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# IMPACT OF STOCK OPTION EXPENSING ON SMALL BUSINESSES

## HEARING

BEFORE THE

## COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

## UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 28, 2004

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COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

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## Testimony



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COMMENTS FOR THE RECORD

# IMPACT OF STOCK OPTION EXPENSING ON SMALL BUSINESSES

**WEDNESDAY, APRIL 28, 2004**

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
*Washington, DC.*

The committee met, pursuant to notice, at 10:04 a.m., in room 428A, Russell Senate Office Building, Hon. Michael Enzi presiding.

Present: Senators Enzi, Fitzgerald, Allen, Ensign, Levin, Bayh, and Pryor.

## OPENING STATEMENT OF THE HONORABLE MICHAEL ENZI, A UNITED STATES SENATOR FROM WYOMING

Senator ENZI. I will go ahead and call this hearing to order. I want to welcome all of the panelists from our two distinguished panels and express appreciation for all of you taking the time to provide us with the information. This is the Small Business Committee, and the approach is on small business. I have to admit that early on in this process I made the mistake of calling in some people that had experience with what I was talking about, had resources to be able to talk about it, and some of those were big businesses and it confused the message. So I am very pleased that we are able to do a small business hearing to emphasize some of the small business aspects and to make sure that there is some kind of a positive delineation between the requirements that we have for mature businesses and growing businesses, particularly small businesses. Small businesses do make up a significant part of all business. There are 23 million small businesses, which is 99.7 percent of all employers. That is one-half of the private sector employers and 60 percent of the net new jobs, 50 percent of the non-farm private GDP and 13 times more patents per firm than the big patenting firms.

Now, I do want to congratulate FASB for work that they have done and for their importance to the international economy. I have been a very strong defender of their independence and am still a strong defender of their independence. It is extremely important that they be an independent board.

I am recognizing kind of a failure to communicate, and it is a failure on my part because I have not been able to get across this small business aspect, the start-up that has been so important in the United States and so important that China is now outdoing new start-ups about 40-to-1 over us. It is because they have a business plan that calls for stock options for small businesses, for start-ups.

Again, small business does not have the opportunity that big business does to represent themselves in a lot of these things. I mentioned a hearing—my first year, this Small Business Committee allowed me to hold a hearing in Casper, Wyoming, on some of the difficulties small businesses were having with the Federal Government. When it was over, one of the news media came up to me and said, "You didn't have a very good turnout today. Only about 100 businesses showed up." Well, Casper is not all that big compared to here, and my comment was, "Any small business that has the extra resources and people to be able to come and testify would fire that person because they can't afford him."

I was pleased that Chairman Herz announced in the November hearing that he was going to have a Small Business Advisory Committee, and I had emphasized it in my opening comments. So, I was particularly pleased that he had paid attention to that.

Now, I had envisioned it to be like NASD's Advisory Committee, and NASD's Advisory Committee meets 4 times a year and they kind of pick what things they want to review on behalf of business. It is my impression that the advisory committee that has been selected at this point for FASB is going to meet twice a year, and they are only going to talk about the topics that FASB wants them to address. I hope there can be some more flexibility in there.

I have also been a little disturbed at some of the letters coming from Members of that Small Business Advisory Committee lobbying on behalf of FASB. I am very worried about the lobbying aspect of this whole thing. Answering questions is extremely important. Educating us is extremely important, but out-and-out lobbying is something that seems kind of out of place in all of this.

I do appreciate the opportunities that I have had to meet with the Chairman and members of FASB. When I see that there is a conference call with institutional investors and they are being encouraged by the Chairman to contact Congress—now, institutional investors are people that, you know, even delve in the realm of hedge funds. It is not small business, and they are being asked to tell us that it is all okay.

Now, in some testimony last week, it was mentioned that the rule is only eight pages long. Well, if you count the appendices, it is 229 pages, and it is very disturbing to me that there are only two mentions in that whole thing about small business.

Now, small business has an investment in stock options. There are 1.4 million businesses. They represent 15.4 million jobs, and they are concerned about what is happening with their stock options.

Another thing that disturbed me about the rule, without any advance warning, suddenly employee stock purchase plans showed up in that. Now, when we are talking about small business in Wyoming, that means that the mom-and-pop business trying to sell their business to their employees, trying to give their employees an opportunity to take it over so there is continuity in the business, are now going to pay attention to FASB and have some complicated rules that they have to follow. I know in last week's testimony that there was mention that the FASB standards for small business are a private choice.

Well, unless it says so somewhere, unless there is a very definite statement, every bank, every supplier, anybody that deals with the business is going to have to make sure that they are following the standard that FASB put out. Somehow we have to make a distinction on that, and until we make a distinction, there isn't any business that really has a choice.

So I think we are kind of passing the buck and shirking the responsibility for small business. It is kind of a mad hatter's game of hide-and-seek for small business where they try to find things out.

I know that a lot of the controversy around this hinges around executive compensation. I know that Congress is very jealous of a lot of people that make a lot of money. We have shown it in actual bills that we have passed limiting the cash compensation that executives can make.

It doesn't matter what we do. There are ways around what we do. Sometimes as we try to put those things into place, we kind of foul things up for everybody.

A recent article in *The Washington Post* found that with or without stock options, executives are going to get their pay. So this proposal wouldn't do anything to curb executive compensation, but it will curb the ability of ordinary workers to receive stock options, and it will curb small business' ability to hire workers and to create new jobs.

One of the ways that a start-up business gets really good technical people is to offer stock options so that they can grow with the business. These small businesses don't have any other way to really provide that incentive for them to come in. They don't have enough cash to pay them cash up front, so it will have a drastic effect on small businesses. This hearing is intended to hear what small business has to say, and that will be the second panel.

I would like to welcome our witnesses today and thank them in advance for their testimony. I will mention that I have condensed my opening comments considerably and hope that people will kind of stick to a format of about 5 minutes on their statements so that we will have time for questions. There are a lot of things we need to go over in this.

On our first panel today, we have two members of FASB: the Honorable Chairman Robert Herz and George Batavick who is chairing the Small Business Advisory Committee. In addition, we have the Honorable Douglas Holtz-Eakin, the Director of the Congressional Budget Office. I appreciate all of you appearing today.

Senator Levin, any opening comments?

## OPENING STATEMENT OF THE HONORABLE CARL LEVIN, A UNITED STATES SENATOR FROM MICHIGAN

Senator LEVIN. Thank you very much, Mr. Chairman.

This is a very important hearing, and we look forward to hearing from our panelists as to the purpose of the FASB rule, what the origin of the rule is, and as to whether or not it has a particular effect on small businesses as distinguished from other companies, and if so, what that effect is.

We adopted a reform following the Enron disaster called Sarbanes-Oxley, and one of the things we did in Sarbanes-Oxley was to give FASB greater independence by giving it a source of revenue which would be protected. We saw that FASB was put under huge, huge political and lobbying pressure about 10 years ago when they decided to require that options be expensed like all other forms of compensation. FASB had to back off at that time despite their beliefs. It is supposed to be an independent accounting board which adopts accounting standards free from political pressure, and this time around it did what it believed was the right thing to do, which is to treat stock options as compensation like all other forms of compensation.

Stock options are the only form of compensation which, up until now, do not need to be expensed. If you give somebody stock, conditional or otherwise, if you give somebody a bonus, conditional or otherwise, based on performance, that must be expensed at one point or another. It is compensation. It has got to show up on the books.

There has been this treatment of stock options which is unlike any other incentive pay or any other pay or compensation of any kind, which for reasons we saw very clearly in the early 1990s, are excluded from the usual rule, which is that compensation is going to show up on the books. Companies get a tax deduction for compensation. They get a tax deduction when the stock options are exercised. In fact, it is now typical that employees get tax deductions up front when the stock options are granted. That is even now allowed, and many employees of small businesses take tax deductions immediately.

So in terms of the argument you can't value stock options, they are valued all the time. They are valued in footnotes which are shown, and employees who take tax deductions now, when given the stock option are allowed in many instances to take tax deductions now. Yet, it doesn't show up on the company's books as an expense.

That double standard fueled the Enron disaster. What happened in Enron and many other companies is that the executives enriched themselves by taking huge amounts of stock options, made the company look a lot better than it was through phony accounting, made the books look great, showed a big profit for the company, had the stock value go up, exercised their options, enriched themselves, and left their companies bankrupt.

The question always haunted me: How could they do that? How can they make the books show a profit and not pay income tax on that profit? How do they survive as an executive by showing a profit on their books but not having to pay Uncle Sam the income tax on that profit? The answer was stock options, because those same stock options which enrich them, in Enron and too many other companies, at the expense of stockholders and employees, those same stock options are a tax deduction. So Enron could deduct the value of those stock options on its income tax, but not show the value of those stock options as an expense on its books. So it had these large profits shown, which were phony profits, but did not have to honestly show the stock option value as an expense on its books. That was a major part of the Enron disaster for us.

Putting all that aside, we have an independent accounting board now, which has made a decision that it is going to require that stock options be expensed. Our Chairman points out that stock options are an extremely valuable tool. They are. So are bonuses a valuable tool for performance. So are grants of stock based on performance, but they all have to be expensed.

Our Chairman points out that stock options are being used in China, and that is great. The issue here isn't whether or not stock options are used. The question here is the accounting for stock options. What will the accounting rule be for stock options? That is the issue, not whether stock options are granted; not anymore than it is whether or not bonuses are granted for performance or whether or not stock itself is given for performance.

Again, when bonuses and stock are given based on performance, they are shown as an expense on the books. That is what the accounting rule is. Stock options are the only form of compensation which is not treated like other forms of compensation, and that is what FASB is proposing to change.

One final comment on China. I understand—and I would like our witnesses to comment on this—that in focusing on stock options, China is also adopting the International Accounting Standard Board rule, which is going to go into effect next year, which requires that stock options be expensed. If we are correct, in China, which is going to make greater use of stock options, they are going to adopt the same accounting principle for those stock options in China as FASB is proposing here domestically.

Finally, a very small percentage of our small businesses use stock options, as far as we can tell. I hope our witnesses will comment on that. The best figure that we can get is that about 3 percent of small businesses, according to one study, use stock option grants. So regardless if or not we have the same accounting rule or a different accounting rule for stock options relative to small businesses under the current rule, which does not require expensing, those stock options do not need to be expensed at all, since only 3 percent of our small businesses apparently use the stock options. Of course, no business, unless it is incorporated, unless it is public, has to adopt the Generally Accepted Accounting Principles, (GAAP). So I think—and I would like statistics on this from our witnesses—the vast majority of small businesses do not follow the GAAP rules because they are not public companies. I would like to hear some testimony on that as well.

Thank you very much, Mr. Chairman, for bringing us together. It is a very important subject, and I look forward, at least as long as I can stay here, to hearing from our witnesses.

Senator ENZI. Senator Allen.

## OPENING STATEMENT OF THE HONORABLE GEORGE ALLEN, A UNITED STATES SENATOR FROM VIRGINIA

Senator ALLEN. Thank you, Mr. Chairman, for having this hearing, and thank you for your expert leadership on this very important issue, which I think affects our economy, our jobs, and the opportunities particularly for small businesses, start-ups, and those that may be small businesses and not publicly traded, but ultimately might be.

I vow to stay here through much of this hearing. We have a battle on the floor possibly on trying to stop taxing of the Internet, so I may have to leave if we get back to that.

Let me make a few observations here on why I think the way that you are bringing the Small Business and Entrepreneurship Committee into focus here on the impact, particularly on smaller businesses, is so right and so appropriate.

First, let me just give everyone here my view. I think incentives are a great idea. I think it is a great idea if employees own part of the company or have the potential of owning more of the company. It has been suggested—and I think it makes a great deal of sense intuitively—that if an employee cares more about just a paycheck every two weeks and actually cares about the market share and how a company is growing and they also have that incentive that those stock options that they might someday get will actually have some value, I think that is a great motivation. In fact, one respected technology CEO said, “Employees with stock options are like homeowners; whereas, those without stock options are like renters.” He saw a difference in attitude, commitment, and the level of entrepreneurial spirit. It all makes a great deal of sense.

My concern with what the Financial Accounting Standards Board is planning to do with this exposure draft—and it seems like they have preordained that they are going to do it—is the impact all this is going to have on jobs and the ability of broad-based stock ownership for broad-based employees, not the top executives of the company, but the ability for companies that may have 50, that may have 500 employees, they may have even 5,000 employees. The point is all the employees from clerical to some of the engineers, to the scientists, to the innovators, all of that is going to have an adverse impact on their productivity and those opportunities for those individuals.

Now, what we have here is an elected Senate, and we are faced with unelected officials on the Financial Accounting Standards Board. And the effect of all the benefits of stock options for employees, broad-based employee stock options, will come to an end if this proposal goes forward. The question, though, and the whole issue here is how are you going to treat employee stock options as an accounting expense and disregard just certain fundamental issues.

First, employees’ stock options are not freely tradable. They inure to the benefit of an employee, and they only have any value of whatever that strike price is eventually achieved 4 or 5 or 6 years down the road. So how do you value something that has no market? How do you put a price on something if it is not for sale? The answer is you cannot, and there is no accurate way to value these options without an open market.

On top of it all, we have a proposal now that really hasn’t been field-tested very much, this binomial approach as opposed to Black-Scholes, which has generally been discredited. So on top of it all, an untested proposal is going forward on something that really is not evaluable.

The stock options, of course, take several years, and the other thing is for small businesses—and even larger businesses—when they have downturns, say in the technology sector, because they are using stock options, which may or may not become worth something someday, rather than laying off employees, they don't have that underlying expense because say their salary component. Their salary that they pay every month, is not as high because they are giving more in stock options. So instead of laying people off, their expenses are less, and that keeps folks motivated, staying with the company, not jumping to another job, so that when the demand kicks in, that talent is still there for that company.

I do also find it distressing that on the Pacific Rim and particularly in China, the People's Republic of China has companies in that country advertising and promoting themselves that they have employee stock options. I would hope in the United States of America that we would want to make sure that we are competitive and that we do not lose talent, we do not lose those jobs, offshoring, so to speak, because of the better incentive packages that creative innovators can get from working in a company in the People's Republic of China. I will also point out Bear Stearns said that if FASB is determined to fundamentally change—to go with their flawed assumptions about their proposals as far as expensing stock options, there will be a 44-percent decline in the Nasdaq 100 companies' profits that they would have been required to expense, employee stock options, if they had to in 2003. So, granted, the Nasdaq 100 are not necessarily small businesses; however, they are businesses—and I do care about businesses, large, small, and medium size, and a lot of small businesses, a lot of those companies on Nasdaq at one time were small businesses. So I think it is very important that we address the economic impact of this on jobs, the competitiveness of the country, and particularly in looking at small start-up companies that want to retain good people, quality people in their workforce, as well as attract people to serve on the board of directors that will also help those companies grow.

I thank you, Mr. Chairman, for your leadership on this very important issue.

Senator ENZI. Thank you.

Senator Bayh.

**OPENING STATEMENT OF THE HONORABLE EVAN BAYH, A UNITED STATES SENATOR FROM INDIANA**

Senator BAYH. Thank you, Mr. Chairman. As much as I would like to think that the audience is gathered here today to hear me give a speech, I suspect that they are here to listen to our panel, and I am here to listen and learn. Let me just take 2 minutes to sort of share my perspective with which I am approaching this issue.

It seems to me that our job as public policymakers is to attempt to reconcile a couple of very important and potentially competing concerns that will be brought up in the course of these deliberations. The first is the importance of the accounting aspect of all of this, the need for accuracy and transparency in accounting that is vitally important to the functioning of our capital markets, the confidence and trust that investors, both large and small, can place in the American system of free market enterprise. That is a very important concern I know we are going to be hearing about today.

Senator Allen alluded to some of the difficulties of achieving accuracy in this context. It seems to me from what I can hear that perfection is likely to escape us, but, nevertheless, we need to do the best we can in terms of achieving accuracy and transparency.

There is also a set of other issues that some of our colleagues have touched upon here. I refer to these as the macroeconomic issues: incenting innovation, which I think is very important in terms of what the competitiveness of the American economy is going to be going forward; global competitiveness, vitally important at this juncture with increased globalization and competition.

It is possible that there is going to be some tension between these different principles that we seek to embody in our decision-making. I was going to say the potential consequences are significant. A couple of decades ago, I believe, the treatment for health care expenses was changed, moving that from a footnote up into the balance sheet, and it set off a chain of events, which may be good, may not be good, depending on your perspective. They were very significant. Companies began to take health care costs much more seriously. That led to the rise of managed care organizations, which has led to, in some respects, a backlash against the provision of care in that regard, which has then led to the call for the Patient's Bill of Rights, et cetera, et cetera, et cetera. A change in the accounting treatment of health care expenses led to really some profound changes in a seventh of the American economy. That touches upon the daily lives of almost every American.

So as I said, that may have been good, it may not have been good, but it was profound. It makes it vitally important that we get this right and at least make some attempt to anticipate what the impact of all this is going to be on accuracy and transparency, but also on the rate of innovation and our ability to compete globally with those we have to compete with.

Those are sort of some of the principles I am trying to approach this debate with. I want to thank our panel members and others for being here today, and I look forward to receiving their wisdom.

Thank you, Mr. Chairman.

Senator ENZI. Thank you.

Senator Ensign.

**OPENING STATEMENT OF THE HONORABLE JOHN ENSIGN, A UNITED STATES SENATOR FROM NEVADA**

Senator ENSIGN. Thank you, Mr. Chairman. I think this is a vitally important issue when it comes to the competitiveness of America in the global economy. What Senator Bayh just talked about, I think, is exactly right. If we mess this up, there could be severe consequences, and I hope that our panel is taking that to heart.

What Senator Levin mentioned was that this isn't about whether to use stock options or not. This is just about how to account for those. The problem with that statement is that the people who are issuing stock options are telling us that if FASB goes ahead with what they are planning, broad-based stock option plans will come to an end.

Now, are the top employees going to get stock grants and are some companies going to use stock grants? Yes. The top employees aren't the people that we are worried about. It is the rank and file employee out there that will no longer, as Senator Allen talked about, be an owner in the company. Silicon Valley was built on stock options. A lot of these start-up companies that could not afford to pay the top prices were giving lower wages, and stock options, basically allowing the individual employees themselves to be an entrepreneur. Part of being an entrepreneur is being a risk-taker. As a veterinarian, I started my own animal hospital in Las Vegas. I was a risk-taker. I was putting my own heart, sweat, money, everything at risk.

Well, that is what broad-based stock options plans do to the front-line employee, do to the secretary, do to the engineer, do to all rank and file workers. They become owners in the company, believers in the company.

When we put in these types of accounting standards that are so complex, you confuse people. I am not an expert, I am not an accountant like our Chairman is. Listening to the CFOs out there and to the people that are going to actually have to comply with this, they are pulling their hair out. They are saying there is no way that they are going to do this. Company after company after company is telling us that, and especially now if—in this draft proposal, you give two different options, binomial, Black-Scholes, and a company is forced to pick one and not the other, you are setting people up for frivolous lawsuits from trial lawyers.

If we are going to expense—which I disagree with in the first place—then we should certainly have a valuation method that is accurate, but also one method that everybody uses so there isn't a choice out there because, otherwise, I believe it is going to once again be just a tremendous windfall to the trial lawyers in America.

What we should be after is accuracy and transparency, and I still don't understand—and maybe the panel can address this—why disclosing stock options at the various prices that they were given on the various financial statements and income statements, why those wouldn't be accurate enough for the average investor. I mean, that is what you are trying to do. You are trying to say, okay, as an investor I see those out there, I can figure out any dilution that represents. But if they are actually being expensed and forcing restatements and effecting the stock price, it just doesn't seem to make sense. My father is a chairman and CEO of a public company. It started at $25 a share, went to $42 a share, to $17 a share, back to $28, down to $7 a share, back to $28 a share, back to $15 a share, to $42, back to $25, and now it is up to $60.

The volatility of markets makes expensing of stock options so incredibly complex that I frankly think that is going to hurt investors and our company and the biggest thing I think that is going to hurt is our competitiveness in the global community. We should be looking at everything we can do to make American business more competitive in the global marketplace. That means reforming regulation and the way we tax our companies and accounting rules. That is certainly a regulation, and we should not be making American companies less competitive, especially with the Pacific Rim, which anyway, is by far the most competitive place for the United States.

So I look forward to hearing from our panel today and certainly hope that our panel is listening to the people who are on the front lines making these decisions. You are not responsible for the competitiveness of the United States. You know, they are, we are, and I hope that we do this right because I am very afraid of what is going to happen.

Senator ENZI. Thank you.

Senator Pryor.

**OPENING STATEMENT OF THE HONORABLE MARK PRYOR, A UNITED STATES SENATOR FROM ARKANSAS**

Senator PRYOR. Mr. Chairman, I am glad you brought this very important issue before the committee today. I appreciate your leadership on it, and I think any comments I would have would really just be ground that has already been plowed by these other Senators. So I would like to just hear from the panel now.

Thank you.

Senator ENZI. Thank you.

We will move to the panel then, and the first person to present, of course, will be the Chairman of the Financial Accounting Standards Board, Chairman of FASB, Robert Herz. He joined PricewaterhouseCoopers in 1974 after graduating from the University of Manchester in England with a B.A. degree in economics, and moved on to Coopers and Lybrand. He has been real active in the AICPA with the security regulations committee and a transnational auditors committee of the International Federation of Accountants. An amazing background, and he has a recent book, "The Value of Reporting Revolution: Moving Beyond the Earnings Game."

Mr. Chairman.

**STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD, NORWALK, CONNECTICUT; AND GEORGE J. BATAVICK, BOARD MEMBER, FINANCIAL ACCOUNTING STANDARDS BOARD, AND CHAIRMAN, FASB SMALL BUSINESS ADVISORY COMMITTEE, NORWALK, CONNECTICUT**

Mr. HERZ. Well, thank you, I guess it is Acting Chair Enzi, and thank you, Members of the Committee. I am Bob Herz, Chairman of the FASB. With me, as you said, is George Batavick, one of my fellow Board members, and he will be chairing our newly established Small Business Advisory Committee. That very good idea did come from Senator Enzi, and we thank him for that. We are pleased to appear before you today on behalf of the FASB and thank you for allowing us to participate in this very important and timely hearing.

We certainly recognize the importance of small business to job creation, to entrepreneurship, and to our Nation's economy. Accordingly, we also recognize the need to carefully evaluate whether our proposed improvements to financial reporting, not just on this subject but in general, not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost-effective manner.

We have got some brief prepared remarks, and I would respectfully request that the full text of our testimony and all supporting materials be entered into the public record.

Senator ENZI. Without objection, they will be included.

Mr. HERZ. As you know, we are an independent private sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission, which is to establish and improve general purpose standards of financial accounting and reporting for both public and private enterprises. We believe those standards are essential to the growth and stability of the U.S. economy because creditors, investors, and other consumers of financial reports rely quite heavily on credible, transparent, comparable, and unbiased financial information to make their economic and investment decisions.

Now, because the actions of the FASB affect so many organizations, our decisionmaking process must be open, it must be thorough, and it must be as objective as humanly possible. Our rules of procedure require an extensive and public due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with many interested parties, consultations with our advisory councils, exposure of our proposed standards to external scrutiny and public comment, and then after the comment period, public redeliberation by the Board, which often, I will tell you, does result in significant changes and improvements to proposals.

Our due process procedures do include participation by users, auditors, and preparers of the financial reports of small business. The recent formation of the Small Business Advisory Committee is intended to further enhance that participation.

We make final decisions only after carefully considering and analyzing input of interested parties. We try our darndest to balance the often conflicting perspectives of the various parties in order to make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of sound, fair, and transparent reporting.

On March 31, we issued a proposal for public comment to improve the accounting for equity-based compensation. It is out for a comment period of 90 days, and we will be holding roundtables and other meetings. George will talk about that. It is the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, review of over 300 comment letters received and over 130 further unsolicited letters, consultation with advisory committees, review of relevant research, meetings with valuation and compensation experts, field visits to companies, public and private discussions with hundreds of individuals, and active deliberation of the Board at 38 public Board meetings, of which about half of those meetings small business issues and non-public-company issues, were discussed.

Based on our work to date, we believe the proposal would significantly improve the financial reporting for equity-based compensation arrangements. We would do that by creating greater transparency and completeness in the reporting and a more level playing field in accounting for different forms of equity-based compensation. We believe the proposal would enhance the comparability of reported results, profitability, and other key financial metrics between companies that choose to compensate their employees in different ways. The proposal would achieve this by a number of provisions, but most notably, and I guess most controversially, by the proposed elimination of the existing exception for so-called fixed-plan employee stock options, which are the only form of stock option, and which are the only form of equity-based compensation that is not currently required to be reported as an expense in the financial statements. The proposal reflects our view that all forms of equity-based compensation should be properly accounted for and that the existing exception for fixed-plan employee stock options results in reporting that not only ignores the economic substance of those transactions, but that also distorts reported earnings, profitability, and other key financial performance metrics.

Thus, under the current rules, the greater the use of these instruments to compensate employees, the greater the distortion of the reported results. I would note in contrast, this distortion does not occur when companies use stock options or similar instruments which can often be quite complex, such as stock purchase warrants for purposes other than compensating employees, for example, to acquire goods and services, employ consultants, or in financed M&A transactions, because in those cases, the current rules do require that the options or the warrants be valued and properly accounted for.

Now, just to digress into the public company arena for just one second, and then we are going to have George focus on small business, in the public company arena the proposal would also bring about greater comparability between the nearly 500 companies that have now voluntarily opted to account for the cost of employee stock options in their financial statements and the many others that have elected not to do so.

It would also result in substantial convergence in the accounting for equity-based compensation between U.S. standards and the international accounting standards that are followed by companies, including many small and non-public companies in over 90 countries around the world.

I would like to now hand it over to George who will discuss the several special provisions contained in the proposal that relate to small business as well as some other small business matters and, very importantly, talk about our continuing work and due process on this important subject.

Mr. BATAVICK. Thank you, Bob, and good morning, everyone. Before I outline the special small business provisions contained in our proposal to improve the accounting for equity-based compensation, I would first like to provide some brief background on small businesses and financial accounting and reporting standards.

First, there is no Federal law requiring non-public enterprises to use FASB standards. Thus, for most small businesses, the use of our standards is primarily a private choice. For some small businesses, that choice may be influenced by whether they have plans to become a public enterprise.

For other small businesses, the decision to follow FASB standards may be influenced or controlled by their current or potential lenders, suppliers, other contracting parties, et cetera. To the extent that one of those parties requires that the financial reports of small businesses comply with our standards, that requirement presumably reflects that party's opinion that our standards result in better, more transparent information for their respective purposes.

Second, it is also important to note that the FASB has long recognized, as part of our ongoing public due process procedures, that the costs of complying with our standards can fall disproportionately on small businesses. In recognition of that fact, the Board actively solicits and carefully considers requests from users, auditors, preparers of financial reports, and considers whether or not there should be special provisions to alleviate the costs of implementing our standards.

These requests come from our continuous and ongoing due process and deliberations throughout the life of a project. In this project on equity-based compensation, if you are following it, all constituents, large and small, could have taken advantage of our free weekly action alert e-mail subscription, which discusses current agenda items and past Board decisions. They could have attended an open Board meeting. They could have called in, or they could have listened to our free webcasts of meetings on the day of the meeting and one week after. Our meetings also get extensive news coverage, and our free website includes an up-to-date summary of all equity-based compensation issues as well as our tentative decisions. We sought input from various State CPA societies, who in turn briefed their clients—in many cases small businesses—on the status of the project. Lastly, liaison meetings with various groups having small business representation and Board and staff speaking engagements provided additional means of receiving valuable input from the small business community.

With respect to this proposal, it is our understanding that although the use of employee stock options is prevalent at some small businesses, particularly start-ups and venture capital-backed enterprises that plan to become public enterprises, the vast majority of small businesses, 3 percent or less, in the U.S. do not grant employee stock options. As indicated earlier, however, for those small businesses that are impacted by our proposal, the proposal includes several special provisions intended to alleviate the costs of implementation.

First, the proposal includes a special provision that would permit most small businesses, including all that are non-public, to measure compensation cost using a simpler, less costly intrinsic value method, rather than the fair-value-based method. Under the intrinsic value method, the amount of compensation expense required to be reported would generally be equivalent to the amount of the income tax deduction for stock options.

Second, the proposal includes a special provision that provides that most small businesses that are non-public enterprises would have a simpler, less costly prospective transition to the new requirements. Finally, the proposal includes a special provision that provides that the effective date of the proposed standard for non-public enterprises would be delayed 1 year until 2006.

I would also like to note that the proposal includes a Notice for Recipients that highlights and describes these special provisions. The notice requests that respondents to the proposal indicate what other special provisions for small businesses might be appropriate and whether any or all such provisions should also be extended to public enterprises that are small business issuers.

The Board currently plans to discuss the proposal's special provisions and other issues about the proposal with representatives of small businesses at our inaugural public meeting of our Small Business Advisory Committee on May 11. Our request for agenda items, which was made to this committee for this meeting, showed interest in this proposal. We also plan to hold several public roundtable meetings with valuation and compensation experts, users, auditors, preparers, et cetera, in June to discuss a broad range of issues.

Following the end of the comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the proposal, including all those issues raised by the small business community. Those redeliberations will include careful consideration of these requests, including ongoing input from the Small Business Advisory Committee.

Only after evaluating the input at public meetings will the Board consider whether to issue a final standard.

On behalf of myself and Bob, I would again like to express our appreciation for inviting us to participate in this hearing. All the information we obtain at this hearing will be carefully considered.

In conclusion, let me assure you—and I know Bob will also assure you—that you and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to reach out actively and solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties.

Thank you again, and Bob and I would welcome any opportunity to respond to questions you may have.

[The prepared statement of Mr. Herz and Mr. Batavick follows:]

Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is one of my fellow board members, George Batavick. George is heading up the FASB's newly established Small Business Advisory Committee ("Committee"). The idea for the Committee originated with Senator Enzi at a hearing he chaired late last year.

We are pleased to appear before you today on behalf of the FASB. We want to thank you for inviting us to participate in this very important and timely hearing.

The Board recognizes the importance of small businesses to job creation, entrepreneurialism, and our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost effective manner.

George and I have brief prepared remarks, and we would respectfully request that the full text of our testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the growth and stability of the United States ("US") economy because creditors, investors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002, is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report transparent and credible information about their activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views.

Our due process procedures include active participation by users, auditors, and preparers of the financial reports of small businesses. The recent formation of the FASB Small Business Advisory Committee is intended to further enhance that participation.

The Board makes final decisions only after carefully considering and analyzing the input of all interested parties. The Board must balance the often conflicting perspectives of various parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of sound, fair, and transparent financial reporting.

On March 31st of this year, the Board issued a proposal for public comment to improve the accounting for equity-based compensation. That proposal is the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, consultation with our advisory councils and valuation and compensation experts, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of the financial reports of small businesses, and active deliberations at 38 public Board meetings at which the provisions of the proposal were carefully developed with consideration given to the ongoing input received from all interested parties.

The Board believes the proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including eliminating the existing exception for so-called fixed plan employee stock options, which are the only form of equity-based compensation that is not currently required to be reported as an expense in financial statements. The proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such and that the existing exception for fixed plan employee stock options results in reporting that ignores the economic substance of those transactions.

The proposal also will provide greater comparability between enterprises that compensate their employees in different ways and, in the public company arena, between the nearly 500 enterprises that have voluntarily chosen to account for the cost of all of their employee stock options and the many others that have elected not to do so.

Finally, the proposal has the secondary, but important, benefit of achieving greater international comparability in the area of accounting for equity-based compensation. In that regard, our international counterpart, the International Accounting Standards Board ("IASB"), issued a final standard in February of this year requiring the expensing of all equity-based compensation. The IASB standard will be followed by enterprises in over 90 countries beginning next year.

The proposal includes several special provisions relating to small businesses. George will briefly discuss those provisions and other small business issues.

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

Before I outline the special small business provisions contained in our proposal to improve the accounting for equity-based compensation, I would first like to provide some brief background on small businesses and financial accounting and reporting standards.

First, there is no federal law requiring nonpublic enterprises to use FASB standards. Thus, for most small businesses, the use of our standards is primarily a private choice. For some small businesses, that choice may be influenced by whether they have plans to become a public enterprise, since public enterprises are required to comply with our standards under the federal securities laws.

For other small businesses, the decision to follow FASB standards may be influenced or controlled by their current or potential lenders, suppliers, other contracting parties, or State regulators. To the extent that one of those parties requires that the financial reports of a small business comply with our standards, that requirement presumably reflects that party's opinion that our standards result in better, more transparent, information for their respective purposes than the use of other existing comprehensive bases of accounting, such as tax basis, cash basis, or regulatory reporting.

Second, it is also important to note that the FASB has long recognized as part of our public due process procedures that the costs of complying with our standards can fall disproportionately on small businesses. In recognition of that fact, the Board actively solicits and carefully considers requests from users, auditors, and preparers of the financial reports of small businesses to defer effective dates, provide for differential disclosures, or provide other special provisions to alleviate the costs of implementing our standards.

With respect to our proposal to improve the accounting for equity-based compensation, it is our understanding that although the use of employee stock options is prevalent at some small businesses, particularly start-ups and venture capital backed enterprises that plan to become public enterprises, the vast majority of small businesses in the US do not grant employee stock options. As indicated earlier, however, for those small businesses that are impacted by our proposal, the proposal includes several special provisions intended to alleviate the costs of implementing the proposed requirements.

First, the proposal includes a special provision that would permit most small businesses (including all that are nonpublic enterprises) to measure compensation cost using a simpler, less costly "intrinsic value method," rather than the fair-value-based method that would be required for most public enterprises. Under the intrinsic value method, the compensation cost for any reporting period would be measured based on the difference between any excess of the fair value of the enterprise's stock and the exercise price of the employee stock options granted with final measurement of compensation cost at the settlement date. The total amount of compensation expense required to be reported under that method would generally be equivalent to the amount of the income tax deduction for stock options.

Second, the proposal includes a special provision that provides that most small businesses that are nonpublic enterprises would have a simpler, less costly "prospective" transition to the proposed new requirements. Finally, the proposal includes a special provision that provides that the effective date of the proposed standard for nonpublic enterprises would be delayed for one year until 2006, as compared to the proposed effective date of 2005 for public enterprises.

I also would like to note that the proposal includes a Notice for Recipients ("Notice") that highlights and describes these special provisions as well as other key aspects of the proposal. The Notice requests that respondents to the proposal indicate what other special provisions for small businesses might be appropriate and whether any or all such special provisions should also be extended to public enterprises that are small business issuers under the federal securities laws.

I also would note, however, that we are aware of some recent surveys and other input from investors indicating strong opposition to any exemptions from our proposed requirements for start-ups and newly public companies, respectively.

The Board currently plans to discuss the proposal's special provisions and other issues about the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee in May. We also plan to hold several public roundtable meetings with valuation and compensation experts, and users, auditors, and preparers of financial reports in June to discuss a broad range of issues about the proposal.

Following the end of the proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the proposal. Those redeliberations will address key conceptual, measurement, disclosure, and cost-benefit issues and will include careful consideration of the ongoing input received from representatives of small businesses, including ongoing input from the members of the Small Business Advisory Committee.

Only after carefully evaluating the input at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.

On behalf of myself and Bob, I would again like to express our appreciation for inviting us to participate in this hearing. All of the information we obtain in connection with this hearing will be carefully considered consistent with our mission and Rules of Procedure.

In conclusion, let me assure you, Chair Snowe, Ranking Member Kerry, and Members of this Committee, that you, and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to actively solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties and that will lead to improving the transparency and credibility of financial reports and, thus, assisting in the strengthening of the US economy.

Thank you again, Chair Snowe. Bob and I would welcome the opportunity to respond to any questions.

Senator ENZI. Thank you.

That was Mr. George Batavick, who is not only on FASB, but he is the Chairman of the Small Business Advisory Committee. He is the former Comptroller of Texaco, Inc. He has company-wide responsibility for strategy and policy matters covering all aspects of accounting and financial reporting, special studies, internal controls, and tactical plan coordination, and he has had a career in public accounting at Arthur Andersen. Thank you for the testimony.

The next person to testify will be Dr. Douglas Holtz-Eakin, who is the sixth Director of the Congressional Budget Office. He spent 18 months as a Chief Economist for the President's Council on Economic Advisers, and he serves as CBO's representative on the Federal Accounting Standards Advisory Board. He served as editor of a number of publications—the National Tax Journal, been involved with the Journal on Human Resources, and a whole list of them, very impressive list of them. We look forward to your testimony, Dr. Holtz-Eakin.

**STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC**

Mr. HOLTZ-EAKIN. Mr. Chairman, members of the committee, the Congressional Budget Office recently delivered to Congress a report on the accounting for employee stock options, which examined the issue from an economic perspective, with a particular focus on measurement issues and on the economic implications of accounting for stock options. I want to highlight three main points of that report, and then I would be happy to take your questions.

The first point is that granting stock options to employees results in a cost to the firm that is equivalent to cash and other non-cash compensation. Using the fair value or cash equivalent of compensatory options at grant and recognizing that value over the period when the corresponding labor services are provided—the vesting period—brings accounting closer to the economic reality of total firm expenses and net income.

That finding is based on three observations:

First, is that stock options are valuable to employees; otherwise, they would not accept them as a substitute for other compensation.

Second, the value of options can differ among employees and change over time. However, the reporting entity is the firm. In reporting net income for the firm, costs should be recognized at the time the labor services are provided; expensing over the vesting period reports that cost for the firm. Any subsequent changes in the value of the options represent a shift of resources among stakeholders in the firm and not a change in the cost of labor compensation—a point that we explain in more detail in the report.

Finally, stock options can be cost-effective. Beneficial incentive or productivity effects will be reflected in earnings. A fair display of the cost-effectiveness will be achieved by showing the cost of labor services required to produce those earnings. For that reason, any accounting standard should recognize their value, but not prohibit the use of stock options.

The second major point is that valuing stock options is more difficult than valuing cash compensation. The difficulty does not appear to preclude the recognition of their fair value, however, especially when compared with the intricacy of other calculations of compensation expenses.

It is more difficult than cash or non-cash benefits, such as employee health insurance, largely because the price is not observed and because it has some special features, such as vesting periods, forfeiture provisions, and restrictions on transferability. However, advances in financial analysis now permit reasonable valuation of a wide variety of such warrants, and indeed they are present in many investment portfolios, including those of the Federal Government.

To provide some perspective, the valuation of employee stock options can be compared with another form of compensation: retiree health benefits. To value those, a firm must forecast employees' tenure, the retirees' marital status, trends in health and mortality, changes in medical technology, and the ultimate cost and utilization of medical services. In short, the valuation exercise is forward-looking and is based on uncertain and volatile prices. Current methods for employee stock options address an analogous situation, and robust options-pricing methods are now available to every MBA. Moreover, as the demand for such valuation increases, we would anticipate further analytic advances and an increased supply of people providing this service to firms.

The final point I want to make from our report is on the economic implication of recognizing the expense of employee stock options. This accounting requirement would not change the economic fundamentals of any business, large or small. Firms' cash flows would not be affected. Their customers, product markets, and competition would be unchanged. Small and large businesses would face the same labor market conditions, and they would have the same tools available to attract highly productive labor. Their taxes would be unchanged. In fact, the underlying financial facts would be precisely the same for all businesses after the accounting change. Thus, the only channel for any real economic effect would be changes in investors' valuation of these businesses.

One would expect that for savvy investors and for most firms, expensing would provide no new information and, therefore, no change in value. Current standards require firms to calculate and disclose, in audited notes, the fair value of the options grants and the effect of recognizing them as an expense, on net income. Expensing would only make this information available more easily and to a broader audience.

Now, it has been argued that there will be a significant decline in stock prices as a result of expensing. In advance, no definitive evidence can be offered for this claim. However, evidence from other similar events—for example, the early 1990s exposure draft from the FASB, firms that have voluntarily adopted expensing in the United States, and firms that have expensed these grants in Canada or the European Union—argues against any significant overall effect on stock prices.

A related concern is that stock prices of businesses too small to be tracked by market analysts may be adversely affected by expensing. Many of the CEOs of such firms believe that expensing will reduce their stock prices and have announced that they will stop granting options. This is a serious issue. The economic importance of these entrepreneurial firms and the informed source of these reports requires that we consider it carefully.

It may be the case that investors in such small firms may be surprised by the information received from expensing stock options and that this will cause a decline in stock prices, an increase in the cost of equity capital, and potentially sizable near-term losses for managers and employees. If some firms are relatively overvalued, other firms are relatively undervalued, and those firms will enjoy a corresponding increase in their stock prices as a result of the accounting change. This would permit near-term expansion of markets and employment by such firms. Those offsetting effects reduce the possibility of a significant overall effect.

Moreover, these same considerations suggest that improved information will allow capital in the economy as a whole to flow to its most productive uses. For the economy as a whole, this would provide a benefit in the form of increased productivity and competitiveness.

Thanks, and I look forward to your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

# CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

## Accounting for Employee Stock Options

before the
Committee on Small Business and Entrepreneurship
United States Senate

April 28, 2004

*This statement is embargoed until 10:00 a.m. (EDT) on Wednesday, April 28, 2004. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.*

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Madam Chair, Senator Kerry, and Members of the Committee, thank you for the opportunity to present the findings of a Congressional Budget Office (CBO) report on accounting for employee stock options.[1] The purpose of the report was to examine the way in which the recognition of the cost of such options—as in the Financial Accounting Standards Board's proposal to require the expensing of compensatory stock options for publicly traded firms[2]—would improve the measurement of net income. In my remarks today, I wish to make three points:

- Granting stock options to employees results in a cost to the firm that is equivalent to cash and other noncash compensation. Like the cost of other compensation, the fair value of options is an expense to the granting firm.

- Valuing employee stock options is more difficult than valuing cash compensation, but the difficulty does not appear to preclude the recognition of their fair value, especially when compared with the intricacy of some other calculations of compensation expenses.

- Recognizing the expense of employee stock options would not change the economic fundamentals of any business, large or small. Thus, any economic effect of this accounting change would derive from altering investors' perceptions of the expenses and net income of some firms. To the extent that recognized net income is closer to its underlying economic value, more accurate perceptions would be broadly beneficial.

## Compensating Employees with Options Is Costly to the Firm

Granting options or other benefits in lieu of cash compensation is an exchange of value for labor services. A fundamental objective of financial accounting is to tally operating flows of resources into and out of the reporting entity in order to measure the net gain or loss from operations during the specified period. Including the fair value or cash equivalent of compensatory options and recognizing that value as an outflow of resources when the corresponding labor services are provided—the vesting period—brings accounting practice closer to economic reporting of total expenses and net income.

Several aspects of that observation merit discussion. First, CBO's analysis is entirely consistent with the notion that stock options are valuable to employees. Indeed, if not, employees would not accept options instead of other compensation.

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1. Congressional Budget Office, *Accounting for Employee Stock Options* (April 2004).

2. Financial Accounting Standards Board, *Proposed Statement of Financial Accounting Standards: Share-Based Payment* (No. 1102-100, an amendment of FASB Statements in No. 123 and 95), March 31, 2004, available at www.fasb.org/draft/ed_intropg_share-based_payment.shtml.

Second, it may be the case that the value of options differs among employees or shifts over time. The focus of accounting for expenses and net income, however, is on the cost of compensation to the firm at the time that the labor services are provided. Expensing over the vesting period the fair value of stock options when they were granted reports that cost for the firm. As detailed in the CBO report, subsequent changes in valuation represent a shift of resources among firms' stakeholders but not a change in the cost of labor compensation.

Finally, stock options can be cost-effective in attracting and retaining a skilled workforce. Any beneficial incentive or productivity effects will be reflected in earnings, as reported in net income. A fair display of cost-effectiveness will be achieved by also showing the cost of labor services. The demonstrated effectiveness of options as an incentive-based compensation tool makes it desirable that proposals to recognize the value of options do not prohibit their use by any company.

## Valuing Options Can Be More Difficult Than Valuing Some Other Forms of Compensation

Compared with pay and purchased fringe benefits such as employee health insurance, employee stock options are more difficult to value because their price is usually not observed directly. In addition, features such as vesting periods, forfeiture provisions, and restrictions on transferability make valuation more complicated than for options without those features. However, advances in financial analysis now permit reasonable valuation of a wide variety of such warrants, as attested by their presence in many investment portfolios—including that of the federal government.

Some perspective on the difficulty of valuing options may be provided by comparison with another form of employee compensation: health benefits for retirees. To value those costs, the firm must project numerous uncertain future conditions, including employees' tenure, retirees' marital status, trends in health and mortality, changes in medical technology, and the cost and utilization of medical services years hence. That is, the valuation exercise is forward-looking and incorporates uncertain and volatile prices. Current valuation methodologies for employee stock options address an analogous situation, with the advantage that robust options-pricing models are now in the standard toolbox of MBAs. In short, the challenge does not appear to be unique or fraught with such practical difficulty that one would prefer a value of zero, which is currently permitted. Moreover, as the demand for such valuations increases, one should anticipate further analytical advances and a growing supply of service providers.

## Recognizing the Fair Value of Options Would Not Change the Economic Fundamentals for Any Business

Cash flows available to conduct operations will not be affected by the form of accounting disclosure in financial statements. Customers, product markets, and competition will be unchanged. Small and large businesses will face the same labor market conditions, and they will have the same tools available to attract highly productive labor. In fact, the underlying financial facts will be precisely the same for all businesses after any new accounting standard is adopted.

Thus, the channel for any possible real economic effect would be a change in investors' valuation of businesses. For savvy investors and most firms, expensing would provide no new information and, therefore, no change in value. That situation exists because the current standard requires firms to calculate and disclose, in audited notes, the fair value of the options granted and the effect that recognizing them as an expense would have on reported net income. For those investors willing to refer to that disclosure, information required by the proposed standard is already available. Expensing would only make that information more easily accessible and broadly available. Nonetheless, it has been argued that there will be a significant decline in the prices of stocks as a result of expensing. The experience of companies that have already begun to expense options in the United States, Canada, and the European Union argues against any significant overall effect.

Another concern has focused primarily on businesses too small to be tracked by market analysts. The belief that expensing employee stock options will reduce their stock prices has prompted some businesses to declare that they will stop granting options rather than recognize the expense, regardless of the benefit of the options to the firms or to their employees. The economic importance of entrepreneurial firms and the informed nature of these reports suggest that they be taken seriously. Perhaps investors in some firms would be surprised to discover the effect of options on earnings. Such businesses would suffer a decline in stock prices and an increase in the cost of equity capital, with potentially sizable near-term losses for managers and employees. But in the same way that some businesses might have been relatively overvalued as a result of understated compensation costs, other firms have been relatively undervalued. The latter would enjoy an increase in stock prices as a result of the accounting change, permitting near-term expansion of markets and employment. Therefore, the effect overall would be smaller than for any single firm.

Such dynamics reflect the fact that improved information and valuation would tend to divert new investment from firms with less productive opportunities toward others with more productive ones. That is, a potential economic benefit for the economy as a whole from the proposed accounting standard would be to increase the flow of capital to those businesses that could use it more productively, as indicated by their higher net income.

This completes my statement, Madam Chair, but if I may, I would like to submit the CBO report on this topic for possible inclusion in the record.

Senator ENZI. I want to thank all three of you for your outstanding testimony and particularly for the more extensive documents that you have provided for us. I was able to go through quite a few of those, but I need to have some answers to some more general questions to start out with.

I am concerned about the method of gathering information about the proposed standard. I guess I am a little disappointed that the concentration is on convincing Congress that what you are doing is right rather than soliciting comments to find out whether what you are doing is right. I am just not familiar with this process of a Board that is supposed to be soliciting—and everything that they write talks about listening and process and accountability and thoroughness, and they have had the appearance of being locked into a primary approach from the very beginning, and everything that seems to be happening continues to put forward that approach.

For instance, I got a letter from the Big Four accounting firms, and they said that that was at the solicitation of FASB officials, asking us not to do any legislation. I have said a number of times that if the small business aspect—if there is an appearance that it has been listened to, then legislation may not be necessary. But if it isn't listened to, there may be a landslide toward doing it.

It is based around listening, not about legislating, and there is so much concentration being done on the legislation that I am not sure that the listening is being done.

Chairman Herz, would you comment on that, as well as your role as a lobbyist?

Mr. HERZ. Well, I think we listen a lot. We meet with many people. We get lots and lots of input. I went over that. Inevitably, some people have views, and when you don't accept their views, they say you are not listening. Listening does not necessarily mean that you agree or obey.

We are continuing to listen. We really are. In fact, on the small business aspect, your suggestions have been outstanding, I think, on the Small Business Committee. Just from my meetings with you, I think I have taken on some of your infectious passion for the subject, and we will continue to do that.

At a hearing actually on the House side back in June, I said that I don't think personally one-size-fits-all in that regard. One of my involvements was being a managing partner of a series of investment funds that invested in a lot of things, including venture capital, direct equity investments in start-ups and the like. I think I have got a pretty decent feel for that.

Our job is ultimately to find the right accounting, accounting that is sound, accounting that is also cost-beneficial, that is understandable, and we are going to listen real hard and work it real hard. You have my commitment to that.

As for the lobbying, I can't help but thinking that it is kind of a little bit like the pot calling the kettle black. You know, we all know from all the press reports—and we didn't want to politicize this issue. Long before we even put this on the agenda, the International Stock Option Coalition was formed, was ready—you know, the press, on Capitol Hill, you called a roundtable yourself right after we put this on the agenda. I think that was a useful roundtable, but hearings were all called. This is about the fifth or sixth hearing this month on this subject.

I understand. I actually think Senator Bayh's perspective is kind of where I would come down. You guys have got—I mean, this is a public policy issue, and there are competing—there may be competing goods. I hope there aren't competing goods. I mean, my view is let's get the accounting right. If you want to incent innovation through stock options, triple the tax deduction, do something else, but let's get the information set right so that the capital markets can work.

In regard to lobbying, we have not asked any firm to lobby for us with respect to our proposed standard to improve the accounting for equity-based compensation. Since 1996, our Washington, DC representative, Jeff Mahoney, has provided information and responded to questions about the FASB and our activities from staff and Members of Congress, Federal Government officials, and other interested parties here in Washington, DC. He also arranges for me to meet directly with many of you, with your staff, and other people in Washington. Our communications sometimes entail lobbying contacts as defined in the Lobbying Disclosure Act relating to proposed legislation that relates to our activities, both Jeff and I and my predecessor, Ed Jenkins, were registered under the Lobbying Disclosure Act on behalf of the Financial Accounting Standards Board.

Our intent is not to lobby, not to politicize at all, but, we have seen on the other side since this issue began and more lately with the well-publicized fly-ins of executives and, as Senator Fitzgerald said at last week's hearing—I don't know what adjective he used—that the place was swarmed with, crawling with high-tech lobbyists. We would rather have this issue discussed on its merits like we are doing today rather than through a political context.

Senator ENZI. Well, I appreciate that. I can tell you, I wouldn't have been nearly as surprised had I gotten a letter from each of the Big Four accounting firms instead of a joint one from the Big Four accounting firms. I didn't know they got together on that personal of a basis.

But to move on, I am really pleased that you did a Small Business Advisory Committee. I am hoping that you will perhaps make it a little bit more of a Small Business Advisory Committee. Under NASD—and I keep using that as an example because I am hearing a lot of good reports on things that are happening as a result of it, the chairman is actually from a small firm. The advisory committee meets on a regular basis. The advisory committee selects what it is going to hear. On your advisory committee, they are going to have a half a day, I think, to look at this proposal and go into the details on this intrinsic and fair value and Black-Scholes and binomial valuation models. I am also wondering if that is nearly adequate. And I am wondering how the comments by the Small Business Advisory Committee will become a part of the docket then on what you are actually going to do. I am also a little concerned about people from that committee already writing letters and saying what is going to happen. If it hasn't even met, it seems a little premature for the committee to have any kind of an opinion yet.

Would either of you care to comment on that?

Mr. BATAVICK. Yes, Senator, I would. Going back to the meeting itself, as you know, when we formed this committee, we reached out to over 20 different organizations for representation—the American Community Bankers, the National Venture Capital Association, Small Business Administration, etc. We believe we have an excellent committee. I have spoken with just about everyone that was nominated for the committee, and I can tell you they are very enthusiastic on two fronts. They are enthusiastic that they are going to be providing us with important issues that we can consider, but they are also interested in getting together as a group so the users and the preparers and the auditors can hash out issues.

It was raised earlier today: Why do some of these private companies follow our standards? Well, these are the types of issues we are going to be discussing to make sure that the users understand what the preparers and the auditors are going through.

We did go out prior to the meeting with a suggestion for agenda items. We did receive a number of requests, and those requests were around the area of equity-based compensation, which, as Senator Enzi said, is going to be the largest topic discussed at our meeting. We also thought it was important to discuss other issues that they brought up. They brought up our Standard 150 on mandatory redeemables. They brought up issues on business combinations. They brought up issues on various other matters like the accounting environment, and whether we should we have differential accounting standards.

So based on those agenda requests from the committee, Mr. Senator, we formed the agenda itself. Also, we are not looking to have just two meetings a year. Unfortunately, that was mis-communicated. What we meant to communicate is that, at a minimum, 2 times a year we will meet. We are going to discuss during this meeting what type of frequency will make sense. Even if the frequency of the meetings is only 3 or 4 times a year, let's say, or 5 or whatever, that doesn't mean that we don't reach out to this committee whenever we want to. That doesn't mean that they can't pick up the phone and call us and give us their input.

If you look at the agenda on equity-based compensation, what you will see is that when we talk about the provisions, when I brief this committee on some of the differential provisions we have for non-publics, we are going to ask them: Should this be expanded to other small businesses and how? What do you need to educate yourself? What help do you need to implement the requirements?

These are all the questions that we are going to be spending a considerable amount of time on at our inaugural meeting. The people that I spoke with are very energetic, very excited about getting together. And I believe they feel coming in here that they will be able to have input and they will be able to make a difference.

Senator ENZI. I appreciate that, and it is very encouraging, and I will be looking forward to the results on that. I know that my time has run out, but I have to ask Dr. Holtz-Eakin a question. I will mention that I would appreciate it if we could put some additional questions to everybody in writing and get some responses. What we are doing, of course, is building a record so that we know what to do in the future and how things are going based on what we have heard today.

Dr. Holtz-Eakin, in the CBO study on FASB, was there any independent technical accounting analysis or just the documentation used from FASB itself? I noticed that there wasn't any mention of small business in the CBO study. So was there any input from small business? Were there any additional studies that were used besides information from FASB?

Mr. HOLTZ-EAKIN. Well, certainly the CBO study reflects our reading of the broad accounting and research literature in economics on both the measurement issues and the economic implications. So it is far from focused on just the materials received from FASB but, rather, on the entire record of published research.

Senator ENZI. Okay. I will have some additional questions.

Mr. HOLTZ-EAKIN. Certainly.

Senator ENZI. I appreciate it.

Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

Mr. Chairman, first of all, I would like my statement to be made part of the record, including that portion which lists some of the leaders in the financial and accounting world who have supported the expensing of stock options.

Senator ENZI. Your full statement will be a part of the record.

[The prepared statement of Senator Levin follows:]

**STATEMENT OF SENATOR CARL LEVIN (D-MI)
BEFORE
U.S. SENATE COMMITTEE ON
SMALL BUSINESS AND ENTREPRENEURSHIP
ON
THE IMPACT OF STOCK OPTION EXPENSING ON SMALL BUSINESS**

April 28, 2004

Since late 2001, a wave of corporate scandals has engulfed the U.S. business world. While business giants like Enron, Adelphia and Tyco got front page publicity, nearly every business, large and small, was in some way hurt by the damage done to investor confidence in our financial systems, our markets, and our financial regulators. Among other problems, many new companies seeking venture capital or an opportunity to go public have experienced a dramatic decline in investor backing.

To stop the wrongdoing and restore investor confidence, Congress held hearings, issued reports, and enacted landmark legislation, the Sarbanes-Oxley Act of 2002. This work focused in particular on halting the accounting abuses infecting so many corporate books. Among other measures, we created a new Public Company Accounting Oversight Board, required companies to disclose material off-balance sheet transactions, and strengthened the independence of the private sector body that sets U.S. accounting standards, the Financial Accounting Standards Board, or FASB, by providing it with independent funding.

Today, because FASB has tackled one of the toughest accounting issues in its history by proposing to require companies to treat stock option compensation as an expense in their financial statements like all other forms of compensation, opponents of stock option expensing want Congress to override FASB's independent judgment, politicize the standard-setting process, and roll over FASB's independence. To do so would be to signal that accounting maneuvers to prop up earnings are still acceptable and turn our backs on the lessons of Enron. It would be a grave mistake.

Today's hearing focuses on how expensing stock options may affect small business. No one is proposing, by the way, to stop any U.S. business – large or small – from issuing stock options. The issue is not whether stock options are valuable incentives that should be used, but whether stock option pay should be accounted for on company books as an expense, just like every other form of compensation. All other forms of compensation – including incentives such as bonuses, conditional stock grants, and stock appreciation rights – now appear as an expense on a company's books. The only exception has been stock options. The issue today is whether FASB will be overridden or allowed to maintain its independence now that it has decided to eliminate that anomaly and require stock options to be treated as an expense, like all other forms of compensation.

Since gaining popularity in the 1980s, because of their stealth compensation feature, the main purpose of stock options has been to compensate corporate executives. In fact, at U.S. publicly traded companies, stock options now provide the majority of CEO pay, boosting CEO pay every year through good times and bad, while leaving average worker pay further and further behind. J.P. Morgan once said that CEO pay should not exceed 20 times average worker pay. In 1990, the pay gap between CEOs and average workers was already 100 times. Last year, CEO pay at about 350 of the largest U.S. public companies averaged $8 million, a 9 percent increase over the prior year, and average CEO pay was 300 times average worker pay. Stock options were the largest single factor in that pay gap.

Stock options have operated as stealth compensation, because most U.S. companies do not show stock option pay as an expense on their books, although those companies deduct stock option pay as an expense on their tax returns. That's the double standard, the gimmick that allows companies to show a huge compensation expense deduction on their tax returns but zero expense on their books. FASB's proposal would put an end to that double standard by requiring companies to treat stock option compensation as an expense on their financial statements, just as they take a tax deduction for the stock option compensation.

FASB proposes taking this action because it views stock option pay as compensation. It has concluded that omitting this expense from a company's financial statement produces misleading accounting results, including making the company's earnings appear larger than they really are. FASB's view is the consensus position in the accounting field. The International Accounting Standards Board, whose standards affect 90 countries, is requiring stock option expensing beginning next year. Canada began requiring stock option expensing this year. A 2002 survey of financial experts by the Association for Investment Management and Research found that more than 80 percent support stock option expensing. All four major accounting firms also favor expensing.

Opponents predict a parade of horribles if FASB goes ahead with its plan. They predict this accounting change will stifle investment and innovation, hurt our stock markets, lead to outsourcing of high tech jobs, and wreak havoc in our economy. But experience already shows these dire predictions are wrong. Since 2002, nearly 500 companies have voluntarily agreed to begin expensing stock options on their books. These companies represent about 20% of the number of companies on the Standard and Poor's index of companies and 39% of that index based on market capitalization. None of the predicted horribles has happened.

Perhaps the most common prediction by opponents is that stock option expensing will depress company earnings which will, in turn, cause stock prices to fall and devastate investment prospects. The facts, however, show otherwise. Just last month, a leading executive pay expert, Towers Perrin, issued a study examining 335 companies that switched to stock option expensing and found that stock performance was the same, on average, as the rest of the S&P 500 and mid-cap 400 indices. Expensing did not affect their stock prices.

Financial analysts have also rejected the doom and gloom predictions, issuing reports with generally favorable reviews of stock option expensing.

–Goldman Sachs Global Equity Research issued a recent report supporting stock option expensing and stated: "We do not expect a material impact on the share prices of most firms."

–UBS Investment Research has stated that expensing is a "long past due change" and "medicine for the long-term health of companies and investors. It will shed light on the true profitability of many companies, helping to separate those that deserve investor capital from those that do not."

–Merrill Lynch says the argument that expensing options will harm U.S. technology leadership and job creation is based on "the following faulty logic: U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements. One might as well argue that money spent on R&D shouldn't count as an expense because it provides employment and helps industries advance."

–Credit Suisse First Boston Equity Research says: "We expect companies to pay closer attention to the economic cost of their stock option plans. Companies don't focus much on costs that they don't have to account for. ... [W]e expect to see a decline in the number of options granted, potentially replaced by restricted stock, cash, incentive options, or nothing if the company had been overcompensating its employees."

–The National Center for Employee Ownership, a long-standing champion of stock options, conducted a 2003 survey of 30 leading business schools and found that 31 out of 37 professors expected expensing to have little or no impact on company earnings.

–Congress' own economists at the nonpartisan Congressional Budget Office, who we will hear from today, have made the same forecast, issuing a recent report which concludes: "[R]ecognizing the fair value of employee stock options is unlikely to have a significant effect on the economy . . . however, it could make fair value information more transparent to less-sophisticated investors."

Honest accounting, in other words, doesn't hurt the economy.

Other leaders in the financial and accounting world, who care about small business and the high tech sector, also support stock option expensing as good for investors and good for markets. They include Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, SEC Chairman William Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, former SEC Chairman Arthur Levitt, former Comptroller General Charles Bowsher, investors Warren Buffett, John Biggs and Pete Peterson, Nobel Prize Winners Joseph Stiglitz, Robert Merton and Myron Scholes, as well as respected groups such as the Council of Institutional Investors, the Investment Company Institute, Financial Services Forum, Consumer Federation of America, National Association of State Treasurers, Institute of Management Accountants, and The Conference Board's Commission on Public Trust and Private Enterprise. None of these persons wants to hurt small business or high technology, yet all of them support stock option expensing.

President Bush, who doesn't support expensing stock options, nevertheless opposes Congressional interference with FASB's independent accounting judgment.

Some opponents claim that expensing stock options will hurt the economy by dampening innovation. But many of the 500 companies expensing options are successful, high tech innovators like Microsoft, Netflix, and Amazon. They also include such diverse companies as General Motors, Dow Chemical, Boeing, BankOne, UPS, and Coca-Cola, each of which relies on technical innovation for business success. The CEO of Netflix, a high tech company that began expensing stock options last year, has stated: "[I]nnovation continues unabated. ... We innovate because it thrills us, not because of some accounting treatment."

Another claim of some opponents is that stock option expensing will force high tech companies to outsource more jobs in order to cut costs. But a number of high tech companies, like Cisco, Dell Computers, IBM, and Intel, have already sent hundreds or thousands of jobs offshore, without expensing their stock options. Intel began outsourcing software research and development operations to India several years ago; in 2003, its CEO was quoted by the Indian press as saying, "I can tell you that the headcount in India will continue to grow and a lot of back office work is also coming." Cisco Systems announced in 2003 that it was "going to increase outsourcing to India in all areas" including software development, and in October announced a "China-based staffing solution" for Cisco's Global Technical Response Center.

Dell Computer, which is based in Texas, recently set up customer and technical support centers in India, China, Morocco, Slovakia, and design centers in China. It also has manufacturing plants in Brazil, Malaysia and China. Although only 36 percent of its revenue comes from overseas sales, Dell has 23,000 employees in other countries and only 22,000 here at home.

These offshoring companies are increasingly paying third world wages for high-end products and handsome profits. The stock option expensing proposal is not the cause of their outsourcing decisions: these companies don't expense their stock options. By invoking outsourcing fears to justify Congress' overriding the expertise and independence of FASB, FASB's opponents undermine the integrity of our financial reporting systems and accounting standards setting process, both of which are critical to investor confidence and long-term capital investment in U.S. companies.

Another red herring argument is that requiring stock option expensing will eliminate broad-based stock option plans and hurt average employees. Again, the facts are to the contrary. Companies that currently offer broad-based plans to their workforce such as Home Depot, Wal-Mart, and Netflix, have already determined that they can expense options without having to terminate their stock option plans. Other companies, such as Microsoft, are replacing stock options with stock grants, but I haven't heard of their employees complaining about getting actual shares of stock. Even these broad based plans, however, reserve more stock options for corporate executives than average workers. The National Center for Employee Ownership has stated: "[W]hile the growth of broad-based options has been an important economic trend, our data nonetheless indicate that even in plans that do share options widely, executives still get an average of 65% to 70% of the total options granted."

It is also important to note that most U.S. small businesses – in fact, most U.S. employers – don't offer stock option compensation to their employees now and, thus, are unlikely to be affected by the FASB proposal. The Small Business Administration estimates that, in 2001, the latest year for which data is available, about 23 million small businesses were operating in the United States. That same year, the IRS received about 6 million corporate tax returns, 2 million partnership tax returns, and additional millions of returns from S corporation owners and sole proprietorships filing as individuals. This data suggests that most small businesses operate as partnerships, sole proprietorships, or S corporations. A nationwide survey by the Bureau of Labor Statistics of stock options issued in 1999, a banner year for stock options, found that only 1.7 percent of non-executive U.S. workers received any options that year, suggesting that, nationwide, relatively few businesses are actually issuing stock options to their employees. Another recently released study of U.S. work establishments with less than 100 workers in a single location by Douglas Kruse and Joseph Blasi of Rutgers University, and Richard Freeman of Harvard University, indicates that 95% of these small businesses did not grant options to more than 10% of their workers in 2002.

The impact that FASB's proposal does have on small business will be eased by three special rules in the FASB proposal to help private companies, including startups and small businesses, mitigate the cost of stock option expensing. First, the proposal gives private companies a choice in how to value their stock options. They can use either the same valuation models as public companies, or an alternative "intrinsic value" method which allows a company to track a stock option's exercise price compared to its stock price and get a final, exact value on the date the stock options are actually exercised. This alternative method eliminates uncertainty in determining a stock option's value, in return for stretching out the expense over time to the exercise date. Second, in contrast to public companies, the FASB proposal allows virtually all private companies to begin stock option expensing prospectively and skip the new accounting for any outstanding, non-vested stock options. Third, the FASB proposal would give private companies an extra year to begin compliance, requiring them to begin expensing in 2006 instead of 2005.

A final argument used by many stock option opponents is that precisely estimating the value of stock options is difficult. But that's true of many items on a financial statement, from the value of goodwill to the reserves required to protect against uncollectible receivables or loans. Companies are already required to value compensation instruments that are even more complicated than stock options, such as long-dated stock warrants and convertible bonds. As Warren Buffett once said, the only value that everyone agrees is incorrect for a stock option is zero.

The bottom line is that the valuation issue, as well as other technical aspects of stock option accounting, ought to be resolved by the accounting experts, of which Congress isn't one.

What Congress can add to the debate is its understanding of the role played by stock options in too many of the corporate scandals that have come before us. I chaired the Enron hearings before the Permanent Subcommittee on Investigations and saw how the books were cooked to make loans and fake sales look like income so Enron could impress Wall Street analysts and boost its stock price. Stock options were the fuel for Enron's dishonest accounting. Enron's CEO took home $123 million from exercising stock options in the same year the company went bankrupt, and so many lost their jobs and life savings.

In addition to enriching executives, stock options played a second vital, but as yet unrecognized, role in the Enron scandal by enabling Enron to show huge paper profits without having to pay taxes on them. During our Subcommittee investigation, I wondered how Enron executives could create huge phony profits to increase the company's stock value and make their own stock options worth a fortune, without sapping the company's treasury to pay income taxes on the inflated income. I learned the answer was those same stock options, which at the same time they were enriching executives, provided Enron with a big enough tax deduction to eliminate any worries about taxes.

For the last five years before it declared bankruptcy, from 1996 until 2000, Enron told its stockholders that it was rolling in revenues, claiming a 5-year U.S. profit of $1.8 billion, according to an analysis of Enron's public filings by Citizens for Tax Justice. During those same years, Enron deducted about $1.7 billion in stock option compensation from its tax returns as a business expense -- cutting its taxes by $600 million and eliminating its tax liability entirely in 4 out of the 5 years. In other words, the stock option double standard allowed Enron to dole out this form of compensation to its executives, claim a huge tax deduction, and escape paying U.S. taxes, while not showing any stock option expense on its inflated financial statements. Enron had a lot of company, by the way, in benefiting from the stock option double standard.

FASB and the folks we rely on to set accounting standards resisted enormous pressure from corporate executives when they decided to end the accounting anomaly that keeps stock options off corporate books as an expense, thereby making a company's earnings look better than they are. Hopefully, Congress will also stand up to the powerful political forces being brought to bear to overrule FASB. Congress needs to match its courage with FASB's courage and protect FASB's independence and ability to resolve controversial accounting issues based on accounting expertise rather than political considerations. That's what we committed to do two years ago when we enacted the Sarbanes-Oxley Act, and it is critical that, in this first big test, we continue to champion, preserve, and fortify FASB's independence. Small business won't be hurt by honest accounting.

Senator LEVIN. These supporters include Alan Greenspan, Treasury Secretary Snow, SEC Chairman Donaldson, Public Company Accounting Oversight Board Chairman McDonough, former SEC Chairman Levitt, and a lot of investors, including Warren Buffett, the Council of Institutional Investors, the Investment Company Institute, Financial Services Forum, Consumer Federation of America, National Association of State Treasurers, Institute of Management Accountants, and the Conference Board's Commission on Public Trust and Private Enterprise.

None of these folks want to hurt small business. All of these folks want honest accounting, and that is what this is all about.

Second, I must say I admire the guts and the courage of the major accounting firms in this country because they have decided to do what they believe is right, which is to support the FASB approach. I can't tell you the pressure that was put on those accounting firms to go against FASB. It was huge. We talk about lobbying? The pressure placed on the accounting firms by their clients to go against FASB was intense.

I have seen that kind of lobbying, by the way, up close and personal. I testified in front of FASB 10 years ago when it first tried to adopt this rule, and there was a room full of hundreds of executives all testifying against FASB, putting huge pressure on them, and they backed down.

They didn't back down this time, and rather than being critical of the four accounting firms for coming together and standing together to do what they believe is right, despite huge pressure from their own clients, I give them great credit for coming together. If they feel that they have to stand together because they are stronger when they are all taking a similar position, then that is not uncommon around here. We can understand that, and I give them credit for their courage. I hope we have the courage not to interfere with the independence of FASB, just the way accounting firms have the courage now to protect the independence of FASB, because that is what this is about. It is not about whether or not we are going to promote incentive pay or stock options.

I am all for stock options. I am all for honest accounting. These are not inconsistent. The question is: How do you account for incentive pay? That is the issue here—not whether you give stock options or bonuses or other forms of incentives, which I think all of us are for. It is a question of accounting for it, and when the professionals who are in charge of the accounting rules tell us honest accounting requires that they be accounted for just like other kinds of incentive pay, I think it would be a mistake for the political leaders of this country to then interfere with that judgment. That is what we are being asked to do, to overturn the independent judgment of FASB. I hope we resist that pressure just the way the accounting firms have resisted the pressure and just the way FASB has resisted the intense pressure from mainly executives. Let's not kid ourselves, what is involved here for the most part are stock options going to executives, because that is where most of the stock options go. The vast majority of them go to executives and have fueled the huge increase in executive pay that we have seen in this country.

In 1990, the pay gap between CEOs and average workers was 100 times. Last year, CEO pay at 350 of the largest public companies was 300 times average worker pay, and stock options were the largest single factor in that pay gap.

Now, with the time that is left, I just want to ask a few questions about some of the statements which have been made about the alleged negative impacts of honest accounting. There has been a study made of companies that have switched to stock option expensing voluntarily, without being required to, and this was a Towers Perrin study. Are any of our panelists familiar with that study?

Are you, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. The staff has looked at it. It was part of the input into our report.

Senator LEVIN. Does that study show that of the 335 companies that switched to stock option expensing, their stock performance was the same, on average, as the rest of the S&P 500?

Mr. HOLTZ-EAKIN. It showed a minimal impact of the move to expensing on stock prices.

Senator LEVIN. All right. Now, Merrill Lynch has taken the following position, against the argument that expensing options will harm U.S. technology leadership and job creation. Their point is this: the logic that expensing stock options will harm technology leadership leads you to the following faulty logic: U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements.

"One might as well argue," Merrill Lynch says, "that money spent on research and development shouldn't count as an expense because it provides employment and helps industries advance."

Do you agree with that, Mr. Herz?

Mr. HERZ. Yes, I agree with that, and I would go further. There are lots of good things that, you know, we just account for properly: pensions, training, occupational health and safety costs. All those, I think we would agree, are good things. But we do proper accounting for them.

So it is hard to understand why for this particular item—and I guess I understand a little bit the emotionalism because it involves the ownership and motivation of the people through the ownership. But, you know, the question really from our point of view is: What is the right accounting? What will make the financials more transparent? What will make the capital markets work better?

Senator LEVIN. On that issue, on the ownership issue—because I think all of us want to promote ownership. I have been a big supporter of ESOPs, employee stock ownership plans. I think they are great. I am all for them. It is a different issue from how do you account for stock options and other incentive pay. I want to just get into one particular kind of stock options, incentive stock options, ISOs, that are given to employees that qualify for special treatment under the Tax Code. I want to see if I understand this correctly.

These incentive stock options which are given are taxable when they are given.

Is that correct, Mr. Herz?

Mr. HERZ. I am not a tax expert, but there used to be a thing called an 83(b) election, which effectively says tax on the grant date, and that is a decision versus kind of waiting to get the final result and the appreciation and get taxed at that point.

Senator LEVIN. So we have a situation where a lot of our employees have the option to pay the tax when the option is granted to them rather than when it is exercised. Is that correct, as far as you know?

Mr. HERZ. Well, yes. Based upon this conversation, that is my recollection. But I am not a tax expert.

Senator LEVIN. Okay. Does anyone else on this panel know about that?

Mr. HOLTZ-EAKIN. No.

Senator LEVIN. All right. Well, then, let me just make this statement, and if it is not true, I will have to ask someone on the second panel. Unhappily, I can't be here to hear the answer, but we will find out for the record.

The National Center for Employee Ownership has reported the following: in a 2002 survey of 275 high-tech, venture-backed firms with 20 to 100 employees, over 80 percent of the firms gave their employees incentive stock options that qualify for special treatment under the Tax Code. Incentive stock options, or ISOs, allow an employee to pay the tax on the value of their stock options on the grant date, employees who prefer to pay for them because they think they have less value now than they will downstream, which means they have to be valued now. And it happens all the time. Do you disagree with that?

Senator ENSIGN. Yes.

Senator LEVIN. All right. In other words, if I am misstating that, fine. What I am saying is that under this provision of the Tax Code, employees with these incentive stock options have the right——

Senator ENSIGN. They pay ordinary income when they take the gain.

Senator LEVIN. They can also value them now. They have an option—no, no. Excuse me. I hope we have a tax expert in the room here because this is a very important point. We all assume that employees pay the tax when they exercise the options, and that is probably the case much of the time. But employees under these incentive stock option plans qualify for special treatment under the Tax Code where they are allowed to pay a tax when it is granted, before it is exercised. In order to do that, they have to be valued.

Now, again, if I am right—and I believe I am—this is a very significant point because what it means is that the argument about valuation, that you can't value these things, is wrong on many counts. We value things that are much more difficult to value than stock options. For instance, grants of stock which will be given to you if a company reaches a certain profitability level, those grants of stock are valued now, even though you don't know if a company will ever get to that profitability level. They value that now. It is compensation. There is no exception for that. It must be valued on this year's—it must be shown, excuse me, on this year's books of the company. So there are very difficult things to value in terms of compensation which may or may not be achieved downstream.

For instance, if a company reaches a certain point, you promise a bonus, that must show on the company's books as compensation.

Even though it is conditional upon a company reaching a certain point, it must show as compensation on a company's books, unlike stock options which never have to show on a company's books as a compensation.

I want to go back to this one point. I think it is important for this committee to get the answer to the question I am raising on the incentive stock options that qualify for special treatment under the Tax Code where an employee is allowed now to take a tax deduction based on the value now of that stock option, even though it cannot be exercised now and can only be exercised later.

Mr. Chairman, I think I have probably taken more time than I should, and I want to thank the Chair and my colleagues for their leniency on this.

Senator ENZI. Thank you.

Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

I do want to address some of the things I talked about in my opening statement. First of all, Senator Enzi's legislation would exempt the top five executives. We have heard that this is all about the executives in the company and that would exempt the top five executives.

In the light of Sarbanes-Oxley, if you are a CFO/CEO and you have to certify these financial statements, and now with the severe penalties that Sarbanes-Oxley brings to the fore, if you were one of those CEOs/CFOs, would you continue broad-based stock option plans if you had been giving them in the past?

Mr. HERZ. If I think they are good thing, yes, absolutely.

Senator ENSIGN. And you think you could value them accurately based on——

Mr. HERZ. Oh, yes. They are already in the footnotes, and those are part of the audited certified financial statements, have been for 8 years. There are 500 companies doing it. Microsoft just took a charge of $2.5 billion or something.

Senator ENSIGN. Isn't Microsoft now doing stock grants, though?

Mr. HERZ. Going forward they are going to restricted stock grants, but they took their charge for the existing options, some number like that. You know, it takes some work, particularly if you have got a broad-based plan; just like if you have a pension plan you have got to do some work. But these things—our experience, you know, we had a whole panel of valuation experts. We talked to the companies that are actually putting it in their——

Senator ENSIGN. Would you use binomial or Black-Scholes going forward?

Mr. HERZ. It depends on the company's circumstances, and that is why we—first of all, the myth that there are two different methods is not right. They are based on the same financial economic theory. The binomial model is just a more flexible version of Black-Scholes. Black-Scholes is just like a hard-wired thing. The binomial is like being able to open it up by periods, but they are based on the same financial economic theory. The binomial allows you to put in more inputs, model in blackout periods. So if you have a more complicated plan that goes out longer, you might want to use the binomial in order to get a more refined estimate, just like if I am a company that only has a few fixed assets and figuring out depreciation, I will probably use some historical kinds of facts versus doing—if I had a lot of fixed assets and different types, I would probably do what are called lifing studies.

Senator ENSIGN. Well, why do you think—because the chairman's bill exempts the top five executives. Why——

Mr. HERZ. No, the other way around. It captures the top five.

Senator ENSIGN. That is what I mean. But what I mean is that it basically takes away the argument that—the CEOs/CFOs of the company would be arguing to keep broad-based stock plans because it benefits them. So we have taken that off the table. Why would they, in arguing against what you all are doing because they believe that it has been a valuable tool, and the feedback that I am getting from them is negative, and I don't know that a lot of you understand it, or accountants in the public understand it. Why do they think there are so many problems with it? Why are they concerned about Sarbanes-Oxley? Why have we heard from so many of them that they will do away with broad-based stock option plans because of what you are doing? I mean, why are those concerns out there if they are not real?

Mr. HERZ. Well, let me make a few comments before I try to play psychologist.

Senator Enzi's legislation, we believe it is fatally, seriously flawed conceptually on a number of grounds, and it really would amount to no expensing, largely. It has a method where there is zero volatility, it doesn't capture the actual value of the options, and it can be manipulated very easily to come to no expense. So, you know, I don't think that does any kind of trick, with all deference to my colleague accountant here, the good Senator.

Why they are arguing that, they may believe it. I happen—this is only my own view, okay? I am not them. I believe that they truly believe, you know, in their business model. I have seen it because I have invested in some of those companies, start-ups. Some of them went public, and they have very much a culture of that and a true belief that that is the secret formula to success. I think that they are, therefore, almost foisting one argument after another after another after another after another.

Our role is to try and get as much information and input as we can to understand as best we can what the real situation is, and that is what we try to do.

Senator ENSIGN. Well, Mr. Chairman, like I said, I know my time has expired, and I just think that the people who are out there who have created these successful business models ought to be paid attention to more closely than they are today because we are in a highly competitive global marketplace, and if we take away one of the tools that has led to this high-tech revolution that we have had in the United States of America, if we take away one of the most valuable tools they have to attract great employees, we could do some great damage to our economy. I know that that is not what you are after, but that may be, in effect, what you end up doing.

Thank you, Mr. Chairman.

Senator ENZI. Thank you.

Senator Bayh.

Senator BAYH. Thank you, gentlemen, for your time today.

Let me start off by asking a couple of questions about the differing institutional roles of the organizations you represent and our responsibility here in the United States Congress. Am I right in saying, Mr. Herz, I think I wrote down during your opening remarks that you realize that the accounting issues are important to innovation and competitiveness. That is why you take your time to try and get it right. My understanding is your charge is, while you understand those are important, it is not really to take into account macroeconomic issues like innovation and global competitiveness and that sort of thing; is that correct?

Mr. HERZ. Yes. We have a charge that says we must be what we call neutral. That does not mean we apply Swiss accounting. It means that in developing what we think is the better accounting, we look at the economic attributes of the transactions, how they impact on the company, its earnings, its cash flow, its financial position, earnings per share.

Senator BAYH. My point is you focus strictly on the accounting and not so much on the—once you are convinced you have got the accounting right, in your opinion, you do not focus on the ramifications quite so much.

Mr. HERZ. And I think the belief there is that the public good we are serving is that the better information therefore makes for a better capital market, you mentioned all of that.

Senator BAYH. Right. Let me follow up on that. It is possible that these different concerns need not be in competition with one another. As I said in my opening comments, I hope we can reconcile it because you do not want to sacrifice transparency and accuracy for the sake of competitiveness and innovation. At the same time, innovation and competitiveness are important, and to the extent there is interplay between these two things, we need to figure out what it is and try and get the balance right so that we do not just serve the interests of accounting accuracy, and that is very important, but that we serve the overall interests of the society we represent well.

So there are some institutional differences here in terms of the breadth of issues we look at, and I am interested to know, is there any analysis been done to see if these things, first of all, can be—I am going to have you, Mr. Eakin—is that how you pronounce your last——

Mr. HOLTZ-EAKIN. Holtz-Eakin.

Senator BAYH. I am sorry. You did address this at least in theoretical terms, but have any of you done any analysis on what the impact the proposed changes would have on innovation, on global competitiveness, on those sorts of broader concerns?

Mr. HERZ. My esteemed colleague can answer that.

Senator BAYH. I assume the answer would be no and no, and Mr. Holtz-Eakin, let me get to you.

You did mention some of these concerns. I took from the tenure of your answer though, that your response was sort of from a theoretical economic perspective as opposed to having actually done an in-depth survey of some kind.

My additional question to you would be, I wonder if when the change in the treatment of health costs was done, did people anticipate the sort of profound impact that it was going to have on the health care system, or at least did they try to anticipate what the consequences were going to be? As I said in my opening statements, those changes may have been good, they may have been bad, but they were profound, and I would hope that before we undertook that kind of thing somebody would have attempted to think it through.

Mr. HOLTZ-EAKIN. There are a lot of different dimensions to your question, and I will address them one at a time. The first is that there is a lot of research on the importance of institutions, legal, regulatory and accounting institutions for economic performance.

Senator BAYH. These specific proposed changes.

Mr. HOLTZ-EAKIN. These specific proposed changes, we have seen——

Senator BAYH. The effect on innovation——

Mr. HOLTZ-EAKIN. Canada propose to——

Senator BAYH. —— [continuing]. And global competitiveness.

Mr. HOLTZ-EAKIN. We have seen Canada propose and implement this.

Senator BAYH. I am sorry, we have seen?

Mr. HOLTZ-EAKIN. We have seen Canada propose and implement expensing. We have seen the EU move there, but we have not had a chance to observe what happens after the fact. But we will have the chance to observe changes from regimes where you did not expense to where you did.

Senator BAYH. We will have.

Mr. HOLTZ-EAKIN. We do not have——

Senator BAYH. But have we as we are sitting here today?

Mr. HOLTZ-EAKIN. We do not have this exact isolated change, but we have observed comparable events.

You talk about retiree health benefits, the evidence from that, again not definitive, is that it did not change dramatically overall valuations of firms. Investors were broadly aware of the——

Senator BAYH. It had a dramatic effect on——

Mr. HOLTZ-EAKIN. It had implications——

Senator BAYH.——[continuing]. Health care was treated.

Mr. HOLTZ-EAKIN. But the channels were—we can talk about those channels, but in terms of the impact that we would see from this expensing proposal, you would expect it to affect valuations of firms.

Senator BAYH. Again, this gets to my first question, which is the range of issues that you have to consider may in some respects be different than the range of issues we have to consider, and while it may not have led to the change in valuations, it did have broad societal impacts that at least deserve some discussion and understanding before you embark upon a profound change I would think.

Yes, Mr. Herz?

Mr. HERZ. I will use some loose wording. Let us suppose that we all agree that a proposed accounting change is absolutely right from accounting, a strict accounting point of view, that it is the right information. It provides better information, better capital allocation because people are now better informed and can make better decisions. Are we saying the truth hurts? I am trying to figure this out because we are visited all day long by people from different industries who will make cases like that. When we went to bat trying to deal with the special purpose entity problems that were highlighted by Enron, and that turned out to be fairly widespread, people would come to us and say: Yes, well, I understand it is really the company's debt, but my special purpose entity is very good. It allows the company to borrow more, to employ more people, to do more R&D. That is good for the economy.

We had a person a while back come from—was advocating we do something related to the steel industry as they were having some problems, and he said: You know, the problem, the steel industry, backbone of America, absolutely needed for national defense. And I do not want to seem cynical here, but it is just that we are on the front line of listening to these things. He said: The problem is we are not cost competitive. We need to be more cost competitive. The big problem there is we have all of these pension costs. You, Mr. FASB, we want you to put all that in the footnotes, take it out of the financial statements.

That is not going to make him more cost competitive. It is just going to hide the information.

Senator BAYH. Of course. My point simply is to you that accuracy is important. There may be consequences to changing the accounting treatment that I think at least from the broader societal perspective, you may reach a decision it is the right thing to do, let us go ahead. But to ignore the fact that there may be other consequences, it seems to me, would be a dereliction of our duty.

Mr. HERZ. I absolutely agree with that. I agree with that, and I thought you couched your opening remarks—you guys have a tough job every day balancing the——

Senator BAYH. Which leads me to my last set of questions for all three of you, which is, has there been any analysis done of some of these other proposals that seek to strike a balance and to reconcile the competing differences, things that would treat large companies and small companies somewhat differently, things that would restrict the exercise of options on the part of executives so they could not game the system, so to speak, things that would encourage or treat differently companies that had broad democratic use of options as opposed to those that were highly concentrated among use?

There are several other suggestions that have been made about how you might be able to try and reconcile these two things. Has there been any attempt to look at those alternatives and to see how they would kind of stack up versus the ones we have been presented with here?

Mr. HERZ. It seems to me they are not mutually exclusive, doing the right accounting and doing some of those other things ought to be potentially complementary. That is why I said that—and again, I am advocating my public policy. That is my job, to do the right, get the right accounting. But I believe very strongly in that, and it seems to me that if you then say, well, I want to counteract, notwithstanding the accounting, I really want to continue to make sure there are broad-based plans. Let us figure out some other way through means at your disposal, taxes or whatever. And I understand that bumps up against other competing priorities.

Senator BAYH. It reminds me—and this will be my final comment, Mr. Chairman. It reminds me in some ways some of the curriculum we had in law school where we would focus on efficiency analysis, what was the most efficient allocation of resources, and you tried to enact the laws in a way that would promote maximum efficiency. However, you also had to be aware that there were other societal concerns in addition to efficiency, and there were times in a democratic society that perhaps you would choose not to take the most efficient path, you would try and quantify what the cost was, but you were trying to achieve other objectives. I do not know whether it is innovation or competitiveness. That is why I ask.

And, Mr. Chairman, I am concerned. What if any—there may be none—but what, if any, is the effect on innovation? What is the effect, if any, on global competition? It is only then that you can see, well, is there a tradeoff here, and if so, how big is it, and what is the price we are paying for going one direction or the other?

Mr. HERZ. I am with you, but the best I can do is all the highly-esteemed people that have spoken, Mr. Greenspan, former Chairman Volcker, other people whose analysis seems to be that it would not have those negative effects. I do not know what their basis is other than the genius in their head.

Senator BAYH. Yes, Mr. Batavick?

Mr. BATAVICK. Yes. The only thing that I would like to add to what Bob said is that for the most part this information is already included in footnote disclosures. So when we first adopted our Statement 123, the analysts and other users of that information could very well have taken that information into account. I do not believe there are any studies out there that show that putting the information in the footnotes caused innovation to be hurt whatsoever. And also, if our proposal does go through and we do require expensing on the income statement, that information will be readily available, be readily disclosed. We have specific disclosures around that information so the readers of the financial statements can tell exactly what the expense is of the stock options.

Although I do not have any empirical data, my gut tells me that it should not hurt innovation because if it is a good business decision to have a stock option plan, then the accounting for that really should not impact innovation in the company.

Senator BAYH. Then, Mr. Holtz-Eakin, I will let you finish up because you have been generous with your time, and there are other hearings going on, unfortunately simultaneously. Your gut tells you, your intuition tells you, that may all be exactly right, but I go back to the retirees' health care cost situation. You know, from an accounting standpoint, absolutely, and it may have been, in fact, the absolute right thing to do, but there were some pretty significant consequences, non-accounting consequences that flowed from that. That had a big impact on society, and I think at least we have some responsibility to try and anticipate what those impacts are going to be, and is it, in fact, the right thing to do on balance? That is really my whole point here today.

Mr. Holtz-Eakin, you get the last word as far as I am concerned.

Mr. HOLTZ-EAKIN. What I hear you saying, Senator, is that there may be larger policy objectives than simply the good accounting and that is certainly the case.

The evidence in the economics literature is that efficient well-informed capital markets on average engender innovation and productivity growth better than almost any other instrument that the private market could imagine. It still may be the case that as a policy matter you might wish to, for example, target more societal resources toward the high-tech industry for a policy objective, and if so, the efficiency question becomes whether an accounting tool focused on employee compensation is the best way to achieve that.

Senator BAYH. I am glad you mentioned that.

Mr. HOLTZ-EAKIN. That is the way to frame the issue.

Senator BAYH. Because Mr. Herz mentioned this in his remarks too, and this really will be my final word. Do these interests in some way compete? If so, how significant is it, and if it is in some way significant, are there different ways to achieve the other societal objectives, innovation, global competitiveness, other than the accounting treatment? And most importantly for us, Mr. Chairman, have these questions been answered? It seems to me that is kind of a big issue hanging over us today.

Thank you.

Senator ENZI. Thank you very much. I do have to comment in regard to one of your comments about the courage of the Big Four accounting firms. I am told by businesses that the cost of doing this binomial or the Black-Scholes calculation will run about half-a-million dollars a year. That is not courage. That is compensation.

I appreciate all the comments here. In that previous round, I concentrated on both applauding you for the small business aspect that you put in there, and encouraging you to go further, and I am very encouraged by those comments. But I do have to ask just a little bit about the stock option expensing itself.

Mr. Herz, I would like your comments on this statement: Key valuation assumptions are subject to considerable judgment and significantly affect option values. For example, a 5 percentage point change in volatility, which you mentioned in regard to my bill, which can be justified solely by alternative ways of looking at historical volatility, produced on the average a 15 percent change in option value, a change in expected term from 3 to 5 years, again, easily justifiable, produce on average nearly a 40 percent increase in option value. The key assumptions are subject to so much judgment and guesswork that selections among a wide range could be justified as the best estimates. The end result would adversely affect the comparability of financial statements of companies in the same industry and at the same stage of development.

Do you have a reaction to that?

Mr. HERZ. Yes. We have met several times and our staff with our panel of very knowledgeable people. We have also visited companies, and there is some judgment involved and there is some skill involved in doing this. They posited though that the range would be a lot tighter than you are stating, and certainly the ranges historically have been tighter than that, and that is because there is some market discipline in all of this that goes on. There are the auditors or the SEC looking at things. There are people that, quantitative people, buy side analysts and all that that compare one company with another, and it imposes some discipline.

This is a real issue and we have posed in our book here, which by the way most of it is just explaining why the rationale behind our decisions and then providing useful guidance and some examples for people, not the standard itself. We have posed a lot of questions around the valuation. Some people would like us to basically get much more prescriptive so that you would almost ensure that the range is very small. We could prescribe volatilities. We could prescribe—we could take the term out of it and just see how long the employee actually stays. All those things are possible.

We are trying to go along the lines of an SEC study that was delivered to Congress last summer on what is called principles-based accounting, where they strongly advocated that the use of bright lines and arbitrary uniform assumptions did not get to the best reporting. What got to the best reporting was diligent analysis and judgment by the companies and by the auditors. I recognize, however, that there are tensions in this current environment. There are people who—and I understand it—that are concerned with the second guessing aspect, whether it be the trial bar or enforcement agencies or whatever, and that is a much broader issue than I think this particular topic.

All registrants now disclose what are called critical accounting estimates, and those are inherent areas in accounting that have significant judgment and impact on the reported financial statements. I can read you the one from—I just happen to have Intel Critical Accounting Estimates: The methods, estimates and judgments we use in applying our accounting policies have a significant impact on the results we report in our financial statements. Some of our accounting policies require us to make difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Our most critical accounting estimates include assessment of recoverability or goodwill, which impacts write-offs of goodwill, valuation of non-marketable securities, et cetera., valuation of inventory, and they go on and on and on.

Senator ENZI. And they charge considerably for the work that they do, and then put in a little protector from the trial lawyers, right?

Mr. HERZ. No, this is something that the SEC put in, not the other—it is to inform people that the income statement and the balance sheet include a lot of estimates. We have a cash flow statement that, for those who say that accounting ought to be much more cash-based, well, you have a cash flow statement, but there is a whole package of financials.

Senator ENZI. I want to go ahead with that statement that I was using because it goes on to say: Beyond the complex accounting questions involved, the issue of employee stock options also raises some significant economic considerations. Not only would the approach under consideration be harmful to mature companies, it would impose the heaviest burden on emerging high-growth companies. There is some more to the statement, but that is enough to get the flavor for it. That is from a Coopers & Lybrand letter of February 5th, 1993, and the person to be referred to for questions is you. I do not want to put you in the category of a reformed Senator, but——

Mr. HERZ. We live and learn.

Senator ENZI. I appreciate the testimony of all three of you, and I do have quite a few additional questions in more detail. I have learned that if I do the really detailed questions here, it puts people to sleep, but it is information that we significantly need, and particularly from Dr. Holtz-Eakin.

Thank you very much.

We will change now to the second panel, and I want to sincerely thank the second panel for their patience and consideration, but mostly for the outstanding testimony that they have that we are about to put into the record so that it can be shared extensively.

While they are taking their position there, I would like to take this opportunity to welcome our second panel to the Senate Committee hearing on the impact of stock option expensing on small business. This is a rather large panel, and we look forward to hearing all of your comments on the important issue.

First I would like to welcome Dr. Keith Carron, the President and Founder of CC Technology, and the CEO of Delta Nu, both small business start-ups located in Laramie, Wyoming. I thank you for coming here to testify, Dr. Carron, and let me personally thank you for all you have brought to Laramie through your hard work and enterprise. CC Technology and Delta Nu are great examples of the positive impact that small businesses can have on our rural communities.

Our second panelist will be Professor Stephen Diamond, and Professor Diamond is visiting us today from Cornell Law School, where he teaches international corporate governance issues. He also fills various advisory and consulting positions for large and small companies, and we thank you for coming today.

Next I would like to welcome Dr. Jere Glover back to the Senate Committee on Small Business. Mr. Glover has worked on both his committee and the House Small Business Committee and has testified before Congress many times concerning the matters of small business, and we appreciate his expertise.

Following Mr. Glover is Marc Jones. He is the President and CEO of Visionael Corporation, a small business located in Palo Alto, California. He is here before us as a small business owner, and an executive involved in every aspect of his company from strategy implementation to administration.

Then we have—I am going to need some help with this name—John Kavazanjian, the President and CEO of Ultralife Batteries, Inc. Ultralife was incorporated in 1991 and has since become a public company with offices in New York and England.

Then Mr. Robert Mendoza will be testifying. Mr. Mendoza is the Founder and Chairman of Integrated Finance Limited, a global financial advisory committee. Mr. Mendoza is also a Managing Director of IFL Capital, which is a limited liability company, and the U.S. broker-dealer affiliate of IFL.

Next we have Mr. Christopher Schnittker, the CFO of Cytogen Corporation, located in Princeton, New Jersey, and Cytogen is a publicly traded biopharmaceutical company that develops medicines for cancer, respiratory and other diseases, and as a fellow accountant, I welcome your comments and insight here today.

Dr. Smith was not able to be here so we will submit his testimony for the record.

We will begin then with Dr. Keith Carron of Laramie, Wyoming.

Dr. Carron.

**STATEMENT OF KEITH CARRON, PH.D., FOUNDER AND PRESIDENT, CC TECHNOLOGY, LARAMIE, WYOMING, ON BEHALF OF THE UNIVERSITY OF WYOMING**

Dr. CARRON. Thank you, Chairman Enzi and members of the committee for inviting me here. I am President and Founder of a technology small business start-up. We are in Laramie, Wyoming, and I would like to explain the role that stock options play in the development of our company and to tell you why I believe the proposed FAS 123 would be detrimental to our growth and perhaps even our survival.

Our company was conceptualized in 1997 by two chemistry professors from the University of Wyoming, and I want to state right off the bat that we did not follow the traditional rules of finding large capital to start our company. Instead we wrote Small Business Innovation Research proposals and Small Business Technology Transfer proposals, otherwise known as SBIR and STTR proposals.

We waited until the proposals were funded, then we incorporated the company, and being two university professors, somewhat naive in business, we added a third founder who is an expert in entrepreneurship.

Since 1998, our company has acquired over $3.7 million in seed capital from the SBIR and STTR programs. These grants have led to two important outcomes, first as intellectual property in the form of patents which are owned by the university and licensed back to us for commercialization, and second, we developed a manufacturing division which designs, manufactures, and sells our products.

The first outcome, I would like to comment, is a direct result of the Bayh-Dole Act in 1980, which was conceived to capitalize on a pool of knowledge that exists in academia. The SBIR/STTR programs have provided us with an avenue that takes this knowledge from the university and to produce it in the marketplace.

The second outcome, our manufacturing division, has already created jobs and wealth in Laramie. Laramie is a small community, about 30,000 people. Companies such as ours are rare in Wyoming, but we are now demonstrating how a technology based enterprise can play a vital role in bringing new wealth to our community by creation of high value-added products that are sold worldwide.

Our manufacturing division has grown out of a single engineer and myself to a business with six full-time employees, and five part-time employees. These employees have made significant contributions to the growth of the enterprise and will continue to do so. In Laramie it is very hard to find key employees, so we have to either retain them when we do find them, or we have to recruit the experience from elsewhere. Recruitment requires cash. In a start-up business cash is short. We are usually cash starved, and as my business adviser reminds me, when you are out of cash, you are out of business.

So one of the most important components of our cash preservation plan is to replace cash incentives with stock options. The best method we have found is the IRS-endorsed Incentive Stock Option Plan, which provides our employees with the opportunity to participate in the wealth creation from their own ongoing contributions.

For example, we are now trying to recruit a high-salaried employee from California, and the most compelling component of our offer has been the stock option plan which will allow him to share in the wealth that he will help create.

Lowering profits by expensing stock options creates, in my opinion, a circular problem. Under FAS 123, the options will be expensed, resulting in decreased profitability for my company. The grantee is thus less likely to exercise the option, rendering invalid the whole original assumption that the option has incurred an expense.

Our small business was funded by seed capital provided by the United States Government through the SBIR/STTR programs, and this model, by its very nature, leads to neutral income statements. These programs are not intended, in themselves, to be a source of wealth creation. When a company is ready to emerge from the R&D mode and to commercialize, it must achieve and maintain profitability to attract working capital. Expensing stock options works against this goal and adds an intangible imbalance to the income statements.

Why do I say intangible? The majority of small businesses fail. The expensing of options will only increase this failure rate, and the irony is that the expense will never be incurred because the options will never be exercised.

Finally, to comment on how widespread the knowledge of FAS 123 is, a week ago I was approached by two bankers from Wheatland, Wyoming. They wanted to bridge our company with a Government agency, the Export-Import Bank, to support a working capital line of credit. The Export-Import Bank is designed to help small companies export their products and reduce the country's trade imbalance. But it is required right up front that their clients have a positive net worth. I believe that by expensing stock options, we would decrease our likelihood of ever receiving this assistance.

I would also like to note that neither of the bankers from Wheatland, Wyoming had heard of FAS 123, and I would also like to note that when we formed our stock option plan through a CPA firm, we were never told that they would show up as an expense on our balance sheet.

I would like to end by saying that, I believe because of the recent abuses highly visible by public companies, the FASB is trying to create a solution, but it will have unintended consequences of doing significant harm by slowing the growth or preventing the growth of private small business start-ups.

Thank you.

[The prepared statement of Dr. Carron follows:]

Testimony of

**Keith Carron, Ph.D.**

On behalf of the University of Wyoming and CC Technology

Presented to the

U.S. Senate Committee on Small Business
and Entrepreneurship

on the topic of the FASB and Small Business Growth in
Rural States

April 28, 2004

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Senator Snowe and Members of the Committee:

My name is Keith Carron, founder and President of a small business start-up, the primary engine for the nation's economic growth and job creation. Thank you for offering me an opportunity to tell the story of my small business, CC Technology, in Laramie WY, and to explain the role that stock options play in the growth of my company. I do not wish to represent myself as an expert on stock options, but rather to provide you with a story of how they are used to create small businesses and why I believe the proposed FAS 123 would be detrimental to the growth and perhaps even the survival of my company.

**CC Technology -- The Origin of a University Spin-Off**

CC Technology was conceptualized in 1997 by two University of Wyoming chemistry professors: Keith Carron and Robert Corcoran. I use the word conceptualized, as we did not follow the traditional approach of capitalizing a company; rather we followed a plan more familiar to university professors. We initially wrote Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) proposals to the National Science Foundation and the National Institutes of Health. The proposals centered on ideas developed at the University, which we felt, had commercial potential. When the proposals were funded we incorporated as CC Technology. Being two university professors naïve about business, we added an experienced entrepreneur, Eugene Watson, to our founding team.

As I tell the story of CC Technology, I want to emphasize points concerning stock in small businesses and the role of stock options. I will summarize these points in a succinct statement at the end of this testimony. At this point it is important to understand that our business was founded with three shareholders who held 100% of CC Technology's stock.

- 100 % of CC Technology's stock was owned by its three founders.

Over our short history, CC Technology has been quite successful in writing SBIR and STTR proposals that have led to a total of over $3.7 million dollars in funding. Our technology developed through these grants has led to two important outcomes: first, intellectual property in the form of patent applications that are owned by the University of Wyoming and exclusively licensed back to CC Technology for commercial development; second, a manufacturing division of CC Technology, operating under the name Delta Nu, which designs, manufactures and sells Raman spectroscopy systems.

Allow me to first address the first outcome - a direct result of the Bayh-Dole act of 1980, which was specifically conceived to capitalize on the pool of knowledge that exists in academia. The SBIR/STTR programs have provided us the perfect avenue to take our knowledge and expertise out of academia into the marketplace. The concept of university ownership and licensing back to the inventors as a vehicle of carrying academic concepts to the marketplace has led to many successful companies and will continue to do so. The SBIR/STTR programs facilitate this movement of innovative ideas.

The second outcome, our manufacturing division, Delta Nu, has already created jobs and wealth in Laramie WY. Laramie is a university community of about 30,000 people. I believe it is fair to say that most money that comes into Laramie is through the university, directly or indirectly. Those dollars circulate around the community through local shops and services. Companies like CC Technology are rare but we are now demonstrating how such enterprise can play a vital role in bringing new wealth to Laramie by applying our knowledge and skills to the creation of high value-added products, now being sold world-wide. These "new" dollars represent significant job creation and economic growth potential for our community.

Delta Nu stemmed from our SBIR/STTR funding. Our proposals discuss new chemical assays and new instrumentation to perform the assays. The newly developed instrumentation required formation of a manufacturing arm of CC Technology. To create this new instrumentation, we hired an Electrical Engineer to assist me in the creation of a new device: a portable, inexpensive Raman system. Unknown to us at the time, this technology and instrumentation enables a major shift in chemical instrumentation, from central labs to distributed locations. Just as computers moved from central mainframe computers to portable computers (PCs), chemical sensors, too, are moving from large centralized devices to small portable systems.

When CC Technology hired its first product development engineer we moved from a company totally dependent on SBIR/STTR funding to a business capable of designing, manufacturing, and selling a product, thereby generating revenue. The R&D needed to develop our first product came from our grant funding. However, as we approached marketability of our first product, the need for working capital became clear. Our R&D payroll could be met with grant funds but not the funds needed for manufacturing, marketing and sales. At this point I wrote our first business plan and approached a local bank for a working capital line of credit. We were able to secure our line of credit with personal guarantees from the two principal shareholders. We received the line of credit because we had personal assets and no business debt. I had my first lesson in bank loans; *if you have money, they like to lend; if you don't, they won't.* We did not have a stock option plan at the time, but if we had, I believe the loss shown on our income statement due to expensing stock options would likely have resulted in our line of credit application being refused.

- SBIR/STTR companies by their nature operate at a near-zero level of profitability and expensing stock options would result in a loss on the income statement, possibly resulting in an inability to negotiate loans or outside investment to break out of the dependence on SBIR funding.

Delta Nu has grown from a single engineer to a business with 6 full-time employees and 5 part-time employees. We have a board of directors and offer full-time employees a complete benefits package. Prior to our adoption of a stock option plan for our key employees, we had grown from three shareholders (founders) to seven shareholders. It is interesting to note that of the four additional shareholders, three no longer contribute to our growth. These individuals were not restricted by a vesting period that a stock option plan usually requires. The fourth shareholder is the University of Wyoming in recognition of our licensing relationship. The vesting period of an option plan clearly is advantageous and is a key feature of our plan.

- Stock options usually include a vesting period requiring ongoing employee contributions, thereby adding value to a business after the grant is made.

CC Technology -- Our Stock Option Plan

Over the last 4 years we have had employees who have shown themselves to be key employees. By key, I mean employees who have made significant contributions to the growth of the company, who will continue to contribute significant value to the company, providing a basis for potential liquidation opportunities for the shareholders of the company. In Laramie such employees are difficult to find and are easily attracted to the high-pay “front range” of Colorado or other areas of concentrated economic activity. The alternative is to recruit employees with experience and potential from elsewhere. Retention and/or recruitment require cash. Start-up businesses usually exist in a cash starved environment - and as I am often reminded; in a small start-up company, when you are out of cash, you are out of business.

One important component in our cash preservation plan is to replace cash incentives with stock in the company. The best method for an employee is the IRS-accepted incentive stock option (ISO) plan. The ISO provides employees the opportunity to participate in the creation of wealth that is a consequence of their on-going contributions to the enterprise.

To date we have offered stock options to two key employees as a means of retention and are now considering offering options to a high-salaried employee from California whose recruitment is essential for our growth. During the interview process, we were able to show a past history of sales and excellent future prospects. But the vital selling point to this potential employee was the opportunity to be more than a tool in creating wealth for existing shareholders. We demonstrated through the offer of options that we want this individual to participate in the wealth they will help create. This is possible through an ISO.

CC Technology -- Tangibles and Intangibles

FAS 123 would require us to show our stock options as an expense on our income statement. How would that affect CC Technology?

- It would decrease profits (or increase losses)
- It would prevent or make it difficult to obtain working capital under the current method of income statement analysis.
- Culture could change, where bankers or investors neglect or suspect the expense due to stock option plans.

First, decreased profits due to stock options create a circular problem. Under FAS 123, options will be expensed, showing a decreased profitability. This in turn makes the grantee less likely to exercise the option. This makes the original assumption about the expense incorrect. Accounting stems from the root *to account for.* Accounting is a science; economic forecasting is not. Meaningful financial data is used to grow companies. This ruling adds tremendous negative value to a company that uses stock options. This decreases profits, most likely into the red or further into the red, such that investment is not possible. This makes it impossible to attract working capital investment. The company fails.

Or, the culture changes and financiers learn to ignore the expensing of stock options. After all, who knows if they will ever be exercised? Then my question is, why add something to financial statements that is not reliable or credible?

Synopsis

At this point I would like to summarize the bulleted statements and succinctly explain my views on FAS 123 and stock options.

Small companies are founded by a handful of individuals. In order to retain those employees that make significant contributions and grow, ownership in the company must be shared with those employees. The best way to include employees in the ownership is to provide options to purchase stock after a vesting period (period of sustained employment and productivity). Our small business started from a business model and seed capital provided by the United States government through the SBIR/STTR program and this model leads to balanced income statements. It is not, nor is it intended to be a source of wealth creation in and of itself. When a company wants to breakout of the grant R&D mode to commercialization it must try to maintain balanced income statements to attract working capital. The expensing of stock options adds an intangible imbalance to an income statement. Why is it intangible? The majority of small businesses fail. The expensing of options will only increase this failure rate. But the irony is that the expense will never occur because the option will never be exercised.

The creation of an ISO must be ratified by the shareholders. This informs them of the potential dilution of the value of their shares. They vote yes or no depending on their belief that the options will increase their stock value further down the road. In a true startup, the number of shareholders is small. The diluting event cannot nor should not be hidden in a hundred pages of CEO reports and beliefs and difficult to interpret financial statements. Small businesses with a handful of shareholders must be prepared to see their shares diluted by the addition of individuals who will be making the value of those shares grow.

Last of all, I would like to make a statement about the public awareness of FAS 123. I heard about it two weeks ago! A week ago I was entertained by two bankers from Wheatland, WY. They were not aware of FAS 123. They want to try to work with CC Technology and the Ex-Im Bank by offering an export working capital line of credit. The Ex-Im Bank is a government agency designed to help small companies export their products and to reduce the country's trade imbalance. Please note, the Ex-Im Bank considers a positive equity to be a requirement for assistance. Expensing stock options would greatly increase the likelihood of not receiving government assistance to help reduce the trade imbalance and this failure would all be based on an expense that may never be realized because the option is never exercised. But, my point for this story is that the bankers knew nothing of FAS 123 and my accountant never mentioned knowledge of FAS 123 to me!! Had we followed FAS 123, we would have provided these bankers with distorted income statements based on the incalculable probability of the future exercise of our options and the incalculable value of our shares at the time of exercise. My point is, why turn the rigors of accounting logic into the realm of astrology and palm reading?

It seems to me that in their zeal to address recent widely-perceived abuses of stock options by a few disreputable top level executives in an even fewer large public companies, the FASB will be creating the unintended consequence of doing significant harm to the nation's economy and competitiveness by throttling back that primary engine of growth, the struggling private small business start-up.

Thank You,

Keith Carron
Professor and CEO
University of Wyoming, CC Technology

Senator ENZI. Thank you very much.
Mr. Diamond.

**STATEMENT OF STEPHEN F. DIAMOND, VISITING ASSISTANT PROFESSOR OF LAW, CORNELL LAW SCHOOL, AND ASSISTANT PROFESSOR OF LAW, SANTA CLARA UNIVERSITY SCHOOL OF LAW**

Mr. DIAMOND. Thank you, Chairman Enzi, for having this important hearing and inviting me to testify.

I will suggest today that, one, the expensing of stock options is an important step towards restoring accuracy, transparency and credibility to the American economy, and two, American managers should reconsider their aggressive use of stock options as a form of compensation because options create a hidden conflict of interest between inside option holders and outside shareholders.

While there may be some difficulty for some companies in adjusting to this new regime, that will be temporary and it will be more than compensated for by an overall lower cost of capital for those same companies, and for those companies that are now only the dream of a young inventor putting in long hard hours in a garage or a university laboratory somewhere.

I am a law professor who specializes in corporate finance and corporate governance, but my interest in this issue is not just an abstract academic exercise. After graduating from Yale Law School, I practiced corporate law in New York and in Silicon Valley for 5 years. While in private practice, I advised dozens of start-ups and public companies, as well as the investment banks and venture capital firms that provide them with financing. I continue to serve as an adviser to start-up companies and was recently elected to a seat on the board of directors of a small publicly-traded technology company, where I also serve on the audit committee and chair the compensation committee.

As an academic it is my job to study and help design institutions to improve overall economic performance. An important principle guiding such institutions in this country is our 70-year-old dedication to providing investors with the best information we can about what is happening to their money. Failing to expense stock options violates this core principle. It undermines the fragile relationship between insiders and outsiders in our corporate system, thus raising the cost of capital for new investment projects.

It also creates an often hidden and little understood conflict of interest between outside shareholders on the one hand and inside option holders on the other. Granting corporate insiders huge option packages allegedly motivates the insiders to manage the corporation in the long-term interest of public shareholders. But this argument is based on a mistaken assumption that stock options are the same as stock. They are not. Options are a different financial instrument from the stock that an option holder receives in exchange for the exercise of the option. In fact, recipients of options do not look forward to becoming long-term investors in a company's stock alongside their fellow outside investors. No, instead they look to the day when they can exchange their option for stock and then immediately sell it for a profit. In many cases that profit is cash they receive from the company and its long-term outside shareholders in the form of costly debt incurred by the company to pay for the shares given to the option holders. In the world of stock options, insiders get paid first, and it is the remaining shareholders who must pay them.

Investors provide the capital to entrepreneurs, who by virtue of their specialized technical or managerial talent, are tasked with the control of the day-to-day operations of a business. In return, investors expect those entrepreneurs will not only work hard on their behalf, but will also be fair and honest in their dealings with them. This relationship is known in corporate law as the separation of ownership and control. When the separation between investors and managers widens, it can cause money to stay on the sidelines.

Today investors are still reluctant to make the very risky and uncertain investments that need to be made to kick start a recovery of the high tech sector. As one example of investor discontent, at Texas Instruments, one of our country's oldest and most successful high technology companies, 57 percent of shareholders voted earlier this month in favor of a proposal recommending to the Board of Directors that they expense stock options.

That is why it is so perplexing to me that so many resist such a basic reform. In fact, Silicon Valley ought to be doing precisely the opposite of what it is doing. It should be showing as much leadership and innovation on this issue as it does on basic scientific research and development. Is it not just a bit strange in these circumstances that corporate managers want to deny their own investors access to vital financial information such as the impact of stock option grants on the overall value of the company? That stock options have value is certainly beyond debate. It is confirmed simply by the fierceness of the opposition to expensing them. One can only conclude that the defensive posture of some is about protecting a strategy of shifting wealth from outside investors to insider option holders, when the insiders have a significant advantage in assessing the real value of the company.

This increases investor uncertainty about value, and thus damages the credibility of all potential entrepreneurs who hope to raise capital for new companies in the future.

Thank you again for the opportunity to share my views with you today. I ask that my written statement be submitted for the record, and I look forward to answering your questions.

[The prepared statement of Mr. Diamond follows:]

# THERE IS NO FREE LUNCH:

# WHY AMERICA'S CORPORATE MANAGERS SHOULD DO THE RIGHT THING AND ENDORSE THE FASB PROPOSAL TO EXPENSE OPTIONS

STEPHEN F. DIAMOND, J.D., PH.D.

CORNELL LAW SCHOOL
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WRITTEN STATEMENT FOR THE RECORD
PREPARED FOR THE HEARING ON

THE IMPACT OF STOCK OPTION EXPENSING ON SMALL BUSINESSES

UNITED STATES SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

APRIL 28, 2004

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

## Introduction and a summary of my argument

Thank you, Senator Enzi, for convening this important hearing and for inviting me to testify. While the topic we are discussing today may seem complex and arcane to many, it lies at the heart of what both makes the American economy so impressive and what makes it subject, unfortunately, to unpredictable and damaging levels of volatility.

I will suggest today, briefly, that

**1) the expensing of stock options is an important step towards restoring accuracy, transparency and, thus, *credibility* to the American economy; and**

**2) American managers should reconsider their aggressive use of stock options as a form of compensation in light of the hidden conflict of interest they create between inside option holders and outside shareholders.**

While there may be some difficulty for some companies in adjusting to this new regime, that will be temporary and will be more than compensated for by an overall lower cost of capital for those same companies and for those companies that are now only the dream of a young inventor putting in long hard hours in a garage or university laboratory somewhere.

I am a law professor who specializes in corporate finance and corporate governance. It is my job to study and help design institutions to improve overall economic performance. An important component of such institutions in this country is our 70 year old dedication to providing investors with the best information we can about what is happening to their money.

Over the last decade or so a dangerous gap has opened up between, on the one hand, the laws that most investors believe protect them from unpredictable or inappropriate behavior by those to whom they entrust their life savings and, on the other, the reality of behavior in the business world.

*Failing to expense stock options contributes to this gap. It undermines the fragile relationship between insiders and outsiders in our corporate system, thus raising the cost of capital for new investment projects.*

*It also creates an often hidden and little understood conflict of interest between outside shareholders of technology companies, on the one hand, and inside senior managers and employee option holders, on the other.*

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

**Not just an academic exercise**

Let me point out that this research interest of mine is not just an abstract academic exercise. After graduating from Yale Law School I practiced corporate law in New York and in Silicon Valley for five years. Although this academic year I am a visiting professor at Cornell Law School in upstate New York, I normally teach corporate law, securities law and international business law in the heart of the high tech world at Santa Clara University School of Law where I have been on the faculty since 1999. I also lecture to MBA students at Santa Clara's business school on global business issues. While in private practice I advised dozens of high tech and biotech startups and public companies, as well as the investment banks, and venture capital firms that provided them capital. I continue to serve as an advisor to startup companies and was recently elected to a seat on the board of directors of a small publicly traded technology company, where I sit on the audit committee and chair the compensation committee.

**Protecting "Other People's Money"**

But in addition to advising companies, I now also play a role in advising investors, particularly large institutional investors such as pension plans. And that has reinforced for me the importance of research into the gap that I mentioned at the outset. The central design principle of our corporate system is the existence of what corporate law scholars call the "separation of ownership and control." That is, owners, or investors, provide capital to entrepreneurs who by virtue of their specialized scientific and managerial talent are tasked with the control of the day-to-day operations of a business. In return, investors expect that those entrepreneurs will not only work hard on their behalf but will also be fair and honest in their dealings with them.

To back up this relationship we use federal securities laws to mandate the regular disclosure of information to investors. This federal regime is complimented by a state law regime that allows shareholders to elect a board of directors to act as their agent in overseeing the work of the entrepreneurs and to vote on major changes in corporate direction. Together, these laws allow shareholders to decide whether they want to hold on to their investment, sell it or, in some cases, exercise their right to voice concerns about the direction of the company.

Combined, these protective devices insure that the gap between corporate insiders and outside investors does not expand to the point of instability. Our ability to manage this gap, to insure that managers behave responsibly when using what Justice Brandeis memorably called "Other People's Money," is a crucial advantage the U.S. economy retains over almost every other country in the world.

For example, recently shareholders have sent strong messages of discontent over insider behavior at corporations such as Disney and Texas Instruments. At Texas Instruments, one of our country's oldest and most successful high technology companies, 57% of shareholders voted earlier this month in favor of a proposal recommending to the

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

board of directors that they expense stock options. Texas Instruments' CEO called for a rule that all companies can follow and said that TI would comply with whatever rule FASB issues.

This system works well most of the time. But it is a system that requires a delicate balance between those on the outside and those on the inside. Government, the judiciary, and even occasionally, academia, can all play a role in assisting the main players, but if the fundamental relationship between investors and entrepreneurs is upset the damage can last for a very long time. That was the case in the wake of the crash of 1929. It took many, many years for credibility to be restored to the financial community and, thus, to entrepreneurs. Government was forced to play a much larger role in the management of the economy. Many have argued that this slowed our rate of innovation and our overall competitiveness. Perhaps only because other nations were even worse off and resorted to even more authoritarian interventions in their economies did we look relatively healthier.

**The damage done by the meltdown of the late 90s is still with us**

In my view, we have not recovered yet from the psychological and financial impact of the telecom and dotcom crash of the late 90s. I told a reporter with the *San Jose Mercury News* several years ago that it would take Silicon Valley a decade to recover from the excesses of the late 90s. The reporter called me back because her editor did not believe the quote was accurate! It was accurate. I only wish I had been wrong; but already we are four years from, almost to the day, the peak of the NASDAQ. Yet both startup activity and venture capital financing, although showing some signs of life recently, continue to languish. This means that promising new technologies in both high technology and biotechnology languish. There is certainly no question about the global demand for the products of such companies. So there must be something on the supply side that is causing the problem.

**Silicon Valley should be leading the fight to expense options**

In my view investors are still reluctant to make the very risky and uncertain investments that need to be made to kick start a recovery of the technology world. You will not hear many institutional investors admit this and you certainly won't hear it from the venture capitalists or the representatives of the technology world. But I think a trust was broken in the late 90s that has not yet been restored.

That is why it is so perplexing to me that so many in the technology world resist a basic reform such as the expensing of stock options. In fact, Silicon Valley ought to be doing precisely the opposite of what they are doing: they should be showing as much leadership and innovation on this issue as they do on basic scientific research and development.

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

**The new world of fictitious capital**

I think there is an explanation for the defensive posture of some Valley managers but it has nothing to do with the arguments that I have heard put forward by lobbyists for the industry. To understand it we have to go back to that basic principle of our corporate structure – the separation of ownership and control, the gap between investors, on the one hand, and entrepreneurs on the other.

As I suggested earlier, that relationship suffered a traumatic blow in the 1929 Crash, unlike anything we have experienced since. As a result, business became more cautious, even bureaucratic. Over time, this slowed innovation and productivity and, finally, profitability. In the early 1970s we suffered a minor echo of the 1929 Crash, as the stock market fell precipitously. Economists call such events "capital shocks." Interestingly, some new research indicates that that early 70s shock was caused by, believe it or not, the early successes of Silicon Valley.

Older companies with shares listed on the New York Stock Exchange and elsewhere were not the source of innovations like the semiconductor and early versions of the future internet. These technologies were instead coming out of young startups whose shares were not yet publicly traded. But investors eventually realized that the value of the older companies had to fall in order to reflect the impact that these new technologies would have once those startup companies started to trade their securities on public markets.

That event – the capital shock of the early 1970s – was the inevitable by product of our system of fictitious capital. Stocks and bonds, after all, are only paper titles to wealth – investors who possess them have only a residual claim to the wealth of a company. They must constantly attempt to predict the *future* value of a company. That is a demanding exercise. When we separate ownership of shares by investors, on the one hand, from management of a company's day to day operations, on the other, we risk a disconnect between the price of the shares and the actual value, in today's terms, of the company itself. The shares, then, can contain a certain amount of fictitious, or apparent, value for a certain period of time until the market can catch up with the changing environment in which the company is operating.

What happened in the early 70s was an early warning of the emergence of a new world, in which innovation happens so quickly that it is very easy for the price of a company's shares to be misaligned with its actual value. That can easily interfere with our ability to steer capital to the most valuable investment opportunities. Investors, then, often must operate as if they were flying an airplane in a dense fog with the instruments broken and the runway lights out.

That is why there is such value in establishing clear requirements for transparency and accountability in financial statements. That stock options have value is beyond

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

debate – it is confirmed simply by the fierceness of the opposition to expensing them coming from so many in the technology world.

But isn't it just a bit strange that those same individuals want to deny their own investors access to vital financial information such as the impact of stock option grants on the overall value of the company? Clearly, this threatens to widen the gap that exists in our system between investors and entrepreneurs. It increases the uncertainty about value and it lowers the credibility of all potential entrepreneurs who hope to raise capital for new companies in the future.

One can only conclude that the defensive posture of some in Silicon Valley is about protecting a strategy of shifting wealth from outside investors to inside option holders when the insiders have a significant advantage in assessing the real value of the company.

**The hidden conflict of interest between managers and investors**

But, as I suggested at the outset, there is a second major dimension to the problem. Insiders in the high tech world and elsewhere often cash in on stock options and walk away with millions even when their company's stock price sinks. Larry Ellison, head of software giant Oracle, cashed in $700 million of options in early 2001. And just in time. A few weeks later Oracle stock plummeted from more than $34 per share to around $13 per share when the company announced that sales and profits were down. Enron insiders walked away with more than $1 billion in cash from stock options as that company fell apart. These insider games strike most Americans as a form of the "infectious greed" that even Alan Greenspan blamed for the malaise that hit the stock markets in the wake of NASDAQ meltdown.

Granting corporate insiders huge option packages allegedly motivates insiders to manage the corporation in the long-term interest of public shareholders. But this argument is based on a mistaken assumption that stock "options" are the same as stock. They are not. "Options" are different financial instruments from the stock that an option holder receives in exchange for the exercise of the option. As the FASB proposal explains at the outset, options are a corporate *liability,* completely distinct from the underlying equity into which they can be converted.

In fact, recipients of options do not look forward to becoming long term investors, or holders, in a company's stock alongside their fellow outside investors. No. Instead they look to the day when they can profitably exchange their options for stock and then, immediately, sell that stock at a profit. In many cases, that profit is cash they receive from, in essence, the company and its long term outside shareholders who must take on costly debt to pay for the shares given to the option holders. In other words in a world of stock options, insiders get paid first and it is the remaining shareholders who must pay them.

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

Unlike options, stock prices are based on an assessment of the long term earning power of a corporation. That reflects the position that long term investors in a company's shares hold in the capital structure of the company. The price of stock *options*, however, is based not only on the value of the underlying stock, but also on the length of time until the expiration date of the option and, most importantly, the volatility of the underlying stock. Options actually increase in value with an increase in the stock's volatility because this increases the chance that the option will be "in the money" (i.e., its market price will be above its strike price) and hence profitable for the option holder to exercise the option and cash in his or her shares rather than let it expire unexercised.

**Options fuel the insider game of financial statement manipulation**

Why should outside public shareholders care about this difference? Because an increase in the volatility of the stock is something that corporate insiders can manipulate by engaging in higher risk projects. Insiders have what Nobel Prize winning economist Joseph Stiglitz calls an "asymmetric information" advantage. They will always know more than outsiders do about the nature of the firm. Insiders have an overwhelming advantage in assessing the potential of projects underway at the company. This does not mean that insiders engage in illegal insider trading. That does happen, unfortunately. But what I am calling your attention to is far more subtle and probably more significant.

The insiders can increase the value of their options by engaging in "all or nothing" gambles. After all, if the project is a success it might cause a huge increase in the stock price, with a gain to outside shareholders as well. If the project is a bust, insiders just tear up their worthless options and move on. The potential for gain to insiders has been so huge in recent years that they have engaged not only in high-risk projects but also in the illegal manipulation of corporate earnings. While outright illegal manipulation is not the norm, it is certainly common for corporate managers in the high tech world to time their entry into and exit out of firms based on the possibility of turning a profit on their stock options.

**Failure to expense options wastes valuable resources**

Of course, this conflict between insiders and outsiders is linked back to my earlier concern about the potential for a build-up of fictitious value in today's stock prices. This insight is reflected in the recent testimony of Craig Barrett of Intel that a growing part of the value equation in today's innovative companies is linked to so-called knowledge workers and the intangible assets, i.e. intellectual property, that they produce. There is little doubt in a world like this that managers like Mr. Barrett need to reward their workforces handsomely. I believe it was Bill Gates who pointed out that the entire "value" of Microsoft walks out the door every evening. The unanswered question, however, is whether:

1) creating a whole new layer in the capital structure of our firms; and then

**Stephen F. Diamond, Visiting Assistant Professor of Law, Cornell Law School, Assistant Professor of Law, Santa Clara University School of Law**

2) pretending it has no value; and then

3) inventing means to avoid disclosing its value to the financial markets; and then

4) allowing insiders to profit at the expense of long term shareholders; and then

5) expending a significant amount of resources defending this compensation scheme in the political arena; all to

6) entrench managers who are more expert at gaming a company's financial statements than they are at producing value for investors and for society as a whole;

is really worth the damage it does to the credibility of our corporate and financial system.

Thus, insiders' interests are not aligned with those of outside public shareholders by stock options. They are, in fact, placed at odds with each other. Despite this conflict, corporations can still pretend that options are given away for free, since they are not currently required to charge the cost of the options as an expense item in company accounts. At the very least, as Senators Levin and McCain correctly argue, options should be charged as a compensation expense. Even more effective would be to get rid of options altogether and allow insiders to hold only restricted stock that they could sell only after leaving the corporation. This would put them much closer to the actual position of outside public shareholders while they are still working for those same shareholders.

Thank you again for the opportunity to share my view with you today. I ask that my written statement be submitted for the record and I look forward to answering your questions.

Senator ENZI. Thank you very much. Everyone's full statement or additional statement, if they want to submit it for the record, will become a part of the record. We do appreciate your testimony, so even if you have a couple of additional thoughts that you need to put in, that is welcome as well.

Mr. Glover.

**STATEMENT OF JERE W. GLOVER, BRAND AND FRULLA, WASHINGTON, DC**

Mr. GLOVER. Thank you, Chairman Enzi. I am pleased to be here to testify about FASB's proposal to expense stock options.

While I have been and am a CEO of several high-tech companies, my primary experience in my career has been involved in helping reduce regulatory burdens on small business and create a fair marketplace and playing field for small businesses. The one thing that I have learned is that one size does not fit all. That is true in shoes and it is especially true in standards and Government regulations.

During the last 3 years of my experience as Chief Counsel for Advocacy at the Small Business Administration, we reduced unnecessary regulatory burdens on small businesses by over $20 billion. We were consistently faced with agency claims that protecting the public interest forced the agencies to place specific burdens on small business, just as FASB is proposing to do now.

These officials routinely said that if their regulations were not finalized exactly as they had proposed, that the environment, worker safety, investor trust, or whatever, would cease to exist.

Forced to reexamine the problems that their regulations were causing, agencies found that small businesses were not the cause of the problem in most cases, and that the regulatory burdens they were proposing were unnecessary and could be modified. In some instances small businesses were completely exempted and the public interest was still served.

I oppose any agencies or organizations that are imposing unnecessary and unintended burdens on small business. FASB's proposal, if finalized as proposed, while well intended, will have a devastating impact on growing small businesses, especially those in Government contracting and those who need to finance their businesses. The burdens in dollars, lost management time and lost opportunities will adversely affect innovation and job creation in America.

Let me explain why I believe the expensing proposals will have an adverse impact that is contrary to the public interest. First, many companies will simply stop giving employees stock options. This to me is the worst possible outcome because it would deprive them of key employees that are necessary to grow and expand their businesses.

Second, many companies will find that they cannot comply with the requirements simply because of the cost will be prohibitive.

Third, for those companies who choose to comply, what if they are Government contractors? Will they be determined, because they have negative net worths and negative profit statements, to be financially not feasible. Under the FAR Regulations, they are not feasible or capable of providing the work because they have loss or bad financial statements. Likewise, when companies turn to borrowing, as the first witness just talked about on this panel, will the banks understand when they come in with negative financials? More importantly, will the Government agencies like the Export-Import Bank, or like the Small Business Administration, make an exception? And what is going to happen when the auditors from the Federal Reserve, Comptroller of the Treasury and FDIC come into the bank and say, look at the financials of the companies you are lending to. I think that that is going to create an additional problem.

Of course, there is the issue of tax consequences on how these options are being treated. Today there is a good bit of flexibility, and I certainly use that in my companies and I know many, many companies do have that flexibility. Will FASB's new proposal change their ability to have that flexibility? I suspect so.

FASB could have avoided this problem if they had, one, adequate representation on the board itself, who fully understood small business and implications. One of the critical problems here is they do not understand—and accountants, by and large, many of them do not understand—how tight cash is for starting companies. They do not have $100,000 or $200,000 or $300,000 to spend on valuation, and even if they did, it would be taking away from other activities.

If they had done a regulatory flexibility analysis. If they had even looked at the opportunity to propose separate regulations for small businesses, they would have proposed different regulations for small businesses. There is no tiering of their proposed regulations. Of course, they could have easily exempted small businesses.

The Regulatory Flexibility Act, which applies to all Federal and most State agencies, has had a phenomenal impact, $40 billion of regulatory savings to date. FASB has completely ignored it.

Under the circumstances, I think that you have to look at the situation. The SEC has found it could live with the Regulatory Flexibility and live well with it, and they do a wonderful job. Had they considered small business at the beginning, I do not think we would be here, and I do not think they would be under the pressure that they are under now. I think small businesses have historically, these solutions that we have talked about are not new. Each White House Conference has recommended them. Congress has recommended them. Most Presidents have required them. FASB has chose to fit everything into one-size-fits-all, and quite frankly, that is not proper.

Thank you.

[The prepared statement of Mr. Glover follows:]

# JERE W. GLOVER TESTIMONY

## UNITED STATES SENATE

## COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP

## WASHINGTON, D.C.

April 28, 2004

**Mr. Chairman and Members of the Committee:**

I am Jere W. Glover with Brand and Frulla, a law firm specializing in litigation and regulatory and administrative law, serve as CEO of two high-tech companies and am advising a new organization, Entrex, new opportunities for small companies to sell their securities to sophisticated investors. I also serve as Executive Director of the Small Business Technology Coalition, the largest organization of Small Business Innovation Research companies in the United States. I am pleased to be here today to testify about Financial Accounting Standard Board's, FASB, proposal to require expensing of stock options.

While I'm not an expert on accounting, accounting standards or FASB, I do have a lot of experience as counsel to this Committee and the House Small Business Committee, and as Chief Counsel for Advocacy of the Small Business Administration. During my tenure as Chief Counsel, we issued over 100 reports and economic studies, testified before Congress over 30 times, intervened in over 200 agency rulemaking proceedings, and reviewed over 5,000 regulations.

I have spent much of my career trying to reduce the regulatory burden on small businesses to create a *fair* economic playing field that allows small businesses to grow and to ensure that regulations imposed on small businesses are really necessary, while addressing the problems actually caused by small business but without compromising public policy objectives.

During the last three years of my tenure as Chief Counsel, we reduced unnecessary regulatory burdens on small businesses by over $20 billion. We constantly were faced with agency claims that protecting the "public interest" forced agencies to place this burden on small business, just as FASB is claiming now. These officials routinely said that if their regulations were not finalized exactly as proposed, the environment, worker safety, investor trust, etc. would cease to exist. Forced to re-examine the problems regulations were designed to address, agencies often found that small businesses were not the cause of the problem, at least not significantly, that the regulatory burdens as proposed were usually unnecessary and could in fact be modified. In some instances small businesses could be exempt entirely and the public interest still served.

I always oppose any agency or organization, in this case the FASB, imposing unnecessary and unintended burdens on small business. FASB's proposal, while well intended, will have a devastating impact on growing small businesses, especially those who are in government contracting and who need to finance their businesses. The burden in dollars, lost management time and lost opportunities will adversely affect innovation and job creation in America. The problem is even worse since small business cannot challenge FASB's decision once it becomes final. Normal protections under the Regulatory Flexibility Act do not apply to FASB decisions.

Let me explain why I believe the expensing proposals will have an adverse small business impact that is contrary to the public interest.

1. Small companies will simply stop giving employee stock options to key employees. This is the worst possible outcome. For years, companies have used stock options to recruit and retain key employees. Small businesses in their start-up and intermediate growth phases simply do not have the working capital to compensate key employees commensurate with their contributions to the firms' successful growth. By allowing these key employees, engineers, scientists, managers, and even CEOs to have stock options and the potential for future monetary gains, small firms are often able to hire the best employees to help them grow their businesses.

2. Many small companies will not even learn of the new restriction on employee stock options until it is too late to comply. Small firms don't read the Federal Register, the Congressional Record and certainly don't read the FASB's proceedings and press releases. I understand that the FASB expects compliance by next year. This virtually guarantees that most small companies will be in violation.

3. The companies that find out about the requirements will not be able to comply because the cost is prohibitive. From what I understand, the computation methods selected by FASB are designed for publicly traded companies and are extremely difficult to apply to small privately owned companies. Since the CPAs most often used by small businesses have never done a valuation of employee stock options under these methods, the companies will have to hire

one of the big four accounting firms to value their employee stock options. The big four will probably be too busy valuing the public companies to work on small firms. In addition to such delays, I've seen cost estimates of several hundred thousand dollars for such valuations. Small firms don't have that kind of money and it certainly isn't a productive use of their limited funds.

4. What happens to firms who choose to comply? If they are government contractors, it can create real problems. They may be found to be "not financially feasible" as that term is used in Federal contracting decisions. Because of the expensing of employee stock options, many will suddenly find themselves to have a negative net worth and significant losses. Under the Federal Acquisition Regulations, such companies are not eligible for government contracts. If a company is seeking to borrow money, it will have difficulty borrowing with a negative net worth and operating losses caused by expensing requirements. Even if the company finds a bank which understands the problem, how will the bank regulators, Comptroller, FDIC and Federal Reserve see the situation? Has the FASB even met with the bank regulators and SBA to examine the impact of its new standards on commercial lending practices?

5. What are the tax consequences of FASB? I'm not sure what the impact of FASB will be on the treatment of stock options. In the past, there has been

flexibility in how options have been treated for tax purposes. I'm concerned that this flexibility will be lost once FASB's proposal becomes final.

One bit of ironic good news is that when a company's key employees leave, the company will have a windfall profit when the stock options are cancelled.

This collateral damage could have been avoided and regulatory proposals more finely tuned to address actual problems if FASB had

1. adequate small business representation on the Board who understood the impact of the proposal on small and emerging companies;
2. a small business advisory group in place when they were formulating the standards. (It appears that the new small business advisory group that is being set up now is arriving too late in the process to change the Board's decisions.);
3. completed a small business regulatory analysis of the impact of the standard on small emerging companies. (All federal agencies and most state agencies are required to conduct such an analysis before they take regulatory actions.);
4. proposed a separate and more appropriate regulation for expensing small company stock options;
5. delayed the effective date of the standard for small companies for a number of years;
6. exempted small companies from these regulations entirely;
7. used some combination of the above.

To date FASB, with the exception of belatedly appointing a small business advisory group, has done none of the above.

FASB's failure to consider in some depth the impact of its action on small and emerging companies or the predictable adverse impact on the nation's economy is not new. Federal, state and quasi- government agencies and organizations will always tend to write one set of standard or rules and apply them to all businesses regardless of the size. However, experience has taught us that this "one-size-fits- all" approach simply does not work.

Almost 25 years ago, Congress passed the Regulatory Flexibility Act, RFA, requiring each federal agency to conduct a regulatory flexibility analysis of the impact of its actions before the agency even proposed a new regulation. The law also requires agencies to develop and consider less burdensome alternatives and to do affirmative outreach to small businesses to help them formulate the regulations. In 1996 Congress strengthened the RFA and provided for judicial review of agency compliance with the law.

Has the RFA changed the way agencies treat small business? Absolutely! To date over $40 billion dollars of regulatory burdens that the agencies originally proposed to place on small business have been eliminated - $20 billion during my last three years as

Chief Counsel and well over $20 billion by my successor. All this was done without endangering worker safety, the environment or even investor confidence.

Let me give you one example of how the RFA has served the public interest. The Environmental Protection Agency (EPA) proposed requiring oil refineries to reduce the amount of sulfur in gasoline. Originally this requirement would have imposed such costly burdens on the small refineries (especially the one in Wyoming) that the small refineries would have gone out of business, reducing the nation's supply of gasoline and increasing consumer prices at the pump. With further analysis, we concluded that the small refineries were less than 2% of the problem. The EPA finally agreed that the small refineries could delay compliance for a number of years. This would allow them to take advantage of new technologies that were being developed. Today all of those refineries are still operating and the environment is still being protected.

Would this work for the expensing of employee stock options? Certainly. I have not seen any evidence that the problems FASB seeks to address are caused by small companies. FASB just has to look at the SEC as a model. By complying with the RFA, the SEC has developed an excellent record customizing its regulations to reduce significantly the burdens on small businesses, without compromising its public interest responsibilities.

To illustrate: When I was helping prepare for the first White House Conference on Small Business in 1980, President Carter requested that each agency highlight at least one major accomplishment to be announced at the Conference. When I went to the

SEC to meet with the senior management, they informed me in great detail that they had to protect investor confidence and could not even consider doing anything for the small emerging companies. These upstart companies would have to comply with all of their regulations – period, end of discussion.

I explained to them that they had done such a good job of protecting investors that they had eliminated virtually any new company from going public for a number of years. By analogy I argued that if OSHA wanted to eliminate all worker injuries, the only way they could be sure that no worker was ever injured was to eliminate all workers. The SEC had in effect eliminated the workers. Going public was simply too expensive and complicated for businesses.

Since that time, the SEC has simplified its reporting requirements, granted exemptions for small companies, created new short forms and allowed Regulation D offerings for smaller companies. The SEC also approved an angel accredited investor network to reduce the regulatory burden on angel investing. With all of these changes and burden reductions on small companies, there has been no increase in investor fraud. If these FASB-type standards were being proposed by the SEC, I'm confident the agency would have found a way to lessen the burden on small emerging companies.

FASB could have done likewise. To verify this conclusion we just need to answer the following questions:

1. What are the public interest issues at stake?
2. How and to what extent does small business contribute to the problem?
3. Will the proposed regulations stimulate or hinder the growth of small business?
4. If hinder, can regulations be designed to eliminate this risk to the economy without compromising the public interest?
5. Should Congress act if FASB does not?
6. Should quasi-governmental boards and organizations, (like FASB) whose decisions have the impact of regulations be forced to comply with the RFA?

I think the answers to these questions are *important to the growth of the U.S. economy and the creation of more American jobs.* If we expect small business to be the engine that grows the U.S. economy and creates jobs, we have to feed the engine, not starve it. Regulations, such as expensing of employee stock options for small emerging companies, put the brakes on the small business engine at the very time we need for the accelerator to be at full throttle. I think the public interest is best served when we have a vibrant, growing, small business economy that is creating jobs, developing new technology and creating whole new industries.

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Senator ENZI. Thank you very much.
Mr. Jones.

**STATEMENT OF MARC JONES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, VISIONAEL CORPORATION, PALO ALTO, CALIFORNIA**

Mr. JONES. Thank you, Mr. Chairman. My name is Marc Jones, and as you mentioned, I am the President and Chief Executive Officer of Visionael Corporation. I appreciate you giving me the opportunity to share my views on the recently released Financial Accounting Standards Board draft calling for the expensing of these broad-based stock option plans that are so prevalent and in favor in Silicon Valley, and the impact of this proposal on small businesses like Visionael.

Our small business is a leading provider of network security and network management solutions designed for the largest and most complex corporate government and service provider networks. We have more than 60 large customers worldwide including customers like Sprint, Verizon, EDS, IBM, the Pentagon and the White House Communications Agency.

Thus, the importance of the stock option issue in front of the committee cannot be overemphasized. Broad-based stock option plans have given me the opportunity to live the American dream. I have been able to buy a house, send my children to good schools, and now be the CEO of a small business. Broad-based stock option plans have also given quite a few Visionael employees the possibility to dream that dream that they themselves can be entrepreneurs, that they can be partners in owning a business and that they can dream one day of the financial success and the rewards that are associated with our company's success.

Now we have a stock option system that works, and it is being threatened by FASB's current exposure draft. FASB is proposing to require all businesses, including small businesses like Visionael, to use a complex formula to calculate the value of stock options, and count that inaccurate cost as an expense. The FASB proposal will curtail or perhaps even eliminate the ability of small business owners to offer our employees stock options.

There are a number of problems with the FASB proposals. Fundamentally, small business owners are opposed to the creation of inaccurate expenses on our financial statements. Our survival is predicated on being able to provide our customers, our suppliers and our financial backers accurate, easy to understand financial statements. For example, an important component of Visionael's capital structure is a line of credit we have with a local bank. They provide us funds while we wait to collect monies owed to us by our customers. However, any borrowings under that line of credit must be repaid if we are unprofitable. Thus, including inaccurate expenses related to our stock option plan into our financial statements could have the impact of us losing an important source of capital for our business.

In addition, it will be difficult to absorb the additional cost of complying with the FASB proposed regulations. We will need to hire outside consultants, some of those accounting firms that you mentioned earlier, along with additional finance personnel in order to comply with the FASB regulations. I currently estimate that Visionael compliance could easily cost us $100,000 or more annually. This means that we will not be hiring two additional engineers, sales people or perhaps we may not undertake certain marketing programs that we would otherwise invest in. These compliance costs are true hard costs, and we will be using expensive capital to pay for them.

I am going to move off of my prepared remarks for a minute because I listened to the panel previously, and the problem that I am having with the previous discourse is that I hear lots and lots and lots about policy this and economic that, and that footnotes here and all that stuff.

The reality of it is that this is equity. It is a form of equity. Who has what piece of the pie? And from a financial-statement perspective, 97 or 98 percent of the issue is a balance sheet issue of, if you look at the company, how is it split up. We currently handle 97 and 98 percent of the issue already on the balance sheet, with full disclosure to anyone—investors and other people interested and other stakeholders in the country.

We are now talking about 1 or 2 percent of this issue, and we are potentially creating rules, and regulations and costs on small businesses that none of the previous panel talked about the small business. They couched it in terms of Texas Instruments that, and HP this, and whatever. That is not the point. The point is how are small businesses supposed to deal with this situation, and what impact will that have on their cultures, their people, their environments, and their opportunities to be successful? So, from Visionael's perspective, and I represent—I am one of the "they," right? Our company is a venture-backed technology company that is trying to create value for our customers here and around the world. We do not get it. And the impact of these proposed regulations on our business are very, very ominous, and for us to willy-nilly look for the truth—the question was about, what is wrong with the truth? Well, if we could come up with the truth, it might help. And the question is what is the cost of getting to the truth? So those kinds of considerations, in my humble opinion, need to be addressed as part of what we do, the decisions that this committee is responsible for making.

So I apologize for taking more time, and I thank you, and I would be happy to answer any questions you might have.

[The prepared statement of Mr. Jones follows:]

# Testimony

# Of

# Marc Jones

# President and CEO

# Visionael Corporation

**"Stock Options and Small Business: Fostering Innovation and Growth"**

**April 28th, 2004**

**Senate Committee on Small Business and Entrepreneurship**
**SR-428A Russell Senate Office Building**
**Washington, DC**

Senators Snowe, Enzi, and Kerry, and distinguished members of this Committee, my name is Marc Jones and I am the President and Chief Executive Officer of Visionael Corporation. I appreciate you giving me the opportunity to share my views on the recently released Financial Accounting Standards Board (FASB) exposure draft calling for the expensing of broad based employee stock option plans and the impact this proposal will have on small businesses like Visionael.

Our small business is a leading provider of network security and network management solutions designed for the largest and most complex corporate, government, and service provider networks. We have more than 60 large customers worldwide, including Sprint, Verizon, EDS, IBM Global Services, Kaiser Permanente, Fidelity Investments, the Pentagon, and the White House Communications Agency.

Visionael is a privately held company founded in 1997 with 20 employees. Since that time, Visionael has created 50 jobs, and we now have approximately 70 employees. All of our employees have been granted stock options in our Company. Stock options, and a belief in the market opportunity for our Company, have encouraged our employees to continue to work at Visionael, because the longer they stay, the more their stock options vest.

Stock options have allowed Visionael to recruit and retain the brightest and most talented employees and have given our employees a deep personal interest in seeing our company grow. Our dedicated employees recognize that their hard work, long hours, and commitment today will lead to improved sales, improved profits, and a much stronger company. Our employees eagerly anticipate the day when our company makes the leap from a small privately owned business to becoming a publicly held company. And they recognize that the success or failure of Visionael rests in their hands. Day in and day out, they pride themselves with doing things more efficiently and more productively, so that the company where they work – and which they own – can succeed.

We rely on rapid innovation and a dedicated work ethic to succeed in the marketplace. Our small business has been able to compete with corporations much larger than Visionael, primarily because of the relationships our people have developed with our customers. When America On-Line thinks of Visionael, they think of Pam, or George, or Ian; these are the people who are responsible for implementing our software. Our Company's success is predicated on having employees who spend long days and nights ensuring the successful deployment of our software. The extraordinary effort our employees provide to our customers is directly related to the pride they feel from being part owners of Visionael.

Today, a stock ownership system that works is threatened by FASB's current exposure draft. FASB is proposing to require all businesses, including small businesses like Visionael, to use a complex formula to calculate the value of stock options, and then to count that inaccurate cost as an expense. The FASB proposal also will curtail the ability of small business owners to offer our employees stock options and will likely lead to the elimination of popular discount employee stock purchase plans.

I am not one who spends a lot of time in Washington, DC or Norwalk, Connecticut, deciphering the minutia of accounting regulations. But what I do know – and the reason I am here today – is that this proposal gives absolutely no consideration to the real world operations of small businesses like Visionael, or to how this plan can be reasonably implemented. The FASB proposal provides small businesses with a completely unworkable approach to valuing stock options, and will lead to inaccurate income statement reporting, thereby making our businesses look less attractive to investors.

This is an extremely important point. In the current economy, the availability of capital is low, while the cost of capital is high. The FASB proposal is particularly punitive to small companies, especially those that rely on expensive, venture capital. Anything that adversely impacts the ability of small companies to address the broader capital markets is a significant problem.

People on both sides of the expensing debate have agreed that no accurate model for valuing employee stock options exists. So, while I support the goal of accurate, understandable financial statements, I don't understand the urgency in moving forward when no method has been developed to accurately value stock options and when current proposals will adversely impact small businesses.

The FASB proposal makes it extremely difficult for small companies to comply because the three "acceptable models" for deriving an expense number are unworkable. The first, the Black Scholes model, has been discredited as being inaccurate for valuing employee stock options. Indeed, one need only look at the language of the Exposure Draft to see that the FASB strongly discourages its use. The second, the lattice or binomial method, uses inputs similar to Black Scholes, but is even more complex because it requires literally thousands of assumptions by the company.

Using either the Black Scholes or the lattice model will require us to input assumptions about the volatility of our Company's stock. But as a privately held company, whose underlying shares have never been liquid and, in many instances, are not even issued and outstanding, it will be nearly impossible (and expensive) for us to come up with a volatility number since there is no historical reference upon which to base that number. This kind of "guessing" and "estimating" can result in significant distortion of the value of the stock option and, in turn, a company's income statement. FASB has long recognized the difficulty that private companies have in measuring volatility by allowing nonpublic entities in its current standard to omit expected volatility and instead use what is known as the *minimum value* method where volatility is set at zero.

Unfortunately, the FASB proposal does not allow continued use of the *minimum value* method. Instead, FASB calls on private companies to make a "policy choice" and use the same fair value accounting that public companies use, either the Black Scholes or the lattice models, or use the third option that FASB proposes, the *intrinsic value* method.

Under the *intrinsic value* method, the stock option expense is measured as the difference between the price of the underlying stock and the option exercise price at the date the option is granted. This calculation must be made each time we report financial results and the expense must be changed each time– this is costly, overly complex and will be confusing to the users of our financial statements.

It is not obvious which of these methods Visionael will use if the current FASB proposal is adopted. All of the methods will yield inaccurate results and all will be expensive to implement. In addition, to the extent a private company becomes an acquisition target, questions about the target's financial statements and how they comply with the acquirer's policies will inevitably negatively impact the target's valuation and the speed by which the transaction can be completed.

Another problem with the FASB proposal is the way that it treats Employee Stock Purchase Plans, or ESPPs. Many employees participate in ESPPs, which will also be severely curtailed, if not eliminated outright, under the FASB rule. Small businesses are not always able to offer 401k plans to their employees and ESPPs are a good way for our employees to bolster their savings for retirement. The FASB proposal will require companies to expense the discount that they offer to employees who buy company stock through their ESPP. If FASB gets its way, this important saving vehicle would be eliminated.

I am particularly confused by this proposal. The purpose behind ESPPs is to make it easier for employees to purchase company stock. The discount is related to eliminating the transaction cost associated with purchasing stock in the open market from stockbrokers. In addition, ESPPs provide a simple way for employees to save by taking money directly from their paychecks. This mechanism also protects employees from inadvertently running afoul of Securities and Exchange Commission laws against insider trading while still encouraging employee ownership of their companies. There is no compelling reason for changing the accounting treatment associated with ESPPs. After all, top company executives are not the major beneficiaries of ESPPs; employees are.

We can debate whether or not lawmakers should do something about curtailing executive compensation abuses at large corporations, but FASB's proposal does nothing to address that issue. Instead, it proposes to inject inaccurate and unreliable numbers into company financial statements.

This plan has serious consequences that create new hurdles that will severely hamper small businesses, the main sector of our economy where jobs are created. It will impose complex accounting rules in an already burdensome regulatory environment for small businesses. The worst-case scenario is that FASB's proposal will impede the creation and growth of a significant number of small businesses. In the best scenario, the few that are created and remain in business will see ownership shifted from broad-based employee ownership to a concentrated ownership in the hands of the top few leaders of the business.

Despite the fact that there is no consensus on how to accurately value stock options, small businesses like Visionael will be forced, in order to comply with the FASB mandate, to significantly alter our business plans. We will need to spend $100,000 each year, perhaps more, to comply with the proposed regulations. Given the cost of capital, we will have to reduce other operational expenses to pay for regulatory compliance. As a practical matter, this means that we will not hire an additional engineer, or two more sales professionals. We may not invest in various marketing activities that could stimulate additional sales for our business. The value of a small business is often determined by its ability to move to be acquired or provide liquidity for investors through a public offering.

The current rules proposed by FASB will not help investors, yet these regulations will clearly negatively impact our small business and our business opportunity. Small business owners will be faced with two options: (1) do not offer stock options to employees, and run the risk of seeing those employees remain with larger multinational corporate competitors; or (2) reallocate precious funding and resources away from core business operations into new accounting regulatory compliance functions, and run the risk of layoffs and hiring freezes. A real consequence of these proposed regulations is that many small businesses will not get started as they won't be able to attract the talented employees necessary to have a successful enterprise.

Much is made of FASB's independence. But FASB has made clear that it cannot and will not consider the economic consequences of its standards. Given the state of our nation's economy, we don't have the luxury of ignoring the economic consequences of this proposal. This Committee is fully aware of the importance of small companies to our economy. As a result, it is Visionael's position that the FASB should formally submit its proposal to the newly formed Small Business Advisory Committee for that Committee's review, consideration and comment. Of course, for the Small Business Advisory Committee to truly have an active role, it would have been preferable for FASB to have obtained the review and comment of the Small Business Advisory Committee before actually issuing the exposure draft. Nonetheless, this problem could be mitigated were FASB to extend the comment period so that the Small Business Advisory Committee has sufficient time to analyze, review and comment upon the exposure draft.

An alternative we support is S. 1890, the "Stock Option Accounting Reform Act." S. 1890 deals with executive compensation problems at big corporations by requiring those companies to expense stock options granted to the top five executives. Most importantly, it requires an economic impact study to be conducted before any additional expensing could go into effect. This economic impact study is particularly important, as it will ensure that all of the possible job and economic implications are examined closely. I urge the Senate to pass S. 1890, which will allow small businesses to continue to offer stock options to employees, and will allow millions of Americans to continue to reap the benefits of ownership in the companies they work.

Small businesses have always been the driving force behind our nation's innovative and economic leadership, and talented and creative employees have always driven the growth of small businesses. At Visionael, we recognize the value of our workforce, and we believe our employees should reap the fruits of their success as owners of our company. FASB's proposal to curtail stock option plans threatens broad-based employee ownership at Visionael and small businesses across this country. I urge you and your colleagues to send FASB back to the drawing board, pass S. 1890, and help protect and expand employee ownership in this country.

Thank you for giving me the opportunity to testify today. I will be happy to answer any questions.

Senator ENZI. Thank you very much.
Mr. Kavazanjian.

## STATEMENT OF JOHN KAVAZANJIAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ULTRALIFE BATTERIES, INC., NEWARK, NEW YORK

Mr. KAVAZANJIAN. Thank you, Mr. Chairman. Thanks for allowing us to express our opinions. I hope I can be as eloquent as Mr. Jones.

The issue of expensing of stock options is a very significant one to us. We make batteries. We are a small company in Upstate New York, Newark, New York, outside of Rochester. We have been in business for 14 years. Five years ago, I became the President, and the company had never been profitable. We are now profitable, over the last year, and we employ 900 people now, up from about 250 several years ago, and stock options are a very important part of the way we have been able to attract and retain our professional talent. Without the engineers, the sales people, the professional managers in the company, there would be no work for the 75 percent of the people who come in every day to make batteries.

Expensing stock options serves no useful purpose in the basic reason we do financial reporting. That is what everybody is missing. Implementing the standard will hurt everyone, but the big companies do not notice it. It will fall heaviest on the small and growing companies like Ultralife, and I will tell you why.

First, financial reporting has one purpose. It is to provide the shareholders with the information on the operational performance of the firm and the data on which to calculate the value of the firm. There are multiple methods for this, and most of them come down to a discounted present value of cash flows, but the fact is that expensing stock options has no added value to that function.

It provides cash, when people exercise them. We are missing that, also. People actually have to buy the stock. And, number two, it dilutes the stock. Well, we already do a Treasury method dilution which takes into account that. It hurts us in our EPS when stock options are exercised. It is accounted for already. Both of these effects are very adequately accounted for.

And, in fact, I was thrilled to hear some of our previous people say, in the footnotes to the financial statements, all of the data is there already. So what purpose is the rule aimed at?

Well, it seems it is not aimed at giving investors an easier way to evaluate a company. In fact, it is going to do the opposite. It is going to make it tougher. And for small companies like us, who do not have all of this analyst coverage to go wade through it, I mean. Certainly, McDonald's, and Microsoft, and AT&T, no problem. The analysts will just back it out. What it is aimed at is to curb excessive executive compensation. I cannot think of a less-effective way to do this than through an accounting change; that really obscures the real operating effectiveness of a company. Put in restrictions, put in standards, put in additional shareholder approvals, take away the tax deductibility, any of that stuff, but do not screw up the one way we reflect to our shareholders how we are doing and what we are worth.

For a small company like us, there is a whole bunch of things it is going to do:

First, it is going to make it harder to attract talent. I mean, you hear that from anybody here. We have to compete against stable companies in our area, like Xerox, Kodak, and Bausch and Lomb, three large companies that are very stable. People take a risk when they come to work for us. We have been able to give stock options to the lowest level of the company. The majority of our grants go to non-executives. It is a major reason we did not lose people when we went through tough times in retrenching the company, and it is a major reason why we retain our talent ever year. The shareholders want this, and they approve of our option plans.

I have done well, because I took a risk in joining the company, coming from Xerox, on the stock options. I have investors who call me up and say, "We are really glad that you are doing well on it because you earned it."

We have been able to grant those stock options down into the company. We have a big challenge, as I said, of being noticed by the marketplace. Most investors look right to the bottom line. And, in fact, we made money in the first and second quarters of last year for the first time. I think—I have not done the detailed calculation—but when our stock went up, if we redid the calculation, we probably would have had to take a charge that would have put us in a loss position in the third quarter. Imagine sitting in a conference call and saying to your investors, we did great this quarter, but we lost money because you wanted our stock so badly, the price went up. It is hard to understand. We increased the value of the firm. We had a positive cash flow. We had good results from operations, but we would have had a loss. It does not make sense.

We need access to capital. I think Mr. Jones was exactly right. We are going to bump up against loan covenants. It is going the put a damper on the share price. I do not want to get too technical on finance, but the corollary to the Modigliani-Miller papers, which are the seminal paper on valuing a firm, from Merton said that if you have less information about a company, the share price will be down because of systematic risk. This is what is going to happen. It is going to obscure information about the company, and it is also going to put more overhead in our financial statement. So $100,000 is probably kind of what we are looking at here. We have already doubled our accounting costs because of Sarbanes-Oxley. I am not going to begrudge that, because if it helps investor confidence, we will do what we have to do, but this does not help investor confidence.

And the last thing is it is going to cause is fluctuations. When interest rates change and basic assumptions change, we are going to have a duty to redo these models. So the better we do in some cases, the worse we are going to do—because we are going to take a charge—and then the worse we do, the better we are going to do because when they reverse that charge, it will actually increase the fluctuations, and fluctuations are bad for companies like us because investors are worried about stability.

So it just seems like this does not make sense to me and to a lot of people here. We cannot let the accounting community bow to the pressure to try to quantify something that is already adequately disclosed, it is already accounted for in our EPS, and it adds nothing to the ability of investors to judge us as a business. It is going to hurt our access to capital, it is going to hurt our ability to invest in capital, to reduce our cost of labor so that we can keep production in the United States, and it is going to hurt jobs. It is disproportional on small businesses. The big ones, it is not going to hurt as much, and that is why they do not want to fight the political battle, and they are just letting it happen.

I will also be happy to answer any questions, and thank you so much.

[The prepared statement of Mr. Kavazanjian follows:]

**Senate Committee on Small Business and Entrepreneurship**
**Hearing entitled "Impact of Stock option Expensing on Small Businesses"**

**Statement of John Kavazanjian, President and Chief Executive Officer**
**Ultralife Batteries, Inc.**
**Newark, New York**

**April 28, 2004**

Good morning Mr. Chairman and esteemed members of the committee. Thank you for allowing us to express our opinions on this very important issue.

The issue of expensing of stock options is a very significant one to us. Ultralife Batteries is a small but growing public company in Newark, New York, a small town outside of Rochester. The company has been in business for 14 years and when I became CEO, 5 years ago, it had never been profitable. After years of hard work, last year we finally became profitable and we now are growing and employ over 900 people, up from 250 several years ago, primarily involved in the design and manufacture of battery products.

Stock options are an important part of the way that we attract and retain professional talent. Without the engineers, salespeople and professional managers in our company there would be no work for the manufacturing employees that make up 75% of our workforce. Expensing of stock options serves no useful purpose in the basic function of financial reporting and implementing this standard will hurt everyone, but will fall heaviest on small and growing companies like Ultralife.

What is the purpose of financial reporting? The purpose is to provide the shareholders with information on the operational performance of the company and the data with which to calculate the value of the firm. There are multiple methods for calculating the value of the firm, but most of them come down to an evaluation of the discounted present value of expected future cash flows. The expensing of stock options provides no fundamental added value to this function. The only effect of options is to provide a cash flow from the exercise and to create more shares which figure into a per share earnings calculation. Both of these effects are quite adequately accounted for in the Treasury method dilution calculation that we all use today to report on earnings.

What purpose then, is the proposed rule aimed at? It certainly is not aimed at giving investors an easier way to evaluate a company---in fact it does quite the opposite by imposing a non-cash cost that must be backed out in figuring the value of the firm. Is it aimed at giving more information? I don't believe so, since we already disclose all the data that is required in order to evaluate the effect of outstanding.

It has been suggested that the real reason to do this is to curb excessive executive compensation. I can think of no way less effective than doing this through an accounting change that then obscures the true operating effectiveness of a company. Impose restrictions, standards or additional shareholder approval, but putting an accounting standard in place is absolutely the worst way to do it.

***What does it mean to Ultralife?***

A small company faces some unique challenges.

First, there is the challenge of attracting talent. Expensing of stock options will constrain our ability to attract and retain talent, for both employees and directors. We are not Kodak, Xerox or Baush and Lomb, three of the largest companies in our area.

We have been able to grant stock options down to the lowest level of the company. The majority of our option grants go to non-executives. It was a major reason why we did not lose more than a handful of professional employees during our lean years and a major reason why we are able to retain our talent as we grow. This is what shareholders want and why they approve of option plans.

We also have the challenge of being noticed by the marketplace. Most investors look at the bottom line performance before going down into the details. For Ultralife, we were profitable for the first time in the first quarter of 2003 and then again in the second quarter. Our stock price rose. If we had to expense stock options, the rise in the stock price probably would have caused a change in assumptions. This could have eliminated our profit and put us in a "loss" position in the third quarter even though we had positive results from operations, a positive cash flow and had clearly increased the value of the firm.

Additionally, we need access to capital to finance our growth. The option expensing proposal will be an artificial damper on share price, hence hurting our access to capital. With capital, we can invest in the equipment to keep the labor content of our product down and production in the United States.

This proposal will also impose even more overhead in our financial reporting. This proposal will cost money through our calculation and administration work and through the audit fees connected with certification by our auditors.

Lastly, it will cause artificial fluctuations in earnings and in share prices. Good performance will be rewarded with an increasing share price. This could cause stock option expense to go up in the next quarter and swing earnings down. Share price will then go down and will cause a positive flow back into the earnings, which will swing it up and the cycle will start again. Instability in share price will discourage investors and could have a very negative effect on the company.

***Summary***

If you allow FASB to implement this, you let them bend a measurement system that is supposed to inform investors, into a tool for influencing behavior. We cannot let the accounting community bow to political pressure and try to quantify something that is adequately disclosed, whose effect is already accounted for in EPS calculations and which adds NOTHING to the ability of investors to assess the value of a company.

Expensing stock options does nothing to help investors understand more about performance or value and in fact will obscure the true measures of performance and value. It will also have a disproportional effect on small companies who have a limited ability to educate the marketplace. This is not in the public interest and should be stopped.

Senator ENZI. Thank you very much.
Mr. Mendoza.

## STATEMENT OF ROBERTO G. MENDOZA, CHAIRMAN, INTEGRATED FINANCE LIMITED, NEW YORK, NEW YORK

Mr. MENDOZA. Mr. Chairman, I would like to thank the committee for giving me the opportunity to testify on this important matter. I do so with some trepidation, though, as you will understand in a second.

I believe that the FASB's position is generally correct, and furthermore that the expensing of options will, in fact, prove beneficial to small businesses and the entrepreneurial spirit. Essentially, I conclude that the analysis of the expensing issue does not differ materially for small companies relative to larger ones and that no constituency benefits from omitting any compensation costs from the income statement.

The fundamental point, of course, is whether or not options represent an expense; that is to say, a cost which should be deducted from revenue in the income statement in the same way as all of the other forms of employee compensation. Since there is general acceptance that options are a highly valued form of employee compensation, it seems clear that they should be expensed provided that it is feasible to measure adequately the cost to the issuer of expensing them and, B, that there is no public policy imperative to require a different, legislatively-mandated accounting treatment.

Financial markets provide compelling evidence that it is perfectly practical to value options which are far more complex than employee stock options through the use of models. Each day literally billions of dollars are traded based on models which depend on the fundamental insight of the Black-Scholes-Merton formula. While it is true that models will only provide an estimate of the cost of granting options, this is not a reason, in my opinion, for not expensing them. The preparation of financial statements requires judgment and a great deal of reliance on estimates; for example, amortization and depreciation schedules and the value of intangibles such as R&D expenses, to name but two. Model-based expensing of options provides approximately the right answer. Failure to expense options provides a precisely wrong answer because, clearly, the cost cannot be zero.

I do not believe that the argument that expensing options through the income statement results in double-counting of the expense withstands logical scrutiny. To make the point with an extreme example, let us assume two identical companies, each with annual income of $100,000, and each with non-employee compensation expenses of $20,000. So, at that level, we have $100,000 of revenue. Both companies have $20,000 of cost. However, one company pays its employees $10,000 in cash, plus sufficient option grants to enable it to attract and retain the employees it needs, and the other pays its employees solely in cash of $40,000. These two companies are otherwise totally identical. The only difference is that one of them pays its employees wholly in cash, the other one pays them partly in cash and partly with options. If you fail to expense the options, the first company will record pre-tax income of $70,000, while the second one will show pre-tax income of only

$40,000. Such a result distorts the comparability of financial statements even between two otherwise identical companies.

My final point is that expensing options will actually benefit small companies and encourage start-ups. The calculation procedure will not impose a material cost on management either in terms of time or expense, and in a moment, rather than give you an estimate, I am going to give you some precise numbers. Income statements which properly reflect the real costs incurred by the business, specifically including all of the compensation costs, will make it easier to attract capital because investors will be able to measure properly the potential returns from the investment.

My conclusion is that it would not serve the public interests for the Congress to mandate a different accounting treatment, but I make this point not simply from a theoretical corporate finance perspective, but also from recent personal experience.

In December 2002, my two partners—Peter Hancock and Bob Merton—and myself raised a substantial amount of money from third-party investors to found an international firm, IFL, which you referred to in your opening, Mr. Chairman. Our goal is to do an IPO within 5 years. We, too, are living the traditional American Dream. We have made considerable progress during our first year. We now have 40 colleagues—we did not start in a garage. We started in a spare office at a law firm with three people—we now have 40 colleagues, are licensed as a broker-dealer in the United States and Japan and are growing rapidly. We told our investors that we planned to expense compensatory options, whether or not we were required to do so, before we started the company.

We believe that this commitment to realistic and transparent accounting helped us to raise the capital for a venture which was both highly risky and highly ambitious.

Thank you.

[The prepared statement of Mr. Mendoza follows:]

Roberto G. Mendoza
Chairman
Integrated Finance Limited

I would like to thank the Committee for giving me the opportunity to testify on this important matter. I believe that the FASB's position is generally correct, and furthermore that the expensing of options will in fact prove beneficial to small businesses and the entrepreneurial spirit. Essentially I conclude that the analysis of the expensing issue does not differ materially for small companies relative to larger ones, and that no constituency benefits from omitting any compensation cost from the income statement.

The fundamental point of course is whether or not options represent an expense, i.e. a cost which should be deducted from revenue in the income statement in the same way as all the other forms of employee compensation. Since there is general acceptance that options are a highly valued form of employee compensation, it seems clear that options should be expensed provided that (a) it is feasible to measure adequately the cost to the issuer of expensing options; and (b) there is no public policy imperative to require a different, legislatively mandated accounting treatment.

Financial markets provide compelling evidence that it is perfectly practical to value options which are far more complex than compensatory options through the use of models. Each day literally billions of dollars are traded based on models which depend on the fundamental insight of the Black-Scholes-Merton formula. While it is true that models will provide only an estimate of the cost of granting options, this is not a reason for not expensing it. The preparation of financial statements requires judgement and a great deal of reliance on estimates – e.g. amortization and depreciation schedules, and the value of intangibles such as R & D expenses to name but two. Model-based expensing provides the approximately right answer; failure to expense options provides a precisely wrong answer since clearly the cost cannot be zero.

In any event the debate over the accuracy of models probably severely overstates the complexity of the problem. A recent insight by Professors Bulow and Shoven of Stanford University demonstrates that the maturity of an option for expensing purposes is typically 90 days rather than several years. This results from the provision in most option plans that the employee must exercise any vested options within 90 days of leaving the company for any reason – including resignation or dismissal without cause. This suggests that companies should expense each quarter the cost of extending an option for a further 90 days. The Appendix describes this approach in some detail, and has been submitted to the FASB. The critical point is that the 90-day life significantly simplifies the valuation exercise – among other reasons because there are active listed and OTC markets in 90-day options which provide observable market prices for the valuation exercise.

The argument that expensing options through the income statement results in "double-counting" of the expense does not withstand logical scrutiny. To make the point with an extreme example, assume two identical companies with annual income of $100,000, and non-employee compensation expenses of $20,000. One company pays its employees $10,000 in cash plus sufficient option grants to enable it to attract and retain its employees, and the other pays its employees solely in cash of $40,000. If you fail to expense the options the first company will record pre-tax income of $70,000, while the second one will show pre-tax income of $40,000. Such a result distorts the comparability of financial statements even between two otherwise identical companies.

My final point is that expensing options will actually benefit small companies and encourage start-ups. The calculation procedure will not impose a material cost on management either in terms of time or expense. Income statements which properly reflect the real costs incurred by the business–specifically including all the compensation costs–will make it easier to attract capital because investors will be able to measure properly the potential returns from the investment.

My conclusion is that it would not serve the public interest for the Congress to mandate a different accounting treatment.

I make this point not simply from a theoretical corporate finance perspective, but also from recent personal experience. In December, 2002 my two partners, Peter Hancock and Bob Merton, and myself raised $45 million to start from scratch an international investment banking firm. Our goal is to do an IPO within five years. We have made considerable progress during our first year – we now have forty colleagues, are licensed as a broker-dealer in the U.S. and Japan and are growing rapidly. We told our investors that we planned to expense compensatory option grants whether or not we were required to do so. We believe that this commitment to realistic and transparent accounting helped us to raise the capital for a venture which was both highly risky and highly ambitious.

Thank you.

Senator ENZI. Thank you very much.
Mr. Schnittker.

**STATEMENT OF CHRISTOPHER P. SCHNITTKER, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, CYTOGEN CORPORATION, PRINCETON, NEW JERSEY**

Mr. SCHNITTKER. Thank you, Senator Enzi, for the opportunity to participate in this hearing and to round out this panel. My name is Chris Schnittker, and I am a Senior Vice President and the Chief Financial Officer of Cytogen Corporation. I am here today on behalf of my company and millions of other public and private small companies that stand to be seriously impacted by the proposed accounting rules set forth by the FASB in their recent exposure draft on share-based payment.

First, allow me to provide a brief description of my company and how it relates to this hearing. Cytogen Corporation is a small, publicly held biopharmaceutical company located in Princeton, New Jersey, at the very heart of the East Coast pharmaceutical corridor. We recently have grown to 65 employees, most of whom are dedicated to selling and marketing our two lead oncology products-Quadramet, a therapeutic radiopharmaceutical to ease the pain of metastatic cancer, or cancer that has spread to the bone, and ProstaScint, a monoclonal antibody-based molecular imaging agent used to image the extent and spread of prostate cancer. We are also developing Combidex, a novel molecular metastatic lymph node imaging agent which is currently under review by the FDA.

Further, we support a research and development joint venture to develop prostate cancer therapies based on our proprietary prostate-specific membrane antigen, or PMSA, marker technology. Clearly, each product or product candidate addresses the serious and substantial unmet medical needs of cancer patients and the physicians who serve them.

Cytogen relies on the dedication and drive of our board of directors, officers and employees to achieve its reach on our currently marketed products and to progress its other product candidates through the long and expensive process of drug research and development. To this end, we have chosen a compensation program for our employees which includes, among other elements, stock option grants and participation in an employee stock purchase program. Our stock option program is a broad-based one, granting stock options to every employee of the company, from our CEO, to my department's staff accountants, to each of the company's administrative assistants. We believe such a program best aligns the interests of all employees with that of the company and its outside shareholders—simply stated, improving shareholder value—but also boosts productivity and allows each and every employee to own a part of our success. I would suggest it also allows them to feel some of the pain of an unsuccessful business or a market downturn with underwater stock options plaguing our industry during the past few years.

At the company level, stock-based compensation allows us to attract, retain, and motivate highly qualified scientific and management personnel, many of whom are courted by the Fortune 500 pharmaceutical companies that surround us in our region. To illustrate the difference between those pharmaceutical companies and Cytogen, I offer a very brief story.

From the window of my offices in Princeton, which literally sits in the shadow of a Top Five pharmaceutical company, I often watch their corporate helicopter deliver people from their New York City offices for meetings, a trip that probably takes them, at best, 20 minutes. This is the same trip that my CEO and I have done several times a week, by car or by train, which often take upwards of 3 hours each way. I certainly do not begrudge this company its success. In fact, in certain aspects of our business, they are a critical business partner of ours. But I do hope that someday Cytogen has access to that level of capital, where private aircraft is a necessity rather than a distant luxury. As we are both competitors for the same intellectual capital in the oncology drug development arena, clearly, much of the deck is stacked against a company like Cytogen because of its size and resource constraints. The promise of stock-based compensation among the smaller companies' employees help to level this playing field.

Further, on our employee compensation model, as the cash outlays for our employee health insurance programs and defined benefit pension plans increase exponentially, we—and most other smaller start-up companies—look to non-cash compensation to supplement cash compensation so as to retain and motivate our employees. In order to compete with large pharmaceutical companies, we need to be able to offer meaningful equity compensation in lieu of the larger cash salaries, bonus programs and other perks offered by other employers in our industry.

I am afraid that, with the expensing of stock options, small businesses will be denied yet another form of compensation to level the playing field and its larger counterparts in the industry. We may investigate the same moves made by other companies towards restricted stock grants and performance-based stock options, but each carries with them a complexity that can be difficult for small companies to administer and equally difficult for rank-and-file employees to understand and, perhaps more importantly, believe in their value. Even with those new compensation methods, I hope we will be able to keep the critical ownership and entrepreneurial spirit alive across all employees at Cytogen.

One of my responsibilities as the chief financial officer is to budget and plan for our future growth, but also to allocate our scarce capital resources, both human and financial, in the pursuit of our corporate goals. The appropriate mix of cash-based versus equity-based compensation for our employees is just one of these decisions. Clearly, the current market has told us that companies who have not yet set a clear course toward a sustainable and profitable business model will not survive. This initiative is especially challenging in the biotechnology industry with our 10-year-plus drug development time lines, disappointments or delays inherent to research and the enormous capital required to progress that research in a timely way.

Cytogen has made several conscious choices in this regard, and we believe the market has rewarded us by moving from a market capitalization of just under $30 million in late 2002, to a current market capitalization of $230 million, a greater than 600-percent improvement in shareholder value.

I would like to sum up my comments with my reflections as to why, and perhaps other employees like me, choose to work for small, development-stage businesses. It is not for the stability of a big company around you with adequate capital to ensure its existence, it is not for the businesses that, to some degree, run themselves due to their market share on vast resources. Among many other reasons, it is simply the speed of innovation, a responsiveness to change, the ability to work with leaders and coworkers who embrace entrepreneurial spirit and the chance to change the face of a dreaded disease like cancer and improve the quality of life for the patients and their families who are affected by it.

On behalf of Cytogen and other similar small businesses, I sincerely appreciate the opportunity to express our views on this issue.

[The prepared statement of Mr. Schnittker follows:]

CYTOGEN

**Statement of**
**Christopher P. Schnittker, CPA**
**Senior Vice President and Chief Financial Officer, Cytogen Corporation**

**Senate Committee on Small Business & Entrepreneurship**
**Hearing on "The Impact of Stock Option Expensing on Small Businesses"**
**April 28, 2004**

Madam Chair Snowe, Ranking Member Kerry, and Members of the Committee:

My name is Chris Schnittker and I am the Senior Vice President and Chief Financial Officer of Cytogen Corporation.

Thank you for the opportunity to participate in this hearing on the impact of stock options expensing on small businesses. The following is my written statement, which I respectfully request to be entered into the public record.

I am here today on behalf of my company and millions of other public and private small businesses that stand to be seriously impacted by the proposed accounting rules set forth by the Financial Accounting Standards Board in their recent exposure draft on "Share-Based Payment", better known as the accounting standard which will require stock option expensing.

First, allow me to provide a brief description of my company and how it relates to this hearing. Cytogen Corporation is a small, publicly-held biopharmaceutical company located in Princeton, New Jersey, the heart of the East Coast pharmaceutical corridor. We currently have about 65 employees most of whom are dedicated to selling and marketing our two lead oncology products, Quadramet™, a therapeutic radiopharmaceutical to palliate metastatic cancer pain, and ProstaScint®, a monoclonal antibody-based molecular imaging agent used to image the extent and spread of prostate cancer. We are also developing Combidex®, a molecular imaging agent which is currently under review by the FDA, and we support a research and development joint venture to develop prostate cancer therapies based on our prostate-specific membrane antigen, or PSMA, technology. Clearly, each addresses serious and substantial unmet medical needs of cancer patients and the physicians who serve them.

Cytogen relies on the dedication and drive of our Board of Directors, officers and employees to advance its reach on our currently-marketed products and to progress its other product candidates through the long and expensive process of drug research and development. To this end, we have chosen a compensation program for our employees which includes stock option grants and participation in an employee stock purchase program. Our stock option program is a broad-based one, granting stock options to every employee of the company – from our CEO, to my department's staff accountants, to each of the company's administrative assistants. We believe such a program best aligns the interests of all employees with that of the company and its outside shareholders – improving shareholder value – boosts productivity, and allows each and every employee to own a part of our success. I would suggest it also allows them to feel some of the pain of an unsuccessful business or a market downturn, with underwater stock options plaguing our industry during the past few years. At the company level, stock-based compensation allow us to attract, retain and motivate highly qualified personnel – many of whom are courted by the larger pharmaceutical companies that surround us in our region. From the window of our offices in Princeton, which literally sits in the shadow of a top-five pharmaceutical company's R&D facilities, I often watch their corporate helicopter deliver people from their New York City offices for meetings – a trip that probably takes at best 20 minutes. This is the same trip that my CEO and I have done several times a week by car or train, which often can take upwards of 3 hours each way. I certainly do not begrudge this company it's success – in fact, in certain aspects of our business, they are a critical business partner of ours. But I do hope that someday Cytogen has access to that level of capital where private aircraft is a necessity, rather than a distant luxury. As we are both competitors for the same intellectual capital in the oncology drug development arena, clearly much of the deck is stacked against a company like Cytogen because of its size and resource constraints. The promise of stock-based compensation among the smaller company's employees may help to level this playing field to some degree.

Further on our employee compensation model, as the cash outlays for employee health insurance programs and defined benefit pension plans increase exponentially, we, and most other small or start-up companies, look to non-cash compensation to supplement cash compensation so as to retain and motivate our employees. In order to compete with large pharmaceutical companies, we need to be able to offer meaningful equity compensation in lieu of the larger cash salaries, bonus programs and other perks offered by other employers in our industry. I am afraid that, with the expensing of stock options, small businesses will be denied yet another form of compensation to level the playing field with its larger counterparts in the industry. We may investigate the same moves made by other companies towards restricted stock grants or performance-based stock options, but each carries with them a complexity that can be difficult for small companies to administer and equally difficult for rank-and-file employees to understand and, perhaps more importantly, believe in their value. Even with these new compensation methods, I hope we will be able to keep the critical ownership and entrepreneurial spirit alive across all employees at Cytogen.

One of my responsibilities as a Chief Financial Officer is to budget and plan for our future growth but also to allocate our scarce capital resources, both human and financial, in the pursuit of our corporate goals. The appropriate mix of cash-based versus equity-based compensation for our employees is just one of these decisions. Clearly, the current market has told us that companies who have not yet set a clear course towards a sustainable and profitable business model will not survive. This initiative is especially challenging in the biotechnology industry with our 10-year-plus drug development timelines, disappointments or delays inherent to research, and the enormous capital required to progress that research in a timely way. Cytogen has made several conscious choices over the last few years on its march towards sustainable profitability. These include rationalizing its own internal cell signaling R&D efforts in 2002, which resulted in the laying-off of nearly 75% of its R&D workforce, and controlling the growth of its in-house sales force in support of its growing product base. In previous years, my company has also outsourced its manufacturing efforts for both of its lead products with major pharmaceutical companies, when GMP-quality manufacturing became too costly for a small biotechnology company, at the same time forfeiting a degree of control over our own destiny. We have also further rationalized our investment in R&D by the formation of a joint venture with another public company to share the costs, and decidedly the rewards, of developing our proprietary PSMA technology. The market has rewarded us to some degree for these changes, rising from a market capitalization (defined as the number of common shares outstanding multiplied by quoted market price) of just under $30 million in late 2002 to a current market capitalization of $230 million – a greater than 600% improvement in shareholder value. But there is still work to be done.

The FASB's proposals on options expensing are being handed to Cytogen at a very critical juncture in our history. If adopted, we would need to work these charges into our profitability model before we can determine the true "cost" of our option programs and how we will continue to support them in the future. The results of our initial option valuations, the implementation of the proposed binomial valuation methods and the costs of consultants or software to produce these valuations certainly give us reason to consider the course of discontinuing our broad-based stock option program or reducing the amount of options we grant within that program. We would certainly not be the first company I have read about since this issue began its progress through rulemaking to amend, curtail or eliminate its broad-based employee stock option program. These costs, coupled with the burgeoning costs of recent requirements of the Sarbanes-Oxley Act of 2002 and corporate governance initiatives implemented by NASDAQ, will hit smaller businesses harder than larger, well-established entities. The irony, to some degree, is that many companies are considering doing away with stock options at a time when, as a result of the market rebound over the past few months, they are once again a substantial motivating factor for our employees. Rationalizing this program at this time will be a difficult "sell" to our employee base.

We are also concerned at Cytogen about the market's reaction to a potential setback in our path towards profitability as a result of the proposed stock option accounting rules. Cytogen's access to capital on terms favorable to the company is a critical factor to the future success of our business. My CEO and I spent much of the first quarter of 2004 engaged in capital raising activities, leading up to a successful $26 million capital raise during April. This process involved many face-to-face meetings over several months with bankers and advisers developing our strategy and getting them comfortable with the Cytogen model. This process culminated in a condensed 2-day deal "road show" to interested investors. During this 48 hour period, we met with approximately 15 potential institutional investors – most of which were less than an hour in length. I would argue that helping a potential investor become truly knowledgeable about your financial model and cash flow prospects in less than one hour, especially on a company as multifaceted as Cytogen, is going to be near impossible if we are soon asked to carve out substantial non-cash charges like stock-based compensation. The core cash flow models of companies like ours is a critical marker of their eventual success or failure. An investor's understanding here is critical to their decision whether or not to invest. I would rather be spending that hour discussing the future promise of our marketed products and the quality of our research and development programs than dissecting our true cash flows from our public financial statements.

I would like to sum up my comments with my reflections as to why I, and perhaps many other employees like me, choose to work for small, development-stage businesses, particularly in the life sciences arena. It is not for the stability of a big company around you with adequate capital to insure its existence. It is not for businesses that to some degree run themselves due to their market penetration or vast resources. Among many other reasons, small businesses offer:

- The speed of innovation;
- The responsiveness to change;
- The ability to work with leaders and co-workers filled with entrepreneurial spirit; and
- The chance to change the face of a dreaded disease like cancer and improve the quality of life of the patients and their families who it affects.

For the anxiety, the long hours, the working weekends, and last-minute travels – I hope that my company's leaders, my co-workers and my staff can share in the reward of their company's success, commensurate with the enormous risks they assume in working for a small business. An important and effective tool for sharing this success is through the broad-based grant of employee stock options.

I fear that bringing subjective, assumption-based accounting charges to bear on the current system of employee equity compensation puts undue pressure on small companies and their ability to attract, retain and motivate the very employees that are critical to their success. I believe delaying the current rulemaking on stock-based compensation until 1) we have addressed the accountants' and investors' concerns over valuation methodologies and comparability among companies and 2) we better understand its broad economic impact to small business is of vital importance.

On behalf of Cytogen, and other similar small businesses, I sincerely appreciate the opportunity to express our views on these important issues.

Senator ENZI. Thank you.

I want to thank all of the panelists for their enthusiastic and varied testimony. It covered a wide range of information here. I also want to thank Chairman Herz for staying and listening to the comments. There was just a tremendous amount there, and I think it helps to explain a little bit why some of the big mature companies are particularly excited about expensing theirs and why small companies may not be. I am reminded, when I went to Kyoto for some of the negotiations on global warming, and when I got there I found out that the United States was the only country that was there under the impression that it was an environmental conference. All of the rest of them realized it was an economics conference, and we took some blows as a result of that, and some of the other countries did very well.

This is perhaps a mature versus growing company issue, but I do really get excited when I'm around small businessmen, and I know that it is that excitement that you have and your understanding of what you are doing that is really the secret to the success of your companies. You have taken some risk and been willing to do that, and I have no doubt that the companies here will succeed.

Mr. Kavazanjian, did I get it?

Mr. KAVAZANJIAN. Yes.

Senator ENZI. All right. Your presentation made me think that your batteries will do better than that company that has the funny bunny.

[Laughter.]

Mr. KAVAZANJIAN. We hope so.

Senator ENZI. You really did a great job. All of you are excellent spokesmen on the issue, and again there is that variety of information, and I want to get into that a little bit.

I will start with Dr. Carron because you have worked with SBIR and STTR and competitively competed for awards. Will the stock option hamper the growth and ability of firms to participate in that, and can you provide any examples of areas that it might have an affect on the business?

Dr. CARRON. Well, those programs, again by their very nature, you write a budget, and at the end of the grant period, you had better have matched your budget. So they lead to balanced income statements.

If we try to attract employees through the stock option plan, that will give us a negative balance on our income sheets and, I believe, lead to the failure of our company just because we will not be able to grow out of that R&D mode into a mode that actually manufactures and sells products, which I believe is the goal of the SBIR and STTR programs.

Senator ENZI. Right. When you get one of those grants, it is my understanding that you are routinely audited. Do you think there would be any concerns on how the expensing of options is done and what impact that might have?

Dr. CARRON. Well, you are correct. We do have to undergo an annual audit. I am not sure how the agencies would view a negative income statement, but I am sure it would be a bad strike on our company.

Senator ENZI. Thank you.

Mr. Schnittker, you broke away from a large pharmaceutical company to pursue a specialized niche in technology, and one of the things that kind of is in the back of my mind is can all of your employees pronounce the names of the stuff that you have? Is that a part of the test?

Mr. SCHNITTKER. I think we work very hard to try to make those names difficult to pronounce.

[Laughter.]

Senator ENZI. I was impressed that you just rattled those off. But you have pursued a specialized niche in technology, and given that your firm was able to retain and recruit personnel, and you said through stock options, how would you propose to recruit and retain employees if this rule is finalized this way?

Mr. SCHNITTKER. Well, there are other alternatives that are out there. It is something that we have considered a lot lately. In fact, just two weeks ago, we took on a very important hire who was an individual from Amgen. It involved a relocation to the East Coast, and he will now be our senior vice president of sales and marketing.

One of the considerations that obviously any employee makes when they decide to come on with a firm is what the package is worth and what the company offers. For us, we are looking at things like restricted stock programs, perhaps increased compensation, perhaps increased bonus programs, a variety of other things, many of which are cash based, which is difficult for us. Capital comes at a great cost. I heard somebody else on this panel mention that.

The other option that we are looking into are performance-based stock options, which have a little bit of a different accounting impact, but are extremely difficult to administer, especially in the rank-and-file employee range. It is very difficult to create a series of objectives that are quantifiable and measurable for absolutely all of your 65 employees.

My CEO is compensated with stock options that are performance based, and I think that is very important, and it is very clear to identify for a CEO what his four or five goals are over the next 5, 10 years, but I really question our ability to do that much broader than senior management.

Senator ENZI. So the other employees there, their performance measurement is how well the stock does, then.

Mr. SCHNITTKER. How they support the company and its success. We have a very robust goal-setting program. We have a lot of requirements that go right down into the individual departments: Clinical Development, Research, Sales and Marketing. So they all understand what their piece is of the bigger pie, and as long as they do their piece, the theory is that that will support the company's success.

Senator ENZI. I have been trying to get the Federal Government to do a performance and results type of compensation. I have not had much success.

Thank you.

Professor Diamond, on the last page of your written testimony, you mentioned getting rid of options altogether. So are you against stock options or just because they are accounted for differently at the present time? I am curious as to that statement.

Mr. DIAMOND. I think that stock options, as I suggested in my oral statement, create a conflict of interest between the optionholders and outside investors. And we have to keep in mind that wherever there is a small business, there are also lots of small investors, and they deserve a clear and unbiased picture of the financial condition of the company. And I think stock options induce insiders, and particularly senior managers, to manage the company in a way that increases risk and volatility and then distorts the outcome for the company.

So, in the long run, I think that we should move away from stock options. I favor use of restricted stock or cash-based forms of compensation.

Senator ENZI. So that would be why it was noticeably absent in your testimony—any discussion about the accounting of the evaluation process, which is one of the concerns of the small business is how you get to that number.

Mr. DIAMOND. Well, I am not particularly troubled by the resources that will be required to provide accurate valuation. The market does it already in part, and I think that services will emerge to provide that for small companies, if it is necessary. I think we have to be very careful here about blurring the lines. We are talking about small companies that want to go public. Stock options for small companies that do not want to go public are really irrelevant. So we are talking about small companies that want to tap into the public markets. That is where the options have real value for the employees.

That talented individual did not leave Amgen to join a small, I am sorry, company that I had not heard of before in Princeton, New Jersey, right, because he expects to be part of a private company for the rest of his life. He expects it to be a public company and to sell his shares into the public markets at some great profit to himself. So we have to be careful that we do not blur the line between all 22.9 million small firms in this country and maybe the million or so that really are looking to tap into the public markets.

If you are looking to tap into the public markets, you are tapping into the large retirement systems of America's workers, teachers, toll booth collectors, police officers, nurses, et cetera, whose retirement assets provide the fundamental capital that goes into our public markets. And those individuals deserve a clearer, better picture, more accurate picture of the financial condition of these companies. It seems appropriate for certain small companies that intend to move in that direction to begin to adopt the FASB approach. A company that does not intend to go public does not have to because they do not have to use GAAP accounting. So really, the option for many small companies is just to ignore the FASB.

But if you are going to be talking about tapping into the public markets, where the real payoff is for these individual employees, you are living in a different world.

Senator ENZI. I will move to Mr. Mendoza because we are talking about here, at this point, the ability to easily calculate that. Mr. Mendoza, you used to be with JP Morgan as an investment banker, and so you worked with Mr. Merton of the Black-Scholes-Merton valuation model. Last year, JP Morgan Chase entered into an agreement with Microscoft, where JP Morgan Chase would buy the outstanding stock options of the Microsoft employees, and based on our calculations, the pricing is well below the valuation that would occur of Black-Scholes-Merton was actually used.

How would you account for the discrepancy, especially since Microsoft is one of the most heavily followed stocks by researchers? If they do not use Black-Scholes-Merton, then why would small growing companies do it? They made a major shift, and you probably have some insight into that for us.

Mr. MENDOZA. Well, I will try, Mr. Chairman.

First of all, in terms of my own background, I did work for JP Morgan for 31 years, but left before the merger with Chase Manhattan. So I was not involved in that particular transaction. I do know something about it and have, together with my partners, written about it in an op-ed piece.

I think that the fundamental point that I would make is that the purchaser of those options—in that case, the bank—did use a pricing methodology which was either a naive Black-Scholes model or some variant, as the chairman of the FASB discussed this morning. Those valuation models all have a common heritage. They are not different in the way that has been represented, but I think it was as simple as the buyer using a valuation model, and the seller not doing so. The seller got too low a price, and the buyer got the difference. It was pure economics.

Senator ENZI. But heavily discounted.

Mr. MENDOZA. Absolutely. It was heavily discounted because the buyer did use the model and bought the options at a lower-than-model price.

Senator ENZI. You were able to raise $45 million, I think, to start an international investment banking firm and are planning to do an IPO?

Mr. MENDOZA. We are hoping to, but it is a few years away.

Senator ENZI. Have you evaluated what the cost of expensing your stock options will have on the ability to do that IPO?

Mr. MENDOZA. Yes, sir. We think it will facilitate it, as it facilitated the raising of the money because we believe that honest, transparent, realistic accounting just attracts buyers. As Chairman Greenspan has recently said, we believe that the market is going to place an increasing premium on the integrity of financial statements and not counting a very important part of your compensation cost, expensing some of it and not the rest of it, does not, I think, promote integrity of financial statements.

I did mention in my prepared remarks that I was going to give you some numbers on the actual costs in terms of time or money of expensing options. Our small company has just negotiated an agreement with a new investor who is going to purchase around 10 percent of our stock. He, quite appropriately, asked for audited statements which we did not have. Our accounting firm is PricewaterhouseCoopers, and we asked them how long it would take to provide audited statements from the drafts they had already given us, and it takes about 3 weeks.

The draft came back yesterday, and one of the things that had not been done was to expense our options. So we called up and said, well, we need to expense the options because that is what we believe is right. They told us that under APB 25, you could use a zero volatility assumption which, again, would result in no expense. We said, no, we need to expense them, but we do not want to be silly about this. If it is going to delay the process so we cannot raise our additional funding, we will not do it. We are not required to.

The answer came back that it would not delay the process, it would not increase the cost of our audit, and we computed the number, the actual expense number, in under 20 minutes.

Senator ENZI. Thank you.

Mr. Glover, since FASB is not a Federal agency, but a private-sector entity, are there any remedies available to small business if FASB does get it wrong?

Mr. GLOVER. I do not know of any, sir. I think all Federal agencies and most State agencies have to comply with some version of the Regulatory Flexibility Act. While this is a quasi-Government or Government-sanctioned entity, the Regulatory Flexibility Act, the Administrative Procedures Act, none of the safeguards apply. And I would think, candidly, that there are no small businesses with the financial resources to have challenged it under any circumstances.

Senator ENZI. Since FASB is a federally recognized standard-setter, should the FASB 123 proposal be subjected to the Regulatory Flexibility Act or should FASB be required to live up to the standards set in the act?

Mr. GLOVER. I think the latter part of that question is very clear. They certainly should be. We have not found any Federal agencies, despite protestations at the beginning, that could not meet and comply with the law, and when they did, they found that they got a better outcome. So I think that they should.

The legal issue of whether the law should be changed, I think that is going to be dependent upon whether FASB changes its existing pattern of activities and really does take it seriously. I am dead serious, when somebody does a regulation that one size fits all, it will not work. Small businesses cannot afford and cannot handle the kinds of burdens, problems, and they do not have the facts upon which to make these assumptions. Many of these companies simply do not have the experience.

So I think, if they do not take that into consideration, if they do not begin considering small business seriously, if they do not have a very active advisory board and make that happen, I think you will have to consider making the law, including them and some other quasi-Federal agencies that have similar situations.

Senator ENZI. FASB is reaching out to small business with their advisory board. A question that I have for all of you is how would you suggest getting the word out to the small business community? Most of them are not going to notice until a FASB directive actually impacts them, but we would like for them to be involved in the comment period so that they can—and I will start with you, Mr. Glover.

Mr. GLOVER. Well, I alerted, I am also the Executive Director of the Small Business Technology Coalition, which is the largest group of SBIR companies in the country, and I did alert our board to that issue. They generally were supportive of my comments today, in the board action, and have directed that we comment on this.

So I think we will get the word out to companies. Because I think the unintended consequences for Government contracting firms and other firms is they will suddenly find themselves in a situation where they cannot obtain audited financial statements for no other reason—and I disagree that all of these companies are going public. They are going to be impacted, and I think we will try to get the word out to those companies, and hopefully some of the other small business groups will do the same.

Senator ENZI. Thank you.

Mr. Jones, do you want to comment on that?

Mr. JONES. Just on that particular issue. As I listened to that, I thought it was kind of interesting because I know, in our company, our heads are pretty down. I had no idea that the Small Business Advisory Committee had this website and whatever, and the real question is how would I?

And so the big issues for, I think, our small companies are what is the composition of the Advisory Committee? Where do the people come from, and what are their backgrounds that they can help in, one, understanding the issues, truly understanding, not that they are not responsible, but that they understand the issues because they are living it, in terms of the composition of the committee itself. And then those people have access to lots of other similarly situated people who can provide the kind of input that I understood from the testimony today was wanted by the committee, the Advisory Committee.

Senator ENZI. From your testimony, and also Mr. Kavazanjian's, you mentioned that you had kind of a broad base, and I am curious as to what you think the effect will be on your lower-level employees, the non-executives. I appreciated your comments that this becomes an extra step and does not have a lot of value. Now, if you are going to be doing some additional capital-raising or something like that, then there could be some additional value to it, but if you are just trying to operate, as you have been operating, what effect is it going to have on your lower-level employees?

Mr. JONES. It has a significant impact on our lower-level employees because I think part of what has been missing in the debate about all of the stock options is that there are all sorts of things that can happen, but the question is, for lower-level employees, how much capital do they have with which to actually buy restricted stock or to purchase the actual stock options?

I will not go into it, but I can actually answer the questions that came up earlier about the tax implications of the grant of a stock option and what is the difference between a non-qualified and an incentive stock option and so on and so forth. All of us, we actually live that stuff each and every day, and suffice to say, without getting into the details, it was totally mischaracterized this morning. The impact that was characterized and the truth is 180 degrees different.

Anyway, putting that aside, the impact on our employees would be significant because, for us, it is all around capital, how do we get capital, and what is the impact of our financial statements on capital? So, if we have to spend a disproportionate amount of money in order to get what FASB believes are accurate financial statements, that is disproportionate in the context of what impact it will have on our financial statements, that is sort of backwards from our perspective.

So, when we look at, in our case, the reality—and I am sure Mr. Diamond, who has been in Silicon Valley, would attest to this, the way that we today understand the market value of our companies, there are two ways:

The first is when you are raising capital. So, in our particular case, we have raised $40 million with kind of—I guess we have messed-up, if they have got clean financial statements, we have messed-up financial statements, but somehow we have been able to raise $40 million with those messed-up financial statements because we have not been expensing stock options. And so the only time the market determines the value of our business is when you go out and you raise money, and you have various people who set the price for the stock as they purchase into your company.

Every other period is done by the board of directors, and the board of directors are not experts in the financial valuation of a particular company on a particular day. And if you look at companies which go public, a significant amount of effort, and time and expense comes in the SEC process, where all of those stock grants are reviewed, and there is an understanding based on sort of what has happened so that you can look backwards as to whether the valuation of those companies were appropriate for stock issuance purposes, stock option issuance purposes at each of those various points.

And that is probably the single biggest issue of investment and time as part of the public offering process. That, by itself, says that small companies don't have any of the art and skill that was referred to before around being able to implement these set of proposed regulations, and so we will have no choice, because we do not have it, our board of directors do not have it, the liability associated will be very, very significant in terms of, because it goes directly to the financial statements, so you have got to go and make sure you have got experts that are providing you with the information. It is going to be a significant impact on our hard costs in terms of complying with the proposed regulations.

Mr. KAVAZANJIAN. Can I build on that a little bit?

First, this whole thing, the reason why small business is having a hard time being heard here is because there is a sense of inevitability about this thing happening. I had a director tell me, who was a former CEO, he just retired, he said, "Yes, you are right, but it is going to happen anyway."

And the way the inevitabilities had happened is in the assumption that a stock option is an expense like any other expense. And to characterize it any other way is dishonest. I have heard a lot of times from several people today about we have to have honest financial statements, and I am insulted by that. We have very honest financial statements. All of the data is there. Every piece of data is there

And so we have a little different viewpoint of it as an expense. Yes, it is an expense in one regard, but it is an equity expense. The shareholders have said to the employee, if you will stay here and be dedicated to this company, we will let you buy the stock as if you are reaching back to the day that we gave you the option. I sold equity at $4, I sold equity at $5, I sold it at $13, and my stock is $22. I did not revalue that equity on my balance sheet.

We will never win that battle. The accountants have decided that there are beans that are not in a jar that have to be put in a jar somewhere. It does not help the investment community value the firm. We will do nothing different. We will try to do nothing different, assuming I keep my job, we will try to do nothing different, except to educate people, if this happens, about what the real performance of the company is.

And that is where my accounting firm has a heart attack because I say, gee, what I am going to lead with in my press release is our profitability, before stock option expensing, was "X," and they have a heart attack because it is not GAAP. I am not a financial professional, although I was trained in finance, 2 or 3 years ago the flexibility was taken away from us to present alternative ways of looking at our financial statements that might enhance things because they are not GAAP—Generally Accepted Accounting Principles.

So we have this one-dimensional model in what is a four-dimensional world: three dimensions plus time. And everybody wants to sound bite one number. And we give them the sound bite of one number that does not let them evaluate the firm, that further obscures it, it is going to be a mess. So we are going to try to educate the community if it does happen. The problem is that the initial assumption that is an expense, not an equity expense, but a period expense having to do with performance of the company, it is wrong, and I am not going to waste my time trying to convince FASB of that because I do not think they are going to get it. That is where we are.

Senator ENZI. Thank you.

Mr. Diamond.

Mr. DIAMOND. If I could just reply to some of this. Look, the problem is Enron had its SPEs, its off-balance sheet vehicles, disclosed in its footnotes, also. It also had its stock option grants disclosed in its footnotes, but no one could figure out the toxic combination of the two, and the danger is that you get boards of directors who think that stock options are far less costly to a company than they really are, and you create a mono-culture inside the firm to take risks with other people's money, as Justice Brandeis called it, and you drive the company into the ground.

Now, it may be that, historically, we thought that American managers were too risk averse, and a shift to an equity-based world in the 1970s and 1980s was important, and that is where the stock option culture first emerged. But it took hold with toxic effect in the late 1990s, and we are still feeling the effects of that. We funded far too many companies, quite frankly, in the late 1990s, too much money chasing too few good projects, and we ended up with a huge crash.

The NASDAQ is still only at about 50 percent of its peak in the spring of 2000. Confidence has not returned to the market. Money is sitting on the sidelines. I am quite certain that you run an honest business and that you do the best to disclose to your shareholders, but the world gets a little bit more complex than that, and we are talking about the larger picture here.

If I could make just one comment about the issues that came up this morning with respect to global competition. I would not look to China as a model for how to disclose information to investors. It is a corrupt system. There is no rule of law. There is no transparency. There is no independent Securities and Exchange Commission. There is nothing that looks like the Financial Accounting Standards Board. There is no genuine private sector. It is an entirely politically controlled regime.

We have to tap into the world capital markets in this country for a $1.5 billion every day, net, to keep funding our businesses. Foreign investors continue to be willing to put money into this economy for one simple reason, and this is what makes the American economy more competitive than any other economy in the world. We protect minority shareholders' rights. We give them information under the securities laws, and we give them State corporate law to govern the way in which companies are managed. If minority shareholder rights are not protected in this country, people would not invest here.

Foreigners know they can pour money into the American economy and know that there is some basic protection for investors while they do so, and that is why this reform is such a crucial signal to the global economy and to the U.S. economy as a whole.

Senator ENZI. I want to tell you that one of the reasons that I have a lot of faith in this country is because there are a lot of small businesses, and there are a lot of small businessmen like we have on this panel here today. It highly encourages me, when we talk about Enron or WorldCom or Tyco or some of those, we are not talking about small business, and we are really not talking about an accounting problem. We are talking about out-and-out fraud. We are talking about a lack of ethics in this country among certain people, not all of them. There are a lot of big businesses out there that are acting ethically. All of the accounting rules in the world did not keep Enron from doing what they were doing.

There were people—and I recommend a book called, "My Brother's Keeper," which is a biography of a guy that teaches at George Washington University by the name of Emitai Etzioni, who had the opportunity to teach an ethics class at the Harvard School of Business. He went through, in his opening session, a series of questions asking about ethical problems. He started out with some that were grey, and he worked through to some that were absolutely black and white to everybody I know, and he still had these Harvard Business School future executives. In fact, at the time that he did that, they would be the executives that are running these companies right now, saying, "Well, how does it affect the bottom line?" They did not say, "Is it right?" They said, "How does it affect the bottom line?"

The stock options question for small business is not that same kind of a question. I have got to tell you, when I was working on that Sarbanes-Oxley, a little over a year-and-a-half ago, companies were afraid to do restatements, even if restatements raised the value of their company because, even if it raised the value of their company, their stock went in the toilet because people were equating a restatement with fraudulent activity.

For small business, this is going to be—probably for big business, too, but they have more capability to explain what is going on—it is going to be a restatement. These companies that already exist are going to be restating what they have been doing and winding up with some negative balance sheets. The Small Business Administration may get it and may make some exceptions, but it is going to require some changes there. Bankers, when the meeting started, there was standing room only. In the back of the room, there must have been 10 or 15 bankers. I know they were from Wyoming. I will get to meet with them later today. I do not think they loan on negative balance sheets either.

I am also concerned about one line replacing many footnotes. People I know have been able to look at the footnotes, make some translation, decide how the company was doing. So I really have some concerns about what we are doing here, but mostly from the standpoint of small business because we have small businesses in this country that are growing, and we need to make sure that we keep new small businesses.

I held an inventors conference this last summer, and Wyoming is the least-populated State in the Nation, and because of Senate ethics, I was not able to advertise for it. I still had 85 people show up that were right on the verge of having, they have got an invention. They just were not sure what to do with it next, and they have been concerned about how are they protected. We had people there that talked about trademarks, and patents, and copyrights, and prototyping, and venture capital, and marketing, and manufacturing, and shipping, and I am pretty sure I am going to get probably about 75 businesses out of that, some of them with some absolutely great products that I wish could talk about, but they are still in proprietary stage.

I am hoping that some of those companies will be able to use stock options to get the talent they need because, while they may have $100,000, it is going to cost them more than $10,000 for their employees unless they can use stock options, and they are limited on cash. We are having trouble attracting venture capital out our way. So I am trying to watch out for those folks.

I do appreciate everybody's testimony today. The witnesses were outstanding on both panels, but there obviously appears to be a significant difference of opinion. Our small business witnesses have a completely different perspective on FASB's stock option expensing proposal than FASB or the non-small business witnesses.

As we heard from our witnesses and the former chief counsel for advocacy, it is absolutely essential that FASB get it right the first time. I want you folks to still be in business after the rule goes into effect. If FASB gets it wrong, some small businesses will not have any recourse. They will not last long enough for any changes to be made.

I do look forward to hearing the comments from the Small Business Advisory Committee, and I am very encouraged by the comments today that it will be opened up, perhaps with more meetings and more opportunities to have some say in what the agenda will be.

With respect to due process, I am extremely concerned that FASB seems to have already made up its mind on the proposals, and the words do not match up with the actions. If anything, it appears that FASB is orchestrating, through members of its parent board and through a one-sided outreach effort, the notice and the comment process. Now, I hope I am proven wrong on that. FASB's actions do not live up to the high standards that we expect of federally recognized standard-setters, and I strongly believe that if FASB were a Federal agency, then its actions would violate the due provisions of the Administrative Procedures Act. I know there have been some field tests. I am not aware of any of those being done on a small business.

I would like to thank Chairman Herz for being here for the entire thing. It is really outstanding when somebody from that level stays for all of the testimony and the questions. I would like to personally thank Chairman Snowe for allowing me to chair this vital Small Business and Jobs hearing today.

I thank all of you for your time. The record will remain open for 10 days. We will be submitting some more detailed questions to you and would really appreciate your responses.

Thank you.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

# APPENDIX

FOR THE RECORD

**STATEMENT OF SENATOR PETER G. FITZGERALD**
**COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP**
**APRIL 28, 2004**

Thank you, Mr. Chairman, for holding this important hearing today on the Financial Accounting Standards Board, known as FASB, and its recent proposal to require the expensing of stock options.

I would first like to welcome our witnesses, and thank them for taking time out of their busy schedules to be with us today. I look forward to their testimony.

Several bills have been introduced in Congress that would block FASB's new proposal. I oppose those bills for two reasons. First, I agree that stock options should be expensed and support the new FASB proposal, although I believe it could be stronger. Second, I believe that political interference with our private sector accounting standards board would set a dangerous precedent.

We have been down this road before. A decade ago, FASB proposed an accounting standard that would have required companies to record the value of employee stock options as a compensation expense on their income statements. At that time, the Senate overwhelmingly passed a resolution that condemned FASB's new standard, and a separate bill was introduced that would have stripped FASB of its rulemaking authority. Under this threat of evisceration, FASB withdrew its recommendation.

Opponents of the new FASB proposal claim it is difficult to estimate the value of options. I disagree. Options may be sold for cash, which makes them as good as cash. Warrants that are similar to, if not functionally the same as, options are valued and sold on a regular basis. Stock options are traded on markets throughout the world and on exchanges such as the Chicago Board Options Exchange.

Opponents of the FASB proposal also argue that stock option valuations are too difficult to estimate. However, it is also difficult to value many other items for which companies are required to account, including pension liabilities, derivative positions, impairment of goodwill, and even depreciation of plant and equipment. Yet no one argues that for these items, difficulty to estimate gives a company the license to pretend that these expenses do not exist.

Opponents also claim that stock options require no cash outlay by a company, and therefore, need not be expensed. But depreciation, for example, requires no cash outlay either, and no one argues that we should not try to account for the real expense of the depreciation of plant and equipment. Furthermore, large amounts of stock options often later necessitate large cash outlays. Companies often are required to allocate more cash on share repurchases to stem shareholder dilution than the amount the companies would allocate for cash compensation of their employees.

Opponents of the FASB proposal also claim that stock options are not a real expense to a company. If that is so, why do we allow companies to take a tax deduction for the expense of issuing stock options? If the opponents were consistent in their thinking, they would support changing the IRS rules, which currently allow for the tax deductibility of stock option compensation.

Opponents further argue that requiring stock options to be expensed would penalize the earnings of young promising companies, and thereby make it more difficult for such companies to survive and succeed. But as Warren Buffet has written, "Why then require cash compensation to be recorded as an expense given that it too penalizes the earnings of young promising companies?" Going further, Mr. Buffet asks, "Why not allow companies to pay all of their expenses in options and then pretend that these expenses don't exist either?"

Last month before the Joint Economic Committee, Federal Reserve Board Chairman Alan Greenspan stated that if stock options are not expensed, the financial statements would present a distorted view of a company's profitability. He further stated that he views FASB's recommendations for accounting changes to be correct.

Mr. Chairman, I would like to ask unanimous consent that excerpts from Chairman Greenspan's testimony before the Joint Economic Committee and a speech he gave on the topic in 2002 be included in the record following my statement.

On April 20, 2004, the Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, which I chair, held an oversight hearing on the expensing of stock options. One of the most troubling issues we discussed is the impact of issuing employee stock options on shareholders' equity when it is not fully disclosed to the shareholders or other users of the financial statements. Current accounting standards do not require that the reflection of equity dilution by virtue of the issuance of stock options be fully disclosed through the income statement. Moreover, the dilution of shareholders' claims to the earnings of the company is only disclosed for so-called "in the money" options, but is not required to be disclosed for options that have been issued and are not yet in the money.

Under current rules, the financial statements of companies that do not expense stock option compensation are, in my judgment, fictitious. The Financial Accounting Standards Board's proposed new rule would make earnings reports more accurate and would move financial statements from the fiction to the nonfiction section of the public domain. When it comes to stock options, expensing them should not be an option. Truth in financial reporting should be mandatory.

Thank you, Mr. Chairman.

**EXCERPTS FROM TESTIMONY PROVIDED BY THE HONORABLE ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE BOARD, DURING THE JOINT ECONOMIC COMMITTEE HEARING ON ECONOMIC OUTLOOK**
**April 21, 2004**

*"With respect to stock options, I think it would be a bad mistake for the Congress to impede FASB in this regard. First of all, this is an accounting question. I've always argued that accounting is for the purpose of determining whether particular strategies of companies are profitable or not profitable. The whole point of accounting is to tell somebody whether a specific strategy is working or not. The cost of worker input, labor cost, irrespective of the form in which it's paid, is a critical determinant of the reduction process and the determination of whether or not a strategy is profitable. In other words, in simple terms, if your output values are greater than your input values, within certain limits, it's a profitable strategy. If you take one of the significant elements of input of costs and take it off the table, meaning you don't expense stock options, then we're getting a distorted view as to what the profitability of a particular operation is and you will get a distortion in the allocation of capital. Now, it may very well make individual firms look more profitable than they are and people don't like to change that. But the point of issue is not whether it is more or less profitable, but are the figures right? And in this regard, as best I can judge the FASB changes in recommendations with respect to accounting procedures strike me as correct, and it's not clear to me what the purpose of Congress is in this particular procedure."*

*See* Hearing Transcript, as reproduced by LexisNexis Congressional, at page 10.

*"I chose my words appropriately and I think the Congress would err in going forward and endeavoring to impede FASB in its particular activities."*

*See* Hearing Transcript, as reproduced by LexisNexis Congressional, at page 24.

Pete Fitzgerald

The Federal Reserve Board

## Remarks by Chairman Alan Greenspan

**At the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia**
**(via satellite)**
**May 3, 2002**

### Stock Options and Related Matters

I asked Jack Guynn and Bob Eisenbeis what issues you would like me to address this morning. They suggested that events associated with the failure of Enron have refocused attention on a number of accounting issues.[1]

In an economy as large, diverse, and complex as ours, sound corporate governance--including the accurate measurement of corporate performance--is essential if our nation's resources are to be directed to their most efficient uses. There can be little doubt that, on the whole, both, as employed in the United States in recent decades, have been of very high quality. We simply could not have achieved our level of economic performance if capital were allocated on the basis of grossly inaccurate information.

But the very complexity and dynamism of our system requires that we constantly evaluate the tools employed for measuring corporate performance to ensure that they adapt appropriately to the evolving financial and economic environment. In that regard, the increasing use of stock option grants to employees has raised new challenges for our accounting system.

Such options are important to the venture capital industry, and many in high-tech industries have counselled against making any changes to current practices. They argue that the use of options is an exceptionally valuable compensation mechanism; that recognizing an expense associated with these grants would reduce the use of options, harming high-tech companies; that the effect of options on fully diluted earnings per share is already recognized; and that we cannot measure the costs of options with sufficient accuracy to justify their recognition on financial statements.

These are important concerns. This morning, I would like to address them and other related issues. The seemingly narrow accounting matter of option expensing is, in fact, critically important for the accurate representation of corporate performance. And accurate accounting, in turn, is central to the functioning of free-market capitalism--the system that has brought such a high level of prosperity to our country.

Capitalism expands wealth primarily through creative destruction--the process by which the cash flow from obsolescent, low-return capital is invested in high-return, cutting-edge technologies. But for that process to function, markets need reliable data to gauge the return on assets.

Measures of profitability, however, can only be approximate. Although most pretax profits reflect cash receipts less cash costs, a significant part of profits results from changes in the valuation of items on the balance sheet. The values of almost all assets are based on their ability to produce future income. But an appropriate assessment of asset value depends critically on a forecast of forthcoming events, which by their nature are uncertain.

A bank, for example, books interest paid on a loan as current revenue. However, if the borrower subsequently defaults, that presumed interest payment would, in retrospect, be seen as a partial return of principal and not as income. We seek to cope with this uncertainty by constructing loan-loss reserves, but the adequacy of those reserves is also subject to a forecast. Similarly, depreciation charges against income, based on book values, are very crude approximations of the decline in the economic value of physical plant and equipment. The actual decline will not be known until the asset is retired or changes ownership. Another example is the projection of future investment returns on defined-benefit pension plans, which markedly affects corporate pension contributions and, hence, pre-tax profits. Thus, how one chooses to evaluate the future income potential of the balance sheet has a significant effect on *current* reported earnings.

The estimation of earnings is difficult enough without introducing biases into the calculation. I fear that the failure to expense stock option grants has introduced a significant distortion in reported earnings--and one that has grown with the increasing prevalence of this form of compensation.

As I noted at the outset, some view the current treatment of option grants as having been a major aid in raising capital to finance the rapid exploitation of advanced technologies. While the vital contribution of new technology to the growth of our economy is evident to all, not all new ideas create value on net. Not all new ideas should be financed. In recent years, substantial capital arguably was wasted on a number of enterprises whose prospects appeared more promising than they turned out to be. This waste is an inevitable byproduct of the risk-taking that generates the growth in our economy. However, the amount of waste becomes unnecessarily large when the earnings reports that help investors allocate investment are inaccurate.

Stock-option grants, properly constructed, can be highly effective in aligning the interests of corporate officers with those of shareholders. Such an alignment is an essential condition for maximizing the long-term market value of the firm.

Regrettably, some current issuance practices have not created the alignment of incentives that encourages desired corporate behavior. One problem is that stock options, as currently structured, often provide only a loose link between compensation and successful management. A company's share price, and hence the value of related options, is heavily influenced by economy-wide forces--that is, by changes in interest rates, inflation, and myriad other forces wholly unrelated to the success or failure of a particular corporate strategy.

There have been more than a few dismaying examples of CEOs who nearly drove their companies to the wall and presided over a significant fall in the price of the companies' stock *relative* to that of their competitors and the stock market overall. They, nonetheless, reaped large rewards because the strong performance of the stock market as a whole dragged the prices of the forlorn companies' stocks along with it.

Stock or options policy should require that rewards reflect the success or failure of managements' decisions. Grants of stock or options in lieu of cash could be used more effectively by tying such grants through time to some measure of the firm's performance relative to a carefully chosen benchmark. Many corporations do tie the value of stock and option grants to *relative* performance, but most do not. To be sure, an untied option grant can be thought of as an option whose value moves with the performance of the corporation *relative* to the competition, coupled with a call option on, for example, the S&P 500 stock index. It can be argued that the latter is merely another form of compensation that helps firms retain valued employees. I am sure that is right, but does a compensation system tied to the overall stock market serve a company well?

* * *

Let me now turn to option accounting. A stock option is a unilateral grant of value from existing shareholders to an employee. It is a transfer through the corporation of part of the market capitalization owned by existing shareholders. The grant is made to acquire the services of the employee, and presumably has a value equivalent to the cash or other compensation that would have been required to obtain those services--what economists call the opportunity cost of employing those services. That value is obviously a function of when, and under what conditions, the option can be exercised. To assess the cash equivalent of the option, only the market value of the option at the time of the grant matters. Subsequent changes in the value of the option are not relevant to the exchange of labor services for value received, just as future changes in the purchasing power of *cash* received for services rendered do not affect the firm's compensation costs.

The accurate measurement of input costs is essential for determining whether the corporation earned a profit from its current activities. That determination was relatively straightforward when all receipts were cash and all expenses were cash costs. But, changes in balance-sheet valuations based on fragile forecasts have become a more important element in determining whether a particular corporate strategy was successful. And, as a consequence, cost estimation has become ever more problematic. But the principle of measuring profit as the value of output less the value of input is not altered by the complexity of measurement.

To assume that option grants are not an expense is to assume that the real resources that contributed to the creation of the value of the output were free. Surely the existing shareholders who granted options to employees do not consider the potential dilution of their share in the market capitalization of their corporation as having no cost to them.

The particular instrument that is used to transfer value in return for labor services is irrelevant. Its value is not. Abstracting from tax considerations, one must assume that the value is the same for the employer irrespective of the nature of the instrument that conveys it--which could be cash or its value equivalent in the form of stock, free rent, a college annuity for one's children, or an option grant.

The ability of options to substitute for cash obviously rests on an expectation by an employee that the price of the company's stock will rise. Expectations of stock price movements, in turn, appear to be significantly influenced by recent stock price behavior. Thus, there is little surprise that stock options gained considerable favor as a form of compensation with the steep rise in stock prices in the late 1990s. Similarly, one might reasonably expect that in an environment with slower stock price gains, option grants would no longer be so favorably viewed by employees as a substitute for cash. As a consequence, more cash or its equivalent might then be required to fund labor services.

One may argue that, because option grants are fully disclosed and their effect on earnings can, with some effort, be estimated reasonably well, financial markets in their collective wisdom see through the nature of any bookkeeping transactions. Hence, how expenses and profits are reported is of no significance, because nothing in the real world is altered. Cash flows, for example, are unaffected. The upshot of this reasoning is that stock prices should be unaffected by whether option grants are expensed or not. Clearly, most high-tech executives believe otherwise. How else does one explain their vociferous negative reaction to expensing if its only effect were to change the book profit reported to shareholders?

I fear they may be right. Indeed, most American businesspeople must believe expensing is more than bookkeeping. Current accounting rules encourage firms to expense option grants. However, only two of the S&P 500 firms reportedly chose to do so in the year 2000. If expensing does indeed matter, at least some of the unsustainable euphoria that surrounded dot-com investing at its peak may have been exacerbated by questionable reported earnings.

The measure of diluted earnings per share currently reported by corporations partially reflects the number of shares that employees could obtain with vested but, as yet, unexercised options. Some have maintained that this is all that is required to capture the effects of option grants. Clearly, this adjustment corrects only the denominator of the earnings per share ratio. It is the estimation of the numerator that the accounting dispute is all about.

Some have argued against option expensing on the grounds that the Black-Scholes formula, the prevailing means of estimating option expense, is approximate. It is.[2] But, as I indicated earlier, so is a good deal of all other earnings estimation. Moreover, every corporation already implicitly reports an estimate of option expense on its income statement. That number for most companies, of course, is exactly zero. Are option grants truly without value?

As I noted earlier, critics of option expensing have also argued that expensing will make raising capital more difficult. But we need to remember that expensing is only a bookkeeping transaction. To repeat, nothing real is changed in the actual operations or cash flow of the corporation. If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been about the true input cost of creating corporate revenues. Capital employed on the basis of misinformation is likely to be capital misused.

Critics of expensing also argue that the availability of options enables corporations to attract more-productive employees. I am sure that is true. But option expensing in no way precludes the issuance of options. To be sure, lower reported earnings as a result of expensing, should it temper stock price increases, could inhibit option issuance. But, again, that inhibition would be appropriate because it would reflect the correction of misinformation.

It is no more valid, in my judgment, to assume that option grant expense is zero than to arbitrarily assume depreciation charges are zero. Both assumptions, excluding interest, increase reported pretax earnings. Both imply that the inputs that produce valued corporate outputs are free.

* * *

One issue that has complicated the discussion of option expensing is the different way it is handled for tax accounting. Under tax law, when options are exercised, the value realized by an employee--that is, the difference between the share price and the strike price--is a deductible compensation expense for the company. The amount of this compensation for tax purposes reflects a rise in the price of the stock after the option grant.

Any such price changes are of no relevance in judging the cost of purchasing labor services, though they do affect the tax liability and possibly the after-tax earnings reported to shareholders of the firm that granted the option.[3] How capital gains and losses associated with these transactions should be reflected in reported earnings is a separate issue.

* * *

I want to emphasize that expensing in no way inhibits the legal authority to issue options. Yes, if investors take currently reported earnings as real, expensing will reduce a corporation's perceived earnings and conceivably its stock price. Employees, accordingly, will consider options less valuable and presumably fewer will be issued. But confusing markets is neither helpful nor permanent. If underlying corporate input costs are real, they cannot be obscured indefinitely.

As I indicated earlier, the continued popularity among employees of option grants as a substitute for cash compensation requires a persistent expected uptrend in a company's stock price. Should compensation shift more to cash, the trend in reported earnings growth would decline relative to an earnings trend in which options have always been expensed. Such a shift presumably would make option expensing more attractive to the corporation.

* * *

With an accounting system that is, or should be, measuring the success or failure of individual corporate strategies, the evolution of accounting rules is essential as the nature of our economy changes. As the measurement needs change, rules must change with them. This does not lend itself to hard-wired legislation, which makes flexibility of rule-making difficult. We would be best served, in my judgment, by leaving issues such as option grant expense to regulatory bodies and the private sector.

There is a legitimate question as to whether markets see through the current nonexpensing of options. If they do, moving to an explicit recognition of option expense in reported earnings will be a nonevent. The format of reports to shareholders will change somewhat, but little more will be involved. Making an estimate of option expense requires no significant additional burden to the company.

If, however, markets do not fully see through the failure to expense real factor inputs, market values are distorted and real capital resources are being diverted from their most efficient employment. This *would* be an issue of national concern.

Clearly then, the greater risk is to leave the current accounting treatment in place. If markets have seen through the accounting, required expensing of option grants will have no effect on the nation's capital allocation. If, however, expensing does affect market values, a continuation of current accounting practice could be costly to capital efficiency.

Some very notable developments in our corporate sector in recent years, most strikingly evident in the collapse of Enron, have unearthed deficiencies in corporate governance. These are being addressed through market repricing and regulatory initiatives.

Despite evident shortcomings that have emerged from time to time, as I noted at the outset, we should not lose sight of the fact that these arrangements over the decades have effectively promoted the allocation of the nation's savings to its most productive uses. Generally speaking, the structure of business incentives, reporting, and accountability has served us well. I am confident that we will make the changes needed to ensure that these structures continue to serve us well in the future.

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**Notes**

1. On topics such as nonfinancial corporate governance and accounting, which are not in the Federal Reserve Board's jurisdiction, I am obviously speaking for myself. Return to text

2. Expensing stock options is required to record the economic cost of labor services purchased with option grants. But like all such balance-sheet-related costs (depreciation, for example), their final accounting disposition can often take years. The reason is that future movements in the price of the underlying stock will create capital gains or losses in the stock option between the time of grant and expiration. Such changes do not alter the economic cost, but depending on how the corporation chooses to hedge option grants, these changes can affect the net worth of the corporation.

The issue does not arise with grants of stock because all capital gains and losses after issuance accrue to the employee. In addition, this issue would not arise with option grants if the corporation fully hedged its exposure to post-grant capital gains and losses. The corporation could do this, in principle, by purchasing a call option on its stock that was identical in all respects to the granted option and then selling that call option at the same time that the employee exercises his or her option. Of course, the call options needed to execute this hedge are difficult to arrange. Given this difficulty, many corporations partially hedge their position by repurchasing their shares in the open market, which leaves them exposed to some post-grant gains and losses. And, to be sure, many other corporations choose not to hedge their option grants at all.

But these are accounting issues that are unrelated to the economic cost of an option at time of grant. They are among the myriad balance-sheet valuation adjustments that endeavor to address the ongoing impact of market valuation changes on all assets and liabilities. Return to text

3. Some firms report different tax liabilities to the Internal Revenue Service and shareholders. Return to text

CARL LEVIN
MICHIGAN

United States Senate
WASHINGTON, DC 20510

April 30, 2004

The Honorable Mike Enzi
Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Mike:

Earlier this week, the Committee on Small Business and Entrepreneurship held a hearing, which you chaired, on the "Impact of Stock Option Expensing on Small Business."

During that hearing, I incorrectly characterized the tax treatment of incentive stock options ("ISOs") by indicating that the tax code would allow ISOs to be valued on their grant date and allow employees to be taxed on that grant date value. In fact, section 422(d)(3) of the tax code requires companies, on the grant date of an ISO, to determine the value of their stock, but not their stock options. This valuation is required because the tax code sets a limit on the ISOs that can be issued to an employee in a calendar year, and that limit is measured by the value of the company's stock, not the stock options themselves as I thought. The tax code also provides that employees are taxed, not on the ISO's grant date, but on the date when the employee actually sells the underlying stock after the stock option is exercised. While my description of ISO tax rules was in error, existing accounting rules applicable to both ISOs and other types of stock options do require companies to determine the fair value of stock option compensation on the date it is granted and then report it either as an expense or in a financial statement footnote. These accounting rules mean that, for financial reporting purposes, many small businesses are already calculating the grant date value of their stock options.

For that reason and the other reasons described in my opening statement at the hearing, I continue to believe that treating stock options as an expense will not hurt small businesses, will advance the cause of honest accounting, and will promote investor confidence in U.S. financial statements. One of the hearing witnesses, Mr. Roberto Mendoza, provided direct evidence supporting this view. Mr. Mendoza testified that his startup company, Integrated Finance Limited, decided from its inception to expense all stock option compensation, and found that its stance actually attracted investors by demonstrating the company's adherence to transparent accounting. Mr. Mendoza also testified that when he determined that the company's draft audited financial statement had failed to include any stock option expense, his accountant agreed to include that expense at no additional cost and was able to calculate the expense itself in less than 20 minutes. This testimony shows that calculating stock option expenses can be quick and inexpensive, and need not be burdensome to small business.

The Honorable Mike Enzi
Committee on Small Business and Entrepreneurship
April 30, 2004
Page Two

I apologize for any confusion my error on the ISO tax issue created at the hearing. I would appreciate this letter being included to clarify the hearing record.

Sincerely,

Carl

Carl Levin

cc: The Honorable John Ensign
The Honorable Peter Fitzgerald

**Senate Committee on Small Business and Entrepreneurship**
**Post-Hearing Questions**
**to**
**Professor Stephen F. Diamond**
**Cornell Law School**
**"The Impact of Stock Option Expensing on Small Businesses"**
**April 28, 2004**

**Questions submitted by Senator Mike Enzi:**

1. Have you reviewed any studies or analyses demonstrating that either the Black-Scholes method or the binomial method, or both, can value employee stock options accurately and reliably?

2. You stated in your testimony that only those small businesses that want to go public would be impacted by the FASB proposal. Does any of your research include statistics on the number small firms that will elect not to go public because of the cost of expensing stock options? Do you have any empirical data that support your findings?

3. You state in your testimony that you are member of the board of directors for small publicly traded technology company. Does this company expense stock options? If so, how many options are granted annually, what methodology is used to calculate the value of the stock options, and what has been the cost to the firm to support this process?

4. Has any of your analysis on this issue included assessments of financial institutions and their views on providing financing to small businesses that show negative balance sheets due to the expensing of stock options?

**As of the date of printing, the Committee had not received a response from Professor Stephen F. Diamond, Cornell Law School to the forgoing questions.**

**Committee on Small Business and Entrepreneurship**
**Post Hearing Questions**
**"Impact of Stock Option Expensing on Small Business"**
**April 28, 2004**
**Robert H. Herz**
**Chairman**
**Financial Accounting Standards Board**

**Questions submitted by Senator Mike Enzi:**

1. **To date, FASB has decided not to conduct tests on valuation models. Previously, FASB went to 18 companies and asked them about the costs of complying with a new standard but did not look at the accuracy of the valuation models for those companies. This would include actual field tests of various valuation models by a cross section of companies, so that significant data could be collected on the accuracy and reliability of different valuation models.**

2. **FASB Spokesperson Sheryl Thompson has defended the decision not to field test valuation models by telling the press [CFO.com on March 1, 2004], that "the ultimate field test has already taken place." She added that public companies "have been performing the field test for seven consecutive years, so the test sample is huge. It probably involved thousands of companies." There's little doubt that Ms. Thompson is referring to the use of Black-Scholes in footnote disclosures the past 10 years. However, FASB is now urging companies to use something different – the binomial model.**

   **How can FASB refuse to test the binomial model on grounds that companies have used Black-Scholes in their footnotes?**

   The Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"), retains the same principle established in FASB Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* ("Statement 123"), that a public entity should measure the cost of employee services received in exchange for awards of equity instruments based on the fair value of the instruments at the grant date. That principle encompasses several valuation techniques, including a lattice model (an example of which is a binomial model) and a closed-form model (an example of which is the Black-Scholes-Merton formula) with appropriate adjustments to reflect the unique features of employee stock options. The lattice model and the closed-form model are based on the same well-established financial economic theory. Those models are routinely used by valuation professionals, dealers of derivative instruments, and others to estimate the fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities. Those models are also routinely used to establish trade prices for derivative instruments, to establish fair market values for United States ("US") tax purposes, and to establish values in adjudications. Finally, those models are used routinely by enterprises in estimating the fair value of financial instruments, including derivatives, convertible bonds, and employee stock options, and reporting those amounts in their audited and certified financial reports. Although most enterprises have historically used a closed-form model in complying with the requirements of Statement 123 over the last eight years, some enterprises have used a lattice model. Those enterprises include some of the more than 575 enterprises that have voluntarily adopted option expensing. Importantly, the Proposal does not require that all enterprises use a lattice model or a closed-form model. The Proposal permits nonpublic enterprises to determine the expense based on the difference between the current fair value of their shares and the exercise price of outstanding employee stock options, i.e., based on the "intrinsic value" of the stock options. Public enterprises would also be permitted to use this approach in circumstances in which, after a diligent effort, they conclude that it is not possible to determine the fair value of the employee stock options they have granted with sufficient reliability. The Proposal's Notice for Recipients includes six issues seeking additional input on these and other measurement issues. Consistent with the Financial Accounting Standards Board's ("FASB" or "Board") Rules of Procedure, the input received on those issues will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

3. **Are there any studies FASB has relied on that show, specifically, that the binomial method values employee stock options accurately? If so, please provide a list of the studies. If there are not any studies that FASB relied on or if the FASB has no such data, what is the reason that FASB does not conduct field tests on the accuracy of the binomial model.**

   Examples of the types of input, data, and evidence that the FASB considered in developing the Proposal's measurement guidance include:

   - Extensive discussions with a variety of parties including the Financial Accounting Standards Advisory Council, the User Advisory Council, and many other groups representing preparers of financial reports, and auditors, and investors, and other users of financial information.
   - Results of discussions with many valuation experts and compensation consultants, including those on the FASB's Options Valuation Group.
   - Results of "field visits" with a number of public and private companies covering a range of industries.

- Data relating to the information about employee stock option compensation contained in the disclosures of the audited and certified financial reports of enterprises.
- Input from the many public enterprises that have voluntarily elected to include the expense relating to employee stock options in determining their reported net income. Those enterprises currently number over 575, cover a wide range of industries, and include enterprises representing 41 percent of the S&P 500 index based on market capitalization. Again this information is subject to an independent audit and management certification.
- Information and views in the many comment letters received in response to the FASB's November 2002 Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment.
- Work done on this subject by other accounting standard setters, including the International Accounting Standards Board ("IASB") and the Canadian Accounting Standards Board ("AcSB"). In February 2004, the IASB issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment* ("IFRS 2"). IFRS 2, effective in 2005, requires the expensing of all equity-based compensation based on a measurement method generally consistent with that contained in the Proposal. Similarly, in September 2003, the AcSB issued *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870 ("Section 3870"). Section 3870, effective in 2004, also requires the expensing of all equity-based compensation based on a measurement approach generally consistent with the Proposal and IFRS 2. Of note, many of the Canadian enterprises and hundreds of other foreign enterprises that will be using Section 3870 or IFRS 2 are registrants under the US federal securities laws and, therefore, subject to the rules and regulations of the US Securities and Exchange Commission ("SEC").

As indicated in response to Question 2, the FASB is continuing to actively solicit input on the measurement guidance contained in the Proposal. The input received will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

4. **The Association for Investment Management and Research (AIMR) – an expensing advocate – recently ran ads in the Wall Street Journal and Roll Call urging its members to write the FASB to support your exposure draft. Has FASB had any conversations with anyone at AIMR about these ads? Did they ask FASB whether it wanted them to run the ads?**

AIMR is a worldwide, nonprofit professional association of 70,000 securities analysts, fund managers, and investment advisors. The FASB did not have any conversations with the AIMR about the advertisements prior to their running in the Wall Street Journal and Roll Call. AIMR did not ask the FASB whether we wanted them to run the advertisements.

5. **This very same group, AIMR, 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."***

6. **Does FASB disagree with AIMR's arguments that field testing can be "enormously helpful?"**

   Field testing can be "enormously helpful," in some circumstances, particularly when the Board is developing an entirely new principle or guidance in an area not previously addressed by the accounting literature. As indicated in response to Question 2, those circumstances do not exist with respect to the Proposal. As indicated in response to Question 3, the Board conducted field visits in connection with the development of the Proposal. Those field visits included inquiries focusing on "implementation problems," particularly the costs of implementing the Board's tentative measurement guidance. The Board concluded that the field visits provided them with a sufficient understanding of the potential costs and benefits and implementation issues raised by the tentative measurement guidance necessary to support the issuance of the Proposal for public comment. As indicated in response to Question 2, the FASB is continuing to actively solicit input on the measurement guidance contained in the Proposal. The input received will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

7. **Last year, the Business Roundtable filed comments with FASB regarding field testing that included the following comments:**

   **"We recommend the FASB develop and sponsor a comprehensive market test of the grant value of employee stock options. Specifically, a large number of investment banks and other institutions with sophisticated modeling techniques should be asked to provide bid and ask prices for at-the-money options to purchase stocks of a large number of diverse companies. The test should specify that (1) the options are not transferable. . ., (2) the options cannot be exercised until after a typical vesting period. . ., and (3) the investment bank or other purchaser may not hedge the option position by, for example, borrowing stock and shorting it against the option. In addition, such a test could be refined to reflect specific features of individual options plans . . . so that plans that incorporated desirable governance features would benefit from a lower charge."**
   **(Comment Letter to FASB, January 31, 2003)**

**What is your response?**

See responses to Questions 2, 3, and 6.

8. **AIMR has run ads endorsing FASB's exposure draft and urging people to write letters to FASB in support. AIMR is one of only eight organizations that nominate people to serve on the Board of Trustees of the Financial Accounting Foundation, which oversees the FASB. Do you think that there is any conflict when the same organization that nominates individuals to your oversight board takes out ads in support of a specific standard? Please provide the committee with any written communication between you and the AIMR in connection with these ads.**

   See response to Question 4. Of note, any organization or individual may nominate people to serve on the Board of Trustees of the Financial Accounting Foundation ("FAF"). Those nominating organizations specifically identified by the FAF are not prohibited by the Rules of Procedure from publicly expressing their views in support of or in opposition to FASB projects, proposals, or activities and frequently do so.

9. **Has FASB considered the impact of mandatory expensing standard on broad-based stock option plans, the outsourcing of jobs or other economic consequences? Has FASB addressed other such issues such as:**

   **Whether the exposure draft will diminish the use of broad-based stock option plans?**

   **Whether the exposure draft will inhibit the recruitment and retention of skilled workers at companies that have historically distributed their options broadly?**

   **Whether the exposure draft will undermine research and innovation because of its impact on the use of broad-based employee stock option plans?**

   **Whether the exposure draft will stimulate or impede economic growth in this country?**

   **Whether the exposure draft will weaken or strengthen the international competitiveness of US businesses?**

   The Board's mission and operating precepts require that it develop and improve accounting standards in a neutral and objective manner that results in economic activity being reported as faithfully as possible. That mission and operating precepts were recently reaffirmed by the SEC following the enactment of the Sarbanes-Oxley Act of 2002. The Board believes that the financial information that results from the application of FASB standards is essential to the growth and stability of the US economy because creditors, investors, and other consumers of financial reports rely heavily on unbiased, credible, and transparent information to make rational resource allocation decisions. Distorting accounting standards and the resulting financial information because of the potential impact that such information may have on the outsourcing of jobs, other economic consequences, or other issues is inconsistent with the fundamental purpose and role of financial accounting and reporting in the US capital market system. Of note, many economic experts have indicated support for the mandatory expensing of all employee stock options, including Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul A. Volcker, Nobel Prize winning economists Robert C. Merton and Joseph E. Stiglitz, and groups like the Financial Economist Roundtable, the Republican Staff of the Joint Economic Committee of the US Congress, the Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Petersen and John W. Snow), major investment banks, and the Congressional Budget Office. Indeed many of those experts have also indicated that mandatory expensing could have positive economic consequences because of improvements in capital allocation that would result from eliminating the existing exception from expense recognition for fixed plan employee stock options and, thus, creating more credible and transparent financial information.

**10. What will FASB do if you hear consistently from people and organizations during the comment period that the binomial method is likely to be inaccurate and costly?**

As noted in response to Question 2, the Proposal does not require the use of "the binomial method." Following the end of the comment period, the Board will redeliberate at public meetings the issues raised by the Proposal. The redeliberations, consistent with the FASB's Rules of Procedure, will include careful consideration of the input received by all parties. The redeliberations also will benefit from the FASB staff and Board's ongoing discussion of the key issues with interested parties from a broad range of perspectives, including members of the FASB's Option Valuation Group and other valuation and compensation experts that the FASB has been consulting with and will continue to consult with throughout the entire process. As with virtually all FASB proposals, the redeliberations could well result in a number of changes that improve the Proposal. Only after carefully considering the input received in response to the Proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

**11. Has the FASB considered the criteria for auditing companies' financial statements that include valuations using the Black-Scholes valuation model? Using the binomial valuation model?**

The FASB seeks out and receives significant input from the accounting profession on the auditability of FASB proposals. The FASB also has an active dialogue with those organizations responsible for establishing auditing standards. Input on the auditability of the Proposal will be carefully considered as part of the Board's public due process procedures. Of note, as indicated in response to Question 2, the lattice and related closed-form models have been used by many enterprises to value and report on various types of financial instruments, including employee stock options, for many years. Thus, valuations using those models have long been subject to financial statement audits.

**12. What was the rationale behind FASB officials' decision to request that the major accounting firms lobby Congress against any legislation on stock option expensing? Who was the FASB official who made the request(s)?**

Several Congressional staffers asked the FASB, "where are the accounting firms?" regarding the proposed legislation to override the Proposal. We explained that the major accounting firms have long publicly supported the independence of the FASB and, thus, opposed any efforts by Congress to override the FASB's public due process and technical decisions on financial accounting and reporting matters. Those staffers responded that, in light of the extraordinary Congressional lobbying effort by opponents to the Proposal, the FASB should ask the major accounting firms to reiterate their public position in writing. In response to that recommendation, we asked the firms to consider writing such a letter, which they subsequently did.

**13. Are there any circumstances under which FASB would not adopt a final standard requiring the expensing of all employee stock options?**

Consistent with the FASB's Rules of Procedure, the Board has not yet made any final decisions relating to the Proposal, including whether all employee stock options should be expensed. The Proposal's Notice for Recipients requests additional input on that issue and on several other issues relating to small businesses. Following the end of the comment period, the Board will redeliberate that input at public meetings. Only after carefully considering the input received in response to the Proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

**Questions submitted by Senator Ensign:**

1. **Given that the FASB exposure draft suggests companies cannot simply rely on historical volatility to produce a data point for a valuation methodology, wouldn't you agree that volatility is clearly the most difficult future input for a company to accurately predict without leading to a material misstatement? How can we ask CEO's to sign their name on the bottom line of a financial statement with any certainty given all of the variables of these confusing and often inaccurate valuation models?**

   In its public deliberations leading to the development of the Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"), the Financial Accounting Standards Board ("FASB" or "Board") did not find persuasive the argument that the estimated fair value of employee stock options based on currently available valuation techniques would be so unreliable as to impair the credibility and comparability of financial statements. To the contrary, the Board believes that the use of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"), intrinsic value method has and would continue to impair not only the relevance and reliability, but also the credibility, of financial statements by omitting a potentially significant component of the total cost of employee services. The Board noted that thousands of public enterprises have been estimating the fair value of employee stock options, generally consistent with the approach contained in the Proposal, including estimating the expected volatility of the price of the underlying shares, and have been reporting those amounts in their audited financial statements for eight years. Moreover, more than 575 enterprises, 116 of which represent 41 percent of the S&P 500 index based on market capitalization, have estimated and reported all of their employee stock options as an expense in their audited and certified financial statements generally consistent with the Proposal's approach, again including estimating the expected volatility of the price of the underlying shares. In addition, many valuation experts and many other parties, including Federal Reserve Chairman Alan Greenspan and the Congressional Budget Office, agree that employee stock options can be reliably valued. It is widely acknowledged that far more complicated financial instruments, including long-dated and complex derivatives, and convertible bonds containing long-dated options, are valued in the marketplace daily and that value is routinely reported by enterprises. Uncertainties inherent in estimates of the fair value of equity-based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations. For those items, as well for many other items in accounting involving the use of estimates, enterprises are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements. Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing no amounts.

2. **You suggested that only 3% of small businesses use stock options – does that include small businesses that use ESPPs?**

   A frequently cited 1999 Bureau of Labor Statistics survey indicated that 2.1 percent of establishments with 100 or less employees provided stock options to employees in 1999. That same survey indicated that 4.1 percent of establishments with 100 or less employees offered stock purchase plans to employees.

3. **Has FASB asked for or considered the evidence that demonstrates that the above referenced 3% of small companies that do use stock options are also companies that are significantly contributing to innovation and economic growth?**

   Consistent with the FASB's mission and Rules of Procedure, when the Board developed the Proposal it sought input on and evaluated whether the Proposal would fill a significant need and whether the costs imposed to apply the provisions of the Proposal, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered and continues to consider the impact of the Proposal on small businesses. The Board also recently established a Small Business Advisory Committee and solicited input about the Proposal from the members of that Committee. In addition, the Proposal's Notice for Recipients includes three issues specifically relating to small businesses. The Board will continue to actively solicit and carefully consider the input from small businesses throughout its public due process relating to the Proposal.

4. **You mentioned in your oral and written statements that nonpublic entities are not required to use GAAP accounting. Have you considered the long-term implication for the future of FASB as a standard-setting organization if the most innovative, entrepreneurial companies in the nation abandon GAAP reporting?**

   The Board recognizes the importance of nonpublic entities to innovation and entrepreneurialism and to our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by those enterprises in a cost-effective manner. Nonpublic enterprises that have plans to become public enterprises have a strong incentive to comply with FASB standards, since public enterprises are required to comply with "GAAP reporting" under the federal securities laws. Other nonpublic enterprises that currently use generally accepted accounting principles ("GAAP") will continue to do so only to the extent that those who request or demand that those entities use GAAP believe that FASB standards result in more useful information for making rational resource allocation decisions than the other alternatives, including the existing comprehensive bases of accounting, such as tax basis, cash basis, or regulatory reporting. To date, many of those parties and other users of financial reports have expressed support for the Board's project to improve the accounting for equity-based compensation and have urged the Board to complete the project on a timely basis. Many of those parties also believe that if special interests are able, through legislation, to preempt or override the FASB's ongoing project to improve the accounting for equity-based compensation, the integrity of financial accounting and reporting in the United States ("US") will be dangerously compromised. Many also believe that such legislation will severely impede the important ongoing efforts by the FASB to achieve international convergence of high-quality accounting standards. Those efforts have previously been encouraged by the US Congress and the US Securities and Exchange Commission.

5. **The Association for Investment Management and Research recently ran advertisements supporting the FASB exposure draft and calling upon people to write FASB and express their support for the standard. Were you aware the ads were being run before they appeared in the Wall Street Journal and Roll Call? Did you have any communications with the AIMR prior to their running these ads?**

   The Association for Investment Management and Research ("AIMR") is a worldwide, nonprofit professional association of 70,000 securities analysts, fund managers, and investment advisors. The FASB did not have any conversations with the AIMR about the advertisements prior to their running in the Wall Street Journal and Roll Call. AIMR did not ask the FASB whether we wanted them to run the advertisements. The FASB had no communication with the AIMR about the advertisements except for receiving a copy of the advertisement when it was submitted to the Wall Street Journal and Roll Call and before it ran in those publications. The FASB neither had nor sought any input into the contents of the advertisement or the decision to place the advertisement.

6. **You mentioned in your oral and written statements that nonpublic entities are not required to use GAAP accounting. Have you considered the long-term implication for the future of FASB as a standard-setting organization if the most innovative, entrepreneurial companies in the nation abandon GAAP reporting?**

   See response to Question 4.

7. **The Association for Investment Management and Research recently ran advertisements supporting the FASB exposure draft and calling upon people to write FASB and express their support for the standard. Were you aware the ads were being run before they appeared in the Wall Street Journal and**

**Roll Call? Did you have any communications with the AIMR prior to running these ads?**

See response to Question 5.

**Questions submitted by Senator John F. Kerry:**

1. **Are the proposed methods of estimating the value of stock options more or less accurate than methods used to estimate the value of other items that are reported in financial statements for accounting purposes? Provide examples.**

   Uncertainties inherent in estimating the fair value of stock options are generally no more significant than the uncertainties inherent in measurements of many other items that are routinely measured and reported in financial reports. For example, Intel Corporation's ("Intel") Form 10-K for the fiscal year ended December 27, 2003, includes a disclosure of "Critical Accounting Estimates." That disclosure describes "difficult and subjective judgments" in five specific areas that Intel acknowledges "have a significant impact on the results we report in our financial statements." Those five areas include goodwill, non-marketable equity securities, inventory, long-lived assets, and income taxes. Other enterprises have described more than ten specific areas of accounting estimates involving difficult and subjective judgments. For those items, as well for many other items in accounting involving the use of estimates, generally accepted accounting principles require enterprises to use appropriate measurement techniques, relevant data, and management judgment in the preparation of their financial statements. Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing no amounts.

2. **How many small businesses does the FASB estimate issue stock options? What percentage of publicly traded small businesses does this represent? Has the FASB taken into consideration particular difficulties that small businesses may face in valuing stock options?**

   A frequently cited 1999 Bureau of Labor Statistics survey indicated that 2.1 percent of private industry establishments with less than 100 employees granted stock options to employees in 1999. The same survey indicated that 21 percent of publicly held companies offered stock options to employees in 1999. Consistent with the Financial Accounting Standards Board's ("FASB" or "Board") mission and Rules of Procedure, when the Board developed the Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"), it evaluated whether the Proposal would fill a significant need and whether the costs imposed to apply the provisions of the Proposal, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered, and plans to continue to carefully consider, the impact of the Proposal on small businesses. The Board concluded that the Proposal should include special provisions that mitigate the incremental costs those enterprises would incur in complying with the Proposal's requirements. Those special provisions include permitting most small businesses to (1) use a simpler, less costly method to measure compensation cost, (2) use a simpler, less costly method to transition to the new requirements, and (3) have a delayed effective date. The Board recently established a Small Business Advisory Committee and solicited input about the Proposal from the Committee. In addition, the Proposal's Notice for Recipients includes three issues relating to small businesses. The Board will continue to actively solicit and carefully consider the input from small businesses throughout its public due process relating to the Proposal.

3. **Please describe FASB's efforts to seek comment from affected parties in the period leading up to the issuance of the proposed standard. Did small businesses participate in any opportunities for comment, and to what extent?**

The FASB actively sought comment from users, auditors, and preparers of financial reports, including representatives of small businesses, in the development of the Proposal. Representatives of small businesses provided comment letters in response to the November 2002 Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment ("Invitation to Comment"), and provided unsolicited comment letters. Representatives of small businesses also actively participated at public meetings of the Board's Financial Accounting Standards Advisory Council ("FASAC") and User Advisory Council ("UAC") in which the project on improving the accounting for equity-based compensