employees at both companies are holding the same $100,000 of options during the year, producing the same motivation, incentive, and retention effects.



How legitimate is an accounting standard that allows two economically identical transactions to produce radically different numbers?

In preparing its year-end statements, KapCorp will book compensation expense of $400,000 and will show $100,000 in options on its balance sheet in a shareholder equity account. If the cost of stock options issued to employees is not recognized as an expense, however, MerBod will book a compensation expense of only $300,000 and not show any options issued on its balance sheet. Assuming otherwise identical revenues and costs, it will look as though MerBod's earnings were $100,000 higher than KapCorp's. MerBod will also seem to have a lower equity base than KapCorp, even though the increase in the number of shares outstanding will eventually be the same for both companies if all the options are exercised. As a result of the lower compensation expense and lower equity position, MerBod's performance by most analytic measures will appear to be far superior to KapCorp's. This distortion is, of course, repeated every year that the two firms choose the different forms of compensation. How legitimate is an accounting standard that allows two economically identical transactions to produce radically different numbers?

FALLACY 2: The Cost of Employee Stock Options Cannot Be Estimated

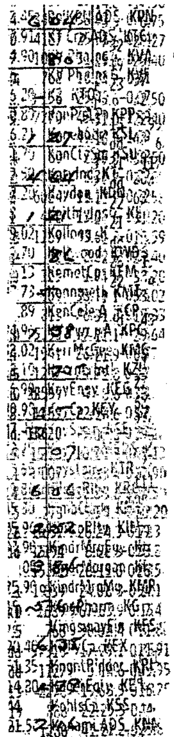
Some opponents of option expensing defend their position on practical, not conceptual, grounds. Option-pricing models may work, they say, as a guide for valuing publicly traded options. But they can't capture the value of employee stock options, which are private contracts between the company and the employee for illiquid instruments that cannot be freely sold, swapped, pledged as collateral, or hedged.

It is indeed true that, in general, an instrument's lack of liquidity will reduce its value to the holder. But the holder's liquidity loss makes no difference to what it costs the issuer to create the instrument unless the issuer somehow benefits from the lack of liquidity. And for stock options, the absence of a liquid market has little effect on their value to the holder. The great beauty of option-pricing models is that they are based on the characteristics of the underlying stock. That's precisely why they have contributed to the extraordinary growth of options markets over the last 30 years. The Black-Scholes price of an option equals the value of a portfolio of stock and cash that is managed dynamically to replicate the payoffs to that option. With a completely liquid stock, an otherwise unconstrained investor could entirely hedge an option's risk and extract its value by selling short the replicating portfolio of stock and cash. In that case, the liquidity discount on the option's value would be minimal. And that applies even if there were no market for trading the option directly. Therefore, the liquidity – or lack thereof – of markets in stock options does not, by itself, lead to a discount in the option's value to the holder.

Investment banks, commercial banks, and insurance companies have now gone far beyond the basic, 30-year-old Black-Scholes model to develop approaches to pricing all sorts of options: Standard ones. Exotic ones. Options traded through intermediaries, over the counter, and on exchanges. Options linked to currency fluctuations. Options embedded in complex securities such as convertible debt, preferred stock, or callable debt like mortgages with prepay features or interest rate caps and floors. A whole subindustry has developed to help individuals, companies, and money market managers buy and sell these complex securities. Current financial technology certainly permits firms to incorporate all the features of employee stock options into a pricing model. A few investment banks will even quote prices for executives looking to hedge or sell their stock options prior to vesting, if their company's option plan allows it.

Of course, formula-based or underwriters' estimates about the cost of employee stock options are less precise than cash payouts or share grants. But financial statements should strive to be approximately right in reflecting economic reality rather than precisely wrong. Managers routinely rely on estimates for important cost items, such as the depreciation of plant and equipment and provisions against contingent liabilities, such as future environmental cleanups and settlements from product liability suits and other litigation. When calculating the costs of employees' pensions and other retirement benefits, for instance, managers use actuarial estimates of future interest rates, employee retention rates, employee retirement dates, the longevity of employees and their spouses, and the escalation of future medical costs. Pricing models and extensive experience make it possible to estimate the cost of stock options issued in any given period with a precision comparable to, or greater than, many of these other items that already appear on companies' income statements and balance sheets.

Not all the objections to using Black-Scholes and other option valuation models are based on difficulties in estimating the cost of options granted. For example, John DeLong, in a June 2002 Competitive Enterprise Institute paper entitled "The Stock Options Controversy and the New Economy," argued that "even if a value were calculated according to a model, the calculation would require adjustment to reflect the value to the employee." He is only half right. By paying employees with its own stock or options, the company forces them to hold highly nondiversified financial portfolios, a risk further compounded by the investment of the employees' own human capital in the company as well. Since almost all individuals are risk averse, we can expect employees to place substantially less value on their stock option package than other, better-diversified, investors would.



The Real Impact of Forfeiture and Early Exercise

Unlike cash salary, stock options cannot be transferred from the individual granted them to anyone else. Nontransferability has two effects that combine to make employee options less valuable than conventional options traded in the market.

First, employees forfeit their options if they leave the company before the options have vested. Second, employees tend to reduce their risk by exercising vested stock options much earlier than a well-diversified investor would, thereby reducing the potential for a much higher payoff had they held the options to maturity. Employees with vested options that are in the money will also exercise them when they quit, since most companies require employees to use or lose their options upon departure. In both cases, the economic impact on the company of issuing the options is reduced, since the value and relative size of existing shareholders' stakes are diluted less than they could have been, or not at all.

Recognizing the increasing probability that companies will be required to expense stock options, some opponents are fighting a rearguard action by trying to persuade standard setters to significantly reduce the reported cost of those options, discounting their value from that measured by financial models to reflect the strong likelihood of forfeiture and early exercise. Current proposals put forth by these people to FASB and IASB would allow companies to estimate the percentage of options forfeited during the vesting period and reduce the cost of option grants by this amount. Also, rather than use the expiration date for the option life in an option-pricing model, the proposals seek to allow companies to use an expected life for the option to reflect the likelihood of early exercise. Using an expected life (which companies may estimate at close to the vesting period, say, four years) instead of the contractual period of, say, ten years, would significantly reduce the estimated cost of the option.

Some adjustment should be made for forfeiture and early exercise. But the proposed method significantly overstates the cost reduction since it neglects the circumstances under which options are most likely to be forfeited or exercised early. When these circumstances are taken into account, the reduction in employee option costs is likely to be much smaller.

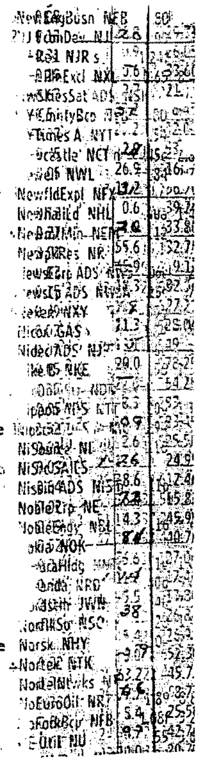
First, consider forfeiture. Using a flat percentage for forfeitures based on historical or prospective employee turnover is valid only if forfeiture is a random event, like a lottery, Estimates of the magnitude of this employee risk discount – or "deadweight cost," as it is sometimes called – range from 20% to 50%, depending on the volatility of the underlying stock and the degree of diversification of the employee's portfolio. The existence of this deadweight cost is sometimes used to justify the apparently huge scale of option-based remuneration handed out to top executives. A company seeking, for instance, to reward its CEO with $1 million in options that are worth $1,000 each in the market may (perhaps perversely) reason that it should issue 2,000 rather than 1,000 options because, from the CEO's perspective, the options are worth only $500 each. (We would point out that this reasoning validates our earlier point that options are a substitute for cash.)

But while it might arguably be reasonable to take deadweight cost into account when deciding how much equity-based compensation (such as options) to include in an executive's pay packet, it is certainly not reasonable to let deadweight cost influence the way companies record the costs of the packets. Financial statements reflect the economic perspective of the company, not the entities (including employees) with which it transacts. When a company sells a product to a customer, for example, it does not have to verify what the product is worth to that individual. It counts the expected cash payment in the transaction as its revenue. Similarly, when the company purchases a product or service from a supplier, it does not examine whether the price paid was greater or less than the supplier's cost or what the supplier could have received had it sold the product or service elsewhere. The company records the purchase price as the cash or cash equivalent it sacrificed to acquire the good or service.

independent of the stock price. In reality, however, the likelihood of forfeiture is negatively related to the value of the options forfeited and, hence, to the stock price itself. People are more likely to leave a company and forfeit options when the stock price has declined and the options are worth little. But if the firm has done well and the stock price has increased significantly since grant date, the options will have become much more valuable, and employees will be much less likely to leave. If employee turnover and forfeiture are more likely when the options are least valuable, then little of the options' total cost at grant date is reduced because of the probability of forfeiture.

The argument for early exercise is similar. It also depends on the future stock price. Employees will tend to exercise early if most of their wealth is bound up in the company, they need to diversify, and they have no other way to reduce their risk exposure to the company's stock price. Senior executives, however, with the largest option holdings, are unlikely to exercise early and destroy option value when the stock price has risen substantially. Often they own unrestricted stock, which they can sell as a more efficient means to reduce their risk exposure. Or they have enough at stake to contract with an investment bank to hedge their option positions without exercising prematurely. As with the forfeiture feature, the calculation of an expected option life without regard to the magnitude of the holdings of employees who exercise early, or to their ability to hedge their risk through other means, would significantly underestimate the cost of options granted.

Option-pricing models can be modified to incorporate the influence of stock prices and the magnitude of employees' option and stock holdings on the probabilities of forfeiture and early exercise. (See, for example, Mark Rubinstein's Fall 1995 article in the *Journal of Derivatives*, "On the Accounting Valuation of Employee Stock Options.") The actual magnitude of these adjustments needs to be based on specific company data, such as stock price appreciation and distribution of option grants among employees. The adjustments, properly assessed, *could* turn out to be significantly smaller than the proposed calculations (apparently endorsed by FASB and IASB) would produce. Indeed, for some companies, a calculation that ignores forfeiture and early exercise altogether could come closer to the true cost of options than one that entirely ignores the factors that influence employees' forfeiture and early exercise decisions.



Suppose a clothing manufacturer were to build a fitness center for its employees. The company would not do so to compete with fitness clubs. It would build the center to generate higher revenues from increased productivity and creativity of healthier, happier employees and to reduce costs arising from employee turnover and illness. The cost to the company is clearly the cost of building and maintaining the facility, not the value that the individual employees might place on it. The cost of the fitness center is recorded as a periodic expense, loosely matched to the expected revenue increase and reductions in employee-related costs.

The people claiming that options expensing creates a double-counting problem are themselves creating a smoke screen to hide the income-distorting effects of stock option grants.

The only reasonable justification we have seen for costing executive options below their market value stems from the observation that many options are forfeited when employees leave, or are exercised too early because of employees' risk aversion. In these cases, existing shareholders' equity is diluted less than it would otherwise be, or not at all, consequently reducing the company's compensation cost. While we agree with the basic logic of this argument, the impact of forfeiture and early exercise on theoretical values may be grossly exaggerated. (See the sidebar "The Real Impact of Forfeiture and Early Exercise.")

FALLACY 3:
Stock Option Costs Are Already Adequately Disclosed

Another argument in defense of the existing approach is that companies already disclose information about the cost of option grants in the footnotes to the financial statements. Investors and analysts who wish to adjust income statements for the cost of options, therefore, have the necessary data readily available. We find that argument hard to swallow. As we have pointed out, it is a fundamental principle of accounting that the income statement and balance sheet should portray a company's underlying economics. Relegating an item of such major economic significance as employee option grants to the footnotes would systematically distort those reports.

But even if we were to accept the principle that footnote disclosure is sufficient, in reality we would find it a poor substitute for recognizing the expense directly on the primary statements. For a start, investment analysts, lawyers, and regulators now use electronic databases to calculate profitability ratios based on the numbers in companies' audited income statements and balance sheets. An analyst following an individual company, or even a small group of companies, could make adjustments for information disclosed in footnotes. But that would be difficult and costly to do for a large group of companies that had put different sorts of data in various nonstandard formats into footnotes. Clearly, it is much easier to compare companies on a level playing field, where all compensation expenses have been incorporated into the income numbers.

What's more, numbers divulged in footnotes can be less reliable than those disclosed in the primary financial statements. For one thing, executives and auditors typically review supplementary footnotes last and devote less time to them than they do to the numbers in the primary statements. As just one example, the footnote in eBay's FY 2000 annual report reveals a "weighted average grant-date fair value of options granted during 1999 of $105.03" for a year in which the weighted average exercise price of shares granted was $64.59. Just how the value of options granted can be 63% more than the value of the underlying stock is not obvious. In FY 2000, the same effect was reported: a fair value of options granted of $103.79 with an average exercise price of $62.69. Apparently, this error was finally detected, since the FY 2001 report retroactively adjusted the 1999 and 2000 average grant-date fair values to $40.45 and $41.40, respectively. We believe executives and auditors will exert greater diligence and care in obtaining reliable estimates of the cost of stock options if these figures are included in companies' income statements than they currently do for footnote disclosure.

Our colleague William Sahlman in his December 2002 HBR article, "Expensing Options Solves Nothing," has expressed concern that the wealth of useful information contained in the footnotes about the stock options granted would be lost if options were expensed. But surely recognizing the cost of options in the income statement does not preclude continuing to provide a footnote that explains the underlying distribution of grants and the methodology and parameter inputs used to calculate the cost of the stock options.

Some critics of stock option expensing argue, as venture capitalist John Doerr and FedEx CEO Frederick Smith did in an April 5, 2002, *New York Times* column, that "if expensing were ... required, the impact of options would be counted twice in the earnings per share: first as a potential dilution of the earnings, by increasing the shares outstanding, and second as a charge against reported earnings. The result would be inaccurate and misleading earnings per share."

We have several difficulties with this argument. First, option costs only enter into a (GAAP-based) diluted earnings-per-share calculation when the current market price exceeds the option exercise price. Thus, fully diluted EPS numbers still ignore all the costs of options that are nearly in the money or could become in the money if the stock price increased significantly in the near term.

Second, relegating the determination of the economic impact of stock option grants solely to an EPS calculation greatly distorts the measurement of reported income. Such fundamental profitability and productivity measures as return on investment, return on capital employed, and economic value added, which are based on accounting income, would not be adjusted to reflect the economic impact of option costs. These measures are more significant summaries of the change in economic value of a company than the prorated distribution of this income to individual shareholders revealed in the EPS measure. This becomes eminently clear when taken to its logical absurdity: Suppose companies were to compensate all their suppliers–of materials, labor, energy, and purchased services–with stock options rather than with cash and avoid all expense recognition in their income statement. Their income and their profitability measures would all be so grossly inflated as to be useless for analytic purposes; only the EPS number would pick up any economic effect from the option grants.

Our biggest objection to this spurious claim, however, is that even a calculation of fully diluted EPS does not fully reflect the economic impact of stock option grants. The following hypothetical example illustrates the problems, though for purposes of simplicity we will use grants of shares instead of options. The reasoning is exactly the same for both cases.

Let's say that each of our two hypothetical companies, KapCorp and MerBod, has 8,000 shares outstanding, no debt, and annual revenue this year of $100,000. KapCorp decides to pay its employees and suppliers $90,000 in cash and has no other expenses. MerBod, however, compensates its employees and suppliers with $80,000 in cash and 2,000 shares of stock, at an average market price of $5 per share. The cost to each company is the same: $90,000. But their net income and EPS numbers are very different. KapCorp's net income before taxes is $10,000, or $1.25 per share. By contrast, MerBod's reported net income (which ignores the cost of the equity granted to employees and suppliers) is $20,000, and its EPS is $2.00 (which takes into account the new shares issued).

Of course, the two companies now have different cash balances and numbers of shares outstanding with a claim on them. But KapCorp can eliminate that discrepancy by issuing 2,000 shares of stock in the market during the year at an average selling price of $5 per share. Now both companies have closing cash balances of $20,000 and 10,000 shares outstanding. Under current accounting rules, however, this transaction only exacerbates the gap between the EPS numbers. KapCorp's reported income remains $10,000, since the additional $10,000 value gained from the sale of the shares is not reported in net income, but its EPS denominator has increased from 8,000 to 10,000. Consequently, KapCorp now reports an EPS of $1.00 to MerBod's $2.00, even though their economic positions are identical: 10,000 shares outstanding and increased cash balances of $20,000. The people claiming that options expensing creates a double-counting problem are themselves creating a smoke screen to hide the income-distorting effects of stock option grants.

Indeed, if we say that the fully diluted EPS figure is the right way to disclose the impact of share options, then we should immediately change the current accounting rules for situations when companies issue common stock, convertible preferred stock, or convertible bonds to pay for services or assets. At present, when these transactions occur, the cost *is* measured by the fair market value of the consideration involved. Why should options be treated differently?

Fallacy 4: Expensing Stock Options Will Hurt Young Businesses

Opponents of expensing options also claim that doing so will be a hardship for entrepreneurial high-tech firms that do not have the cash to attract and retain the engineers and executives who translate entrepreneurial ideas into profitable, long-term growth.

This argument is flawed on a number of levels. For a start, the people who claim that option expensing will harm entrepreneurial incentives are often the same people who claim that current disclosure is adequate for communicating the economics of stock option grants. The two positions are clearly contradictory. If current disclosure is sufficient, then moving the cost from a footnote to the balance sheet and income statement will have no market effect. But to argue that proper costing of stock options would have a significant adverse impact on companies that make extensive use of them is to admit that the economics of stock options, as currently disclosed in footnotes, are not fully reflected in companies' market prices.

More seriously, however, the claim simply ignores the fact that a lack of cash need not be a barrier to compensating executives. Rather than issuing options directly to employees, companies can always issue them to underwriters and then pay their employees out of the money received for those options. Considering that the market systematically puts a higher value on options than employees do, companies are likely to end up with more cash from the sale of externally issued options (which carry with them no deadweight costs) than they would by granting options to employees in lieu of higher salaries.

Even privately held companies that raise funds through angel and venture capital investors can take this approach. The same procedures used to place a value on a privately held company can be used to estimate the value of its options, enabling external investors to provide cash for options about as readily as they provide cash for stock.

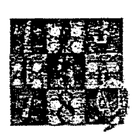
That's not to say, of course, that entrepreneurs should never get option grants. Venture capital investors will always want employees to be compensated with some stock options in lieu of cash to be assured that the employees have some "skin in the game" and so are more likely to be honest when they tout their company's prospects to providers of new capital. But that does not preclude also raising cash by selling options externally to pay a large part of the cash compensation to employees.

We certainly recognize the vitality and wealth that entrepreneurial ventures, particularly those in the high-tech sector, bring to the U.S. economy. A strong case can be made for creating public policies that actively assist these companies in their early stages, or even in their more established stages. The nation should definitely consider a regulation that makes entrepreneurial, job-creating companies healthier and more competitive by changing something as simple as an accounting journal entry.

But we have to question the effectiveness of the current rule, which essentially makes the benefits from a deliberate accounting distortion proportional to companies' use of one particular form of employee compensation. After all, some entrepreneurial, job-creating companies might benefit from picking other forms of incentive compensation that arguably do a better job of aligning executive and shareholder interests than conventional stock options do. Indexed or performance options, for example, ensure that management is not rewarded just for being in the right place at the right time or penalized just for being in the wrong place at the wrong time. A strong case can also be made for the superiority of properly designed restricted stock grants and deferred cash payments. Yet current accounting standards require that these, and virtually all other compensation alternatives, be expensed. Are companies that choose those alternatives any less deserving of an accounting subsidy than Microsoft, which, having granted 300 million options in 2001 alone, is by far the largest issuer of stock options?

A less distorting approach for delivering an accounting subsidy to entrepreneurial ventures would simply be to allow them to defer some percentage of their total employee compensation for some number of years, which could be indefinitely – just as companies granting stock options do now. That way, companies could get the supposed accounting benefits from not having to report a portion of their compensation costs no matter what form that compensation might take.

It is not the proper role of accounting standards to distort executive and employee compensation by subsidizing one form of compensation relative to all others.



What Will Expensing Involve?

Although the economic arguments in favor of reporting stock option grants on the principal financial statements seem to us to be overwhelming, we do recognize that expensing poses challenges. For a start, the benefits accruing to the company from issuing stock options occur in future periods, in the form of increased cash flows generated by its option motivated and retained employees. The fundamental matching principle of accounting requires that the costs of generating those higher revenues be recognized at the same time the revenues are recorded. This is why companies match the cost of multiperiod assets such as plant and equipment with the revenues these assets produce over their economic lives.

In some cases, the match can be based on estimates of the future cash flows. In expensing capitalized software-development costs, for instance, managers match the costs against a predicted pattern of benefits accrued from selling the software. In the case of options, however, managers would have to estimate an equivalent pattern of benefits arising from their own decisions and activities. That would likely introduce significant measurement error and provide opportunities for managers to bias their estimates. We therefore believe that using a standard straight-line amortization formula will reduce measurement error and management bias despite some loss of accuracy. The obvious period for the amortization is the useful economic life of the granted option, probably best measured by the vesting period. Thus, for an option vesting in four years, 1/48 of the cost of the option would be expensed through the income statement in each month until the option vests. This would treat employee option compensation costs the same way the costs of plant and equipment or inventory are treated when they are acquired through equity instruments, such as in an acquisition.

In addition to being reported on the income statement, the option grant should also appear on the balance sheet. In our opinion, the cost of options issued represents an increase in shareholders' equity at the time of grant and should be reported as paid-in capital. Some experts argue that stock options are more like contingent liability than equity transactions since their ultimate cost to the company cannot be determined until employees either exercise or forfeit their options. This argument, of course, ignores the considerable economic value the company has sacrificed at time of grant. What's more, a contingent liability is usually recognized as an expense when it is possible to estimate its value and the liability is likely to be incurred. At time of grant, both these conditions are met. The value transfer is not just probable; it is certain. The company has granted employees an equity security that could have been issued to investors and suppliers who would have given cash, goods, and services in return. The amount sacrificed can also be estimated, using option-pricing models or independent estimates from investment banks.

There has to be, of course, an offsetting entry on the asset side of the balance sheet. FASB, in its exposure draft on stock option accounting in 1994, proposed that at time of grant an asset called "prepaid compensation expense" be recognized, a recommendation we endorse. FASB, however, subsequently retracted its proposal in the face of criticism that since employees can quit at any time, treating their deferred compensation as an asset would violate the principle that a company must always have legal control over the assets it reports. We feel that FASB capitulated too easily to this argument. The firm does have an asset because of the option grant–presumably a loyal, motivated employee. Even though the firm does not control the asset in a legal sense, it does capture the benefits. FASB's concession on this issue subverted substance to form.

Finally, there is the issue of whether to allow companies to revise the income number they've reported after the grants have been issued. Some commentators argue that any recorded stock option compensation expense should be reversed if employees forfeit the options by leaving the company before vesting or if their options expire unexercised. But if companies were to mark compensation expense downward when employees forfeit their options, should they not also mark it up when the share price rises, thereby increasing the market value of the options? Clearly, this can get complicated, and it comes as no surprise that neither FASB nor IASB recommends any kind of postgrant accounting revisions, since that would open up the question of whether to use mark-to-market accounting for all types of assets and liabilities, not just share options. At this time, we don't have strong feelings about whether the benefits from mark-to-market accounting for stock options exceed the costs. But we would point out that people who object to estimating the cost of options granted at time of issue should be even less enthusiastic about reestimating their options' cost each quarter.

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We recognize that options are a powerful incentive, and we believe that all companies should consider them in deciding how to attract and retain talent and align the interests of managers and owners. But we also believe that failing to record a transaction that creates such powerful effects is economically indefensible and encourages companies to favor options over alternative compensation methods. It is not the proper role of accounting standards to distort executive and employee compensation by subsidizing one form of compensation relative to all others. Companies should choose compensation methods according to their economic benefits–not the way they are reported.

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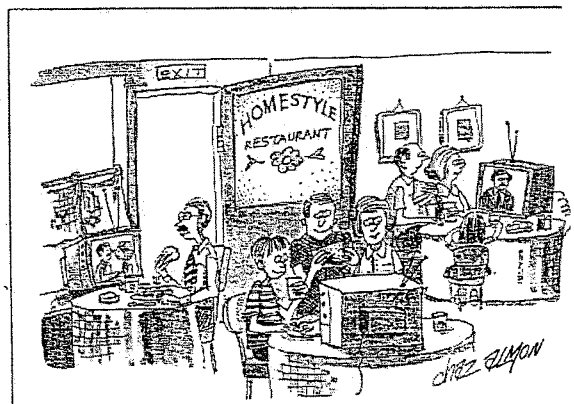

CHARLES ALMON

IFL INTEGRATED FINANCE LTD

Proposal by Integrated Finance Limited for Expensing Employee Compensatory Stock Options for Financial Reporting Purposes

Introduction

Integrated Finance Limited ("IFL") has developed an accounting approach for employee stock options that matches the expense of option-based compensation to the timing and magnitude of economic transfer. The approach, which is adaptable to either closed-form or binomial valuation models, complements the FASB draft proposal by providing a specific framework in which to apply the FASB recommendations.

The IFL approach is driven by the key insight that only the part of the option value earned without the obligation of continued employment should be treated as an expense.[1] We pay specific attention to the fact that most stock option plans stipulate that if the employee resigns or is terminated then the maturity for the *vested* option is truncated to 90 days. Hence, at any given point in time, an employee in fact owns (free and clear of any future commitment to work for the company) only a 90-day option, even if the stated maturity of the option is 10 years.[2] Thus, the "extension" of the maturity as a consequence of the employee's continued employment is the appropriate expense in each accounting period. This approach to expensing vested options in turn has implications for plans that require a vesting period. For such plans, IFL proposes that the option value to be conferred at vesting be estimated quarterly beginning at time of grant and that the corresponding estimated expense be revised and allocated as a pro-rata accrual each quarter over the vesting period.

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[1] The idea that only the value of the part of that option which is owned without requiring continued employment in the future should be expensed was first presented in "Accounting for Stock Options," Jeremy Bulow and John Shoven, Stanford University, unpublished manuscript, January 15, 2004.

[2] For some companies, the maturity because of termination may differ from 90 days. For a company with an N-day maturity provision, the underlying logic for quarterly accounting periods would still apply, and the expense each quarter would equal a 90-day extension of an N-day option. If the termination window is in fact 90 days, the extension and maturity conveniently match up, simplifying the valuation process.

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Summary: IFL Process for Expensing Employee Stock Options
For vested employee stock options that expire 90 days after employee termination, IFL proposes:

1. In the period after the option becomes vested ("the vested period"), outstanding employee stock options should be expensed at the end of each quarter for the incremental value of extending the option for an additional quarter. There is no option expense in the quarter when the option is either exercised or expires.
2. In the pre-vested period ("the vesting period"), employee stock options should be expensed based on an option maturity of the quarter-end date when the option vests plus the termination-linked time-frame dictated by the company option plan; typically, the quarter-end date when the option vests plus 90 days.
3. The expense of an unvested employee stock option should be spread over the vesting period on a pro-rata basis and recalculated each accounting period during vesting to reflect the then current value of the option; the cumulative expense charge over the entire vesting period will equal the fair-market value of the option at its vesting date.

Benefits of the IFL Process for Expensing Employee Stock Options

1. It reflects the actual economics of the exchange of labor for valuable consideration by charging the fair market value of what the firm has transferred to the employee and by allocating that expense to the accounting period in which the employee worked to receive that transfer.

2. In the vested period, valuation typically will not be based on maturities greater than 90 days, for which there are traded options; even when traded prices are not available, most agree that the Black-Scholes and other (lattice) models of option pricing are more accurate for shorter maturity options.

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3. In the vested period, because the termination-linked option maturities generally are 90 days, adjustments in valuation for early exercise before expiration are not likely to be needed or material.
4. At grant, the time horizon for valuation is the vesting period plus 90 days, typically 1.25-3.25 years, which is within a maturity range for reasonably effective model pricing and allows benchmark pricing to publicly traded LEAPs (Long term Equity Anticipation Securities). Furthermore, because options cannot be exercised prior to vesting, any need to estimate early exercise dates is eliminated.
5. In the vesting and vested periods, the IFL approach should lead to a greater degree of comparability in option valuation and expense allocation among companies.
6. It is an option-expense approach that is consistent with expensing restricted stock.

Detailed Illustration of the IFL Process for Expensing Employee Options

We demonstrate the specific application of the recommended approach by means of two hypothetical examples, one for vested options and the other for unvested options.

Example #1: Expensing of Vested Options.

Consider three employees of *XYZ Corporation*, "*A*", "*B*", and "*C*", each of whom has identical total compensation histories at *XYZ* and each of whom has worked at *XYZ* for at least the entire 2003. *XYZ* has an employee stock option plan, which grants 10-year at-the-money options that vest immediately upon grant. If the employee leaves the firm, whether voluntarily or as a result of having been terminated not for cause, the vested options must be exercised within 90 days. Thus, upon leaving the firm, the effective maturity of the vested option becomes 90 days. On December 31, 2003, the price of *XYZ* shares is $100. Suppose each of the employees is granted a 10-year option with an exercise price of $100, which vests immediately.

To determine the valuation and allocation of the option expenses, consider what happens if employee *A* resigns from the firm the next day, January 1, 2004. The expiration date of his option immediately becomes March 31, 2004. As is common for many listed companies, 90-day options on *XYZ* with the same $100 exercise price as the granted options are trading in the public market at $8.20 per option. Since employee *A* owns that option and will not perform any further work for the firm in the future, the fair-market value of that option, $8.20, must be a compensation expense for past effort. The option was granted and vested in 4th Q 2003 and thus we would allocate the entire $8.20 expense to that quarter. It is difficult to justify allocating any of the expense to an earlier quarter unless there was a specific allocation of the option prior to the 4th Q 2003, which, in effect, would have been a grant. Furthermore we want to avoid a process that causes periodic restatements of earlier quarter income. Since employees *B* and *C* had the same rights to leave the firm and retain the option value that *A* has, we charge the same amount, $8.20, as a 4th Q compensation expense for each of them as well.

Continuing with the example, consider what happens if on March 31, 2004, both employees *B* and *C* are at the firm and on April 1, 2004, employee *B* is terminated not for cause. As a result, the expiration date of *B*'s option immediately becomes June 30, 2004. Suppose the March 31, 2004 closing price on *XYZ* is $120 and the fair market value of *B*'s 90-day option with an exercise price of $100 is $22.54. How much of that option value did *B* earn as a consequence of being employed by *XYZ* during the 4th quarter? On December 31, 2003, employee *A* and employee *B* were in identical economic situations with respect to *XYZ*. Subsequently, employee *A* did not work at the firm and employee *B* did. Thus, since employee *B* will not perform any further work for *XYZ* in the future, the difference in the value of the option owned by employee *B* and the value of the option owned by employee *A* on March 31, 2004 must be the option-related compensation received by employee *B* for working in 1st Q 2004. March 31, 2004 is the expiration date of employee *A*'s option and so its value is its intrinsic value, ($120-$100 =) $20. Thus, the difference between the fair market value of employee *B*'s option and employee *A*'s option is $22.54 - $20.00 = $2.54 and that is the compensation expense for *B*'s option in the 1st Q 2004. In effect, by *B* working another quarter beyond *A*, he received a 90-day extension on the maturity of his option relative to *A*'s option. The value of that extension in this case is exactly the *time value of a 90-day option*, the difference between the fair-market value of a 90-day option and its intrinsic value. Since on March 31, 2004, employees *B* and *C* were in identical positions in terms of their relationship to *XYZ*, the compensation expense charged for *C*'s option in the 1st Q 2004 should be the same as for *B*'s or $2.54. Note that there is no further compensation expense charged for *A*'s option because he did not work at *XYZ* in 1st Q 2004.

We now derive the quarterly expenses for employee *C* if he continues to work for *XYZ* for another year. Suppose that on June 30, 2004, the stock price is $90 and the fair market value of a 90-day option on *XYZ* with a $100 exercise price is $3.72. Since *B*'s option expires on June 30, its fair market value is its intrinsic value, $0. Since the only difference between *B* and *C* is that *C* worked the 2nd Q 2004 and *B* didn't, the option-based compensation charge for *C* is the difference between the value of his option, $3.72, and *B*'s, which is worthless.

Suppose that on September 30, 2004, the price of *XYZ* stock is $140 and the fair market value of a 90-day option with an exercise price of $100 is $40.92, then the option-related compensation charge for *C* having worked for the 3rd quarter is the value of an extension of his option maturity date for another 90 days, $40.92-$40.00 = $0.92. Suppose that the stock price on December 31, 2004 is $160 and the fair market value of a 90-day option with an exercise price of $100 is $60.57, then *C*'s option-based compensation charge for working the 4th Q 2004 would be $60.57 - $60.00 = $0.57. Suppose that the stock price of *XYZ* on March 31, 2005 is $175 but *C* had exercised his option some time on or before March 31. An employee with the same option as *C* on December 31, 2004 but who left the firm on January 1, 2004 could have exercised at exactly the same time that *C* did during the 1st Quarter of 2005 and would have received the identical payout. Thus, *C* earned no option-based compensation as a consequence of his working for *XYZ* in the 1st Q 2005 and hence, there is no expense. And of course since his option no longer exists, there will be no expense for it in any later quarter. The entire time path of expensing is summarized in Table 1.

Observations on the effect of truncation of maturity drawn from this example:

The provision in standard option plans that calls for the maturity of a vested option to truncate to 90 days upon the employee leaving the firm has a very substantial effect on the magnitude of option expenses and on the allocation of

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those expenses to various accounting periods. To demonstrate how substantial this effect can be, consider the expensing that would occur in the same hypothetical situation, if the plan terms are changed so that vested options retain their full stated maturity (in this case 10 years from time of grant) even if the employee leaves the firm, voluntarily or as a result of having been terminated not for cause.[3] Under this condition, the options held by employees *A*, *B* and *C* would have had the identical value at all points in time, independently of continued employment beyond the vesting date. By analysis parallel to that leading to a charge of the value of the 90-day option on December 31, 2003, as an expense to 4th Q 2003, we would instead charge the value of a 10-year at-the-money option on that date to the 4th Q 2003. The fair-market value of such an option with the stock price at $100 might be around $50. So without the plan provision of the maturity truncation, there would have been a $150 charge to 4th Q 2003 earnings for the three employees' options and no further expense after that, whether or not the employees left *XYZ*.[4] In contrast, the total expense charged for these options with the truncation provision was: $34.89, allocated: $24.60 for 4th Q 2003; $5.08 for 1st Q 2004; $3.72 for 2nd Q 2004; $0.92 for 3rd Q 2004; $0.57 for 4th Q 2004 and no further expenses thereafter.

The large difference ($150 vs. $35) in the cumulative expense and its distribution across accounting periods caused by the maturity truncation provision is not simply a result of employees with vested options leaving the firm. If all three employees had instead remained at the firm and then exercised in March 2005, the cumulative expenses would have been only $47.85. Furthermore, provided that the stock remained deep in the money at each quarter end from March 2005 to December 2013, even if all three employees had stayed at the firm and did not exercise before the expiration date, still the total expenses charged on the options, $ 65.35, would be considerably less than $150. And that smaller total

[3] Even plans with maturity truncation for termination often contain an exception if termination is a consequence of retirement on or after a specified retirement age. In that case, the retiring employee's vested option retains its entire stated maturity. In the quarter when an employee qualifies for that exception, the expense for maturity extension should be the time value of an option with the remaining stated maturity, not 90 days.

[4] There is no further expense because the options held by the employees contain no greater obligations than if options were issued by the company to non-employee investors for capital infusion. Hence, for financial reporting, the subsequent value of the option including its intrinsic value at time of exercise or expiration is not a compensation expense in return for services to the firm but a capital account matter. It is for that same reason that we expense the intrinsic value, if any, only at the time of vesting and subsequently expense only the time value of the 90-day maturity extensions.

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expense would be distributed over 40 quarters from 4th Q 2003 through 3rd Q 2013 instead of concentrated in a single quarter, 4th Q 2003.[5]

As discussed in the circulated FASB Draft Proposal, the prospect of early exercise of a long-dated option can have a significant effect on its valuation and thus such considerations should be taken into account. However, as we see here for plans with a maturity truncation to 90 days after leaving the firm, no vested option expense valuation involves a maturity of greater than 90 days. Therefore, not taking into account early exercise possibilities will have a relatively small effect on that valuation.

Example #2: Expensing of Unvested Options.

Consider the same circumstances described in the preceding example but now *XYZ*'s option plan has a one-year (4 quarter) vesting period from time of grant. Thus, the at-the-money 10-year maturity options granted to employees *A*, *B*, and *C* on December 31, 2003 will vest on December 31, 2004, provided that the employee has not left the firm as of that date. If the employee leaves the firm for any reason prior to that date, the options are forfeited and the employee receives nothing. Because continued future employment during the vesting period (one year from grant in this example) is a condition for the employees to receive the options, it could be argued that no expense is incurred until the options vest. Under that approach, there would be no expense until the option date and then as described in the preceding example, the value on the vesting date of a 90-day option with a $100 exercise price would be charged as an expense to 4th Q 2004.

If however, as we believe, some of the employees' effort to remain at *XYZ* during the vesting period is attributable to the grant of the options, then there should be an accrual of some of the option expense to quarters Q4 2003, Q1 2004, Q2 2004, Q3 2004, as well as Q4 2004, when the option actually vests. The IFL-recommended accrual method is at the end of each quarter to take the fair-market value of an option that expires 90-days after the last quarter of the vesting period and allocate as an expense charge to each quarter the pro-rata value of that option for the number of quarters since grant less the cumulative amount of the option value already expensed in these earlier quarters. In our example, the

[5] Along the lines in the preceding footnote, there is no option expense for the quarter in which the option expires since the employee does not need to work that quarter to receive the full stated maturity remaining in the option.

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expiration date of the option used for valuation in each quarter of the vesting period will be 90 days after the vesting date, namely March 31, 2005.

Suppose that the fair-market value of a one-year-and-90-day option on *XYZ* with an exercise price of $100 on December 31, 2003 is $18.75. The value of the three options granted to employees *A*, *B*, and *C* is $56.25. Since there are 5 quarters among which the option expense is to be allocated in the vesting period, ($56.25/5 =) $11.25 is the total expense in Q4 2003.

On March 31, 2004, the stock price is $120 and the fair-market value of a one-year option on *XYZ* with exercise price $100 is $30.40. Because employee *A* left the company during the quarter his option was forfeited, its value is now $0, and the combined value of the two options granted to employees *B* and *C* is $60.80. Since two of the 5 quarters for expense allocation are completed, the charge for Q1 2004 is ($60.80 x 2/5 – previous cumulative expense =) $24.32 – $11.25 = $13.07. On June 30, 2004, the stock price is $90 and the fair-market value of a 9-month option on *XYZ* with an exercise price of $100 is $9.14. Because employee *B* was terminated during the quarter his option was forfeited, its value is now $0, and there is only employee *C*'s option remaining. Since three of the 5 quarters for expense allocation are completed, the charge for Q2 2004 is ($9.14 x 3/5 – previous cumulative expense =) $5.48 - $24.32 = ($18.84) which is a *credit* to earnings of $18.84.

On September 30, 2004, suppose that the stock price is $140 and the fair-market value of a 6-month option on *XYZ* with an exercise price of $100 is $42.75. Since four of the 5 quarters for expense allocation are completed, the charge for Q3 2004 is ($42.75 x 4/5 –previous cumulative expense =) $34.20 - $5.48 = $28.72. On December 31, 2004, Employee *C*'s option becomes vested. The stock price is $160 and the fair-market value of a 90-day option on *XYZ* with exercise price $100 is $60.57. Since five of the 5 quarters for expense allocation are completed, the charge for Q4 2004 is ($60.57 – previous cumulative expenses =) $60.57 - $34.20 = $26.37.

Note that as a design feature of the IFL approach, the total cumulative option expense during the entire vesting period is equal to the fair-market value of vested options at the end of the quarter in which they vested, $60.57. Thus, the cumulative expense as of the time of vesting is the same as it would have been if

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there had been no expensing of the options until they vest. However, the recommended accrual method of expenses permits an allocation of the expenses across the quarters in which some of the option-based compensation expense actually occurred, using best available estimates of fair-market value at the time of each accrual. It also ensures that the cumulative expenses are the actual expenses incurred as of the vesting date without a need to restate earlier periods' earnings or expenses.[6] The entire time path of expensing through the vesting period is summarized in Table 2.

Observations on the effect of introducing a vesting period drawn from this example:

It is self-evident that the value of a vested option is greater than the value of an otherwise identical but unvested option at a given point in time. Thus, it may seem inconsistent that the cumulative expense of $60.57 for the unvested options in Example #2 exceeds the cumulative expense of $34.89 for the vested options in Example #1. However, this outcome is primarily the result of the particular time path followed by the stock during the vesting period, which ends up deeply in the money on the vesting date. For example, with the same employee termination pattern, had the stock of *XYZ* instead remained unchanged at $100 throughout the year from December 31, 2003, until December 31, 2004, the cumulative expense of the granted options for the immediate vested case of Example #1 would have been $65.60 and the cumulative expense of the granted options for the unvested case of Example #2 would have been only $8.20.[7] Thus, the after-the-fact differences in expenses between vested and unvested options depend on the time path followed by the stock during the vesting period and can be either larger or smaller.

[6] Robert Kaplan and Krishna Palepu present an accrual method for expensing options during the vesting period in "Expensing Stock Options: A Fair-Value Approach", *Harvard Business Review*, December 2003. While their method and the one presented here are different, they share a similar accounting philosophy. The IFL approach will typically produce a "smoother" time path of expenses than the Kaplan-Palepu procedure, although it is not proposed for that reason.

[7] This specific time pattern of stock price remaining at the money at the end of each expense period maximizes the expenses of the vested options because it maximizes the time value of the options at each expense date.

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Table 1 - Example: Stock Expense during Vested Period

Option Description:	10 year maturity $100 strike price vests immediately maturity truncated to 90 days if terminated initial stock price $100

Timeline	Employee A	Employee B	Employee C	Company
December 31, 2003	granted option	granted option	granted option	expenses three 90 day options stock price $100 90 day option value = $8.20 expense = $8.20 x 3 options = $24.60
January 1, 2004	resigns now owns an option expiring March 31, 2004			
March 31, 2004	option expiring option value $20	employed	employed	expenses the extension of two options for 90 days stock price $120 90 day option value = $22.54 time value of 90 day option = $2.54 expense = $2.54 x 2 options = $5.08
April 1, 2004		terminated without cause now owns an option expiring June 30, 2004		
June 30, 2004		option expiring option value $0	employed	expenses the extension of one option for 90 days stock price $90 90 day option value = $3.72 time value of 90 day option = $3.72 expense = $3.72 x 1 option = $3.72
September 30, 2004			employed	expenses the extension of one option for 90 days stock price $140 option value = $40.92 time value of 90 day option = $0.92 expense = $0.92 x 1 option = $0.92
December 31, 2004			employed	expenses the extension of one option for 90 days stock price $160 option value = $60.57 time value of 90 day option = $0.57 expense = $0.57 x 1 option = $0.57
First Quarter 2005			option exercised	
March 31, 2005				no expense
				Total expense = $34.89

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Table 2 - Example: Stock Expense during Vesting Period

Option Description:	10 year maturity $100 strike price 1 year vesting period option surrendered if terminated prior to vesting initial stock price $100

Timeline	Employee A	Employee B	Employee C	Company
December 31, 2003	granted option	granted option	granted option	expenses the accrued value of three options, maturing on March 31, 2005, spread over 5 quarters stock price $100 option value (maturity of March 31, 2005) = $18.75 expense = $18.75 / 5 x 3 options = $11.25
First Quarter 2004	resigns			
March 31, 2004		employed	employed	expenses the accrued value of two options maturing on March 31, 2005 stock price $120 option value (maturity of March 31, 2005) = $30.40 expense = $30.40 / 5 x 2 quarters x 2 options = $24.32, less $11.25 previously expensed = $13.07
Second Quarter 2004		terminated without cause		
June 30, 2004			employed	expenses the accrued value of one option maturing on March 31, 2005 stock price $90 option value (maturity of March 31, 2005) = $9.14 expense = $9.14 / 5 x 3 quarters = $5.48, less $24.32 previously expensed = -$18.84 (credit)
September 30, 2004			employed	expenses the accrued value of one option maturing on March 31, 2005 stock price $140 option value (maturity of March 31, 2005) = $42.75 expense = $42.75 / 5 x 4 quarters = $34.20, less $5.48 previously expensed = $28.72
December 31, 2004			employed	expenses the accrued value of one option maturing on March 31, 2005 stock price $160 option value (maturity of March 31, 2005) = $60.57 expense = $60.57 / 5 x 5 quarters = $60.57, less $34.20 previously expensed = $26.37
				Total expense = $60.57

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Robert C. Merton is currently the John and Natty McArthur University Professor at the Harvard Business School. Prior to joining the faculty of Harvard in 1988, he served on the finance faculty of MIT's Sloan School of Management for eighteen years. He is a co-founder and Chief Science Officer of Integrated Finance Limited, a specialized investment bank. He is a past President of the American Finance Association and a member of the National Academy of Sciences. In 1997 Professor Merton received the Alfred Nobel Memorial Prize in Economic Sciences for a new method to determine the value of derivatives.

Professor Merton has also been recognized for his achievements in translating finance science into practice. In 1993, he received the inaugural Financial Engineer of the Year Award from the International Association of Financial Engineers. *Derivatives Strategy* magazine named him to its Derivatives Hall of Fame in 1998. In 2002, *Risk* magazine named him to its *Risk* Hall of Fame and in 2003, presented him with its Lifetime Achievement Award for contributions to the field of risk management. A Distinguished Fellow of the Institute for Quantitative Research in Finance ('Q Group'), Mr. Merton received the Nicholas Molodovsky Award from the Association of Investment Management and Research in 2003.

Professor Merton obtained a B.S. in Engineering Mathematics from Columbia University in 1966, a M.S. in Applied Mathematics from California Institute of Technology in 1967 and a Ph.D. in Economics from Massachusetts Institute of Technology in 1970. He holds honorary degrees from University of Chicago and five foreign universities.

Further information including publications can be found at www.people.hbs.edu/rmerton/

Statement of Reginald Reed
Manager, Software Development
Cisco Systems, Inc.

before the

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

of the

House Committee on Financial Services

Wednesday, March 3, 2004, 10:00 am

Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for the opportunity to testify this morning in support of broad-based stock option programs and H.R. 3574, the Stock Option Accounting Reform Act.

My name is Reginald Reed. I am a Manager in the Software Development area for Cisco Systems, Inc. I work for Cisco in the Research Triangle Park, near Raleigh, North Carolina. I have been with Cisco for 7 years.

By way of background, Cisco Systems is the worldwide leader in networking for the Internet. Today, networks are an essential part of business, education, government and home communications.

I am here today to tell you that Cisco Systems and other members of the Employee Stock Options Coalition strongly support H.R. 3574. We need the House and Senate to pass this legislation soon, because the future of broad-based employee stock option plans is in jeopardy.

We are most appreciative, Chairman Baker, for your incredible leadership on this important issue. Thank you for standing up to preserve broad-based employee stock options for the over 10 million U.S. employees who have received them.

When I first considered joining Cisco, I knew that I wanted to work for a company that granted stock options to all, not just some, of its employees. Over the past seven years, I have discovered that although I understood the importance of employee stock options, I had underestimated their power to motivate.

Everyday I see the difference that employee stock options make in the workplace. In my opinion, there is no better way to motivate talented employees. Because of Cisco's broad-based employee option plan, our customers and shareholders benefit. When something is positive for employees, customers and shareholders, it is a very powerful tool.

At Cisco, employees are tied to the company's bottom line in large part because of the stock option grants we receive that make us all owners. Employee stock options allow us to better understand how hard work and innovation play a central role in the company's overall success.

The sense of ownership created by stock options at Cisco and other companies is part of the driving force behind the advances in information technology that take place throughout the industry. Cisco's stock option program has helped turn our Research Triangle Park operation into a major engineering hub on the East Coast.

At Cisco, I see the benefits of employee stock options everywhere I look. I have 5 engineers who report directly to me. I see first-hand how stock options make them think and act like owners. I see the extra mile they go, the extra energy they provide, and the extra innovation they seek. I also know how stock options incentivize me. And as I look at my managers, I see the same dynamic.

Our CEO, John Chambers, has put it very well. He has said that the difference between workers who receive employee stock options and those that don't is a lot like the difference between owning a home and renting one. The mindsets are totally different. When you own a home, it is a reflection of you – from the basement to the attic, you want everything to be perfect. When you rent, you just want to make sure that you get the security deposit back.

The 35,000 employees who make up Cisco Systems are owners. We want to make the most innovative products. We want to develop the newest technologies. Employee stock options are an essential part of that commitment that binds all of us together. Employee stock options are an integral part of the formula for customer and shareholder value.

If stock options are expensed, many companies will be forced to cut back on programs that benefit rank-and-file employees and instead, only give them to top executives. If this happens, we will lose much of our ability to attract, retain, and motivate dedicated employees. The call for expensing of employee stock options, as I read it, came about because people were concerned about bad executive behavior. The irony is that these misdirected reforms to expense all stock options will largely impact rank and file employees like me. This is why, Chairman Baker, your legislation addresses those initial concerns so well while also preserving broad-based employee stock option programs.

A little over a year ago, my wife Julie, a test engineer and employee at Cisco, and I welcomed our first child into our family. The stock options I exercised five years ago went towards a down payment for a house our child calls home. In the future, my goals for my stock options are for a more secure retirement and good education for my daughter. While we make regular contributions to our 401(k) plan, Cisco's stock option program will hopefully provide the extra help we need to make an active and happy retirement an attainable goal. Although many of my stock option grants are currently "under water" – meaning the price at which they were issued is more than the stock price is now – I know that my co-workers and I will ensure that Cisco's future is bright for all of our shareholders and have no doubt that the company will be one of those leading our economic recovery.

I'm not an accountant. I'm not an expert in financial statements or footnotes or the securities laws. But I do know the benefit of stock option plans that are broad-based. And like the millions of other workers in this country who receive employee stock options, I am worried that unelected, accounting regulators are going to make a decision that effectively eliminates broad-based employee stock option plans and negatively affects our economy and our country.

We need your help. We need our elected officials in the United States Congress to step in and preserve broad-based stock option plans. That's why on behalf of the employees of Cisco I ask you to pass H.R. 3574.

Thank you very much for inviting me here today and taking the time to listen to my testimony. I will be pleased to answer any questions that you might have.

STATEMENT FOR THE RECORD OF DANIEL K. WEISS, CPA, JD
CHIEF FINANCIAL OFFICER
HIGHWAY PATROL RETIREMENT SYSTEM
ON BEHALF OF THE STATE OF OHIO PUBLIC EMPLOYEE PENSION FUNDS
Before the
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
March 3, 2004

On behalf of the five Ohio public retirement systems and the Ohio Public Employees Deferred Compensation Program, thank you for the opportunity to comment on H.R. 3574.

The six organizations that I represent have one-and-a-quarter million members and beneficiaries, and combined invested assets of 135 billion dollars.

Ohio's public pension fund managers strongly support the independent authority of FASB in setting accounting standards, which would be severely undermined by H.R. 3574. This legislation would be a significant setback in the new era of honest accounting that has been ushered in by the Sarbanes-Oxley Act.

FASB, with its expertise and public discourse on proposed standards, is uniquely positioned to set accounting rules. We must allow FASB to do its job.

Investors deserve full and accurate financial information. The investment community has learned -- the hard way -- that we need greater transparency, not less transparency. We need greater discipline in accounting rules, not less discipline.

Let us continue the trend of protecting shareholders who invest in the financial markets.

Please protect the investments on which our members depend for a secure retirement by opposing H.R. 3574.

STATEMENT FOR THE RECORD OF RICHARD L. TRUMKA
SECRETARY-TREASURER
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
Before the
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
Wednesday, March 3, 2004

On behalf of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and our affiliated unions' 13 millions members, I appreciate the opportunity to comment on H.R. 3574, "The Stock Option Accounting Reform Act," which would block the Financial Accounting Standards Board (FASB) from issuing a new standard requiring mandatory expensing of stock options until completion of an "economic impact" study.

Our interest in stock option expensing stems from the fact that our members are also investors. Union members participate in benefit plans with over $5 trillion in assets. Pension plans sponsored by unions affiliated with the AFL-CIO hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors.

In coming weeks, FASB is expected to issue a proposed standard on equity-based compensation that would require companies to charge stock option costs against earnings beginning in 2005. The AFL-CIO strongly supports FASB in its efforts to close an accounting loophole that has allowed corporations to understate the true cost of compensation to senior executives and other management employees.

In an attempt to position H.R. 3574 as a compromise bill, its authors would require companies to expense options granted to their top five executives. However, H.R. 3574 would also require companies using an option pricing model like Black-Scholes to assume that the underlying stock price has zero volatility. This "minimum value" approach results in unrealistically low cost estimates because much of the value of stock options derives from the volatility of stock prices. The minimum value approach is rarely used except where historical volatility data is unavailable -- for options on untraded stocks, for example -- and its adoption here suggests that the objective of H.R. 3574 is to keep CEOs knee-deep in stock options without having to report the real cost to shareholders.

Moreover, as Mark Rubinstein demonstrates in the *Journal of Derivatives*, the minimum value approach can easily be manipulated to drive the reported value to zero or near zero ("On the Accounting Valuation of Employee Stock Options," Fall 1995). This is done by raising the exercise price and multiplying the number of options in order to maintain the real value of the grant while lowering its reported "minimum value."

However, even if the cost of option grants to senior executives were calculated using a fair value approach, we reject any compromise that results in some options being counted as an expense and others not. We agree with FASB Chairman Robert Herz, who last year testified before the Senate that "financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermines the credibility and value of that information and the proper functioning of the capital markets by impairing investors' capital allocation decisions."[1]

What we oppose is giving one particular form of compensation – in this case, stock options – preferential accounting treatment over other more important employee benefits such as wages, pensions or health care. If the corporate opponents of stock option expensing truly want to help America's working families, they should instead focus their efforts on encouraging the expansion of retirement plans and health care coverage.

Despite attempts to portray stock options as a broad-based benefit, few ordinary workers receive stock options. At the height of the stock market boom in 1999, only 0.7 percent of private sector workers earning less than $35,000 received stock options, compared with 12.9 percent of workers earning $75,000 and above.[2] Even in Silicon Valley, where options are sometimes granted to a cross-section of employees, households with stock options have a median income of $122,000.[3]

Stock options have widened the pay gap between executives and ordinary workers. In 1980, prior to the widespread use of stock options in executive compensation, CEO pay stood at approximately 42 times the average worker. Two decades later, CEO pay reached 531 times the average worker's pay. The majority of this increase was due to stock options, which have become the biggest component of today's CEO pay packages.

We do not believe that mandatory expensing "threatens small businesses and imperils the fragile economic recovery," as the American Enterprise Institute's James K. Glassman claimed in his Senate testimony last year. Compared to large corporations, few small businesses grant their employees stock options. Bureau of Labor Statics data shows that only 2.1 percent of companies with 100 employees or less granted stock options, compared with 10.1 percent of companies with over 100 employees. We believe this data shows that stock option expensing will have little if any impact on America's small business, and that H.R. 3574's small business exemption is simply a public relations ploy.

Mandatory expensing enjoys almost unanimous support among institutional investors and governance advocates, including the Conference Board Commission on

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[1] Statement of Robert H. Herz, Chairman, Financial Accounting Standards Board, for the Roundtable on "Preserving Partnership Capitalism Through Stock Options for America's Workforce," United States Senate, May 8, 2003.

[2] Bureau of Labor Statistics, "Pilot Survey on the Incidence of Stock Options in Private Industry in 1999," press release October 11, 2000.

[3] 2002 Gallup Poll of Media Use and Consumer Behavior for the San Francisco market, cited in Mark Schwanhausser and Jeanne Cardenas, "Stock Options Slow After Dot-Com Bust," *San Jose Mercury News*, December 13, 2002.

Public Trust and Private Enterprise, the Council of Institutional Investors, Institutional Shareholder Services, and the Teachers Insurance and Annuity Association - College Retirement Equities Fund. Warren Buffett, Securities and Exchange Commission Chairman William H. Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul Volcker, and Nobel Prize-winning economists Robert C. Merton and Joseph E. Stiglitz are also in favor of mandatory expensing.

The support of institutional investors and other disinterested observers belies the concerns of Intel Chairman Andrew Grove, who claimed in a letter to shareholders that mandatory expensing "could cause real economic harm to Intel, our stockholders, and our economy." Speaking on behalf of union pension funds and other Intel investors, Grove's regard for our well-being seems misplaced.

Investors have demonstrated their support by voting in favor of expensing at annual meetings of shareholders. Last year, worker fund proposals on expensing options won majority votes at 30 companies, and many companies where our funds filed proposals have joined the growing ranks of major corporations such as Microsoft that have voluntarily begun expensing stock options. According to Bear Stearns, 483 companies have announced their intention to voluntarily expense stock options, including 113 members of the S&P 500, representing 41 percent of the index's market capitalization.

In our view, the stock option accounting loophole not only has caused a misallocation of capital in favor of companies that understate their compensation costs, but also has resulted in the over-reliance on stock options at the expense of other forms of executive compensation that better align management interests with the interests of shareholders. Many companies, for example, have told us that they are reluctant to use performance-based stock options that are indexed to their competitors because indexed stock options must be expensed under the current accounting rules.

Unlike actual share ownership, stock option grants to executives create perverse incentives that are not in the best interests of long-term shareholders:

- stock options can encourage executives to take excessive business risks by promising executives all the benefit of share price increases with none of the risk of share price declines;

- stock options can reward short-term decision-making because many executive stock options can be exercised just one year after the grant date;

- executives can profit from share price volatility (a measure of shareholder risk) by timing when they exercise their stock options;

- because option holders are not entitled to dividends, dividend yields have fallen to historic lows, and many companies have instead used this cash for stock buybacks to prevent dilution from executives' stock option exercises; and

- stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

The goal of accounting is to facilitate comparisons between companies -- a goal not being met under the current system when some companies expense options and others do not. If stock options are not expensed, a company that pays its employees in stock options has lower compensation costs and therefore artificially higher earnings. As former Enron CEO Jeffrey Skilling explained in his Congressional testimony, "you issue stock options to reduce compensation expense and, therefore, increase your profitability."

This is not the first time FASB has attempted to require appropriate expensing of stock options. In the mid-1990's, just as the great orgy of executive option grants was beginning, FASB attempted to require option expensing, and was pressured by Congress into abandoning the position it had adopted on the merits. We believe that this thwarting of FASB's role as an independent body was a key initiator of the chain of events that led to the corporate scandals of the last several years.

FASB's decision to require stock option expensing in 2005 will strengthen investor confidence in the financial statements of large and small businesses, thus lowering their cost of capital. The efficient allocation of capital to the most economically valuable business activities depends on consistent accounting rules. For this reason, we believe all businesses should expense stock options, so that stock options do not artificially boost any company's profit reports. Congress should let FASB do its job.

We appreciate the opportunity to present our views on this important matter.

COUNCIL OF
INSTITUTIONAL
INVESTORS

Suite 512 • 1730 Rhode Island Avenue, N.W. • Washington, D.C. 20036 • (202) 822-0800 • Fax (202) 822-0801

March 2, 2004

The Honorable Richard H. Baker
United States House of Representatives
341 Cannon House Office Building
Washington, DC 20515-1806

The Honorable Paul E. Kanjorski
United States House of Representatives
2353 Rayburn House Office Building
Washington, DC 20515-3811

Re: March 3, 2004, Hearing on H.R. 3574, Stock Option Accounting Reform Act

Sirs:

The Council of Institutional Investors, an association of more than 140 corporate, public and union pension funds collectively responsible for more than $3 trillion in pension assets, is writing to oppose H.R. 3574 and to urge Congress to cease its efforts to impede the Financial Accounting Standards Board from doing its job of independently setting U.S. accounting standards. The Council respectfully requests that this letter be made an official part of the record for this hearing.

Members of the Council have a significant financial stake in the U.S. capital markets, investing on average more than 75 percent of their portfolios in domestic stocks and bonds.

Audited financial statements are one of the primary sources of information available to guide and monitor their investment decisions. As a result, the integrity of these statements is critical to Council members and their millions of pension system participants and beneficiaries.

Financial reporting standards should be shaped solely by what provides the most relevant, comprehensive information about a company's financial performance and condition—not by what results in the most attractive reported numbers. This is why Council members approved the following policy calling on companies to expense all stock options:

March 2, 2004
Page 2 of 2

> *Since stock options granted to employees, directors and non-employees are compensation and have a cost, companies should include these costs as an expense on their reported income statements with appropriate valuation assumptions disclosed.*

Requiring companies to expense only options granted to the CEO and the next four highest compensated executives, as proposed in H.R. 3574, is insufficient and poor accounting. Such a bill reflects an interest to inappropriately protect corporations at the expense of the millions of U.S. citizens investing their hard-earned dollars in the U.S. capital markets.

But this is a decision that should not be made in Congress in the first place. Determining what should be accounted for and how is the job of the FASB, which is an independent body charged with setting accounting standards. The FASB has the expertise to consider accounting issues. It also has an open and fair process for getting public input on proposed accounting standards.

Congressional interference on stock option expensing, or any other accounting issue, is always inappropriate. The Council finds the current legislative efforts to impair the FASB's independence particularly disappointing during a time when investors have collectively suffered tremendous losses in the U.S. capital markets, due in part to corporate scandals resulting from overly-aggressive or fraudulent accounting practices. Any efforts to stonewall the FASB will ultimately hurt millions of U.S. investors.

Please contact me with any questions.

Sincerely,

Ann Yerger

Ann Yerger
Deputy Director

cc: The Honorable Michael G. Oxley, Chairman, Committee on Financial Services
The Honorable Barney Frank, Committee on Financial Services

STATEMENT FOR THE RECORD OF JAMES P. HOFFA
GENERAL PRESIDENT
INTERNATIONAL BROTHERHOOD OF TEAMSTERS
Before the
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
Wednesday, March 3, 2004

On behalf of the International Brotherhood of Teamsters, I appreciate this opportunity to comment on H.R. 3574, "The Stock Option Accounting Reform Act". I would like to register the Teamster's opposition to the Bill and request that this testimony be made part of the official record of this hearing.

The International Brotherhood of Teamsters (IBT) represents 1.4 million active members and over 600,000 retirees. Our Union, through its individual pension and health and welfare benefit trusts, has assets over $100 billion. Therefore, our Union's support for regulatory and statutory changes as they relate to the rights and benefits of equity owners of listed corporations should carry a particular significance with lawmakers.

As you are well aware there have been several Bills introduced, in addition to the one being discussed at the March 3rd hearing, to stop or curtail the Financial Accounting and Standards Board's (FASB) project that will require the expensing of the fair value of stock options granted to employees. FASB is expected to come out with a final rule on the accounting of stock options sometime in mid-March. This final rule will be the result of an exhaustive process in which FASB has consulted with corporations, users of financial statements and experts in the field of accounting to determine the best method to account for employee stock options in corporate balance sheets. These bills being considered by Congress would, if enacted, impair FASB's independence by overriding FASB's independent and objective decisions about how and when to improve the accounting for employee stock options.

This is not the first time FASB has attempted to require appropriate expensing of stock options. In the mid-1990's FASB attempted to require option expensing, but was pressured by Congress to abandon its position.

This thwarting of FASB's role as an independent body did nothing to protect shareholders from the corporate collapses that have plagued investors over the past several years. This time, we hope that Congress will respect FASB's independence and not interfere with a process that we believe will result in providing shareholders with more transparent financial statements.

We appreciate the opportunity to present our views on this important matter. Please contact the IBT's Office of Corporate Affairs at (202) 624-8100 should you have any questions about our position on this important issue of corporate governance reform.

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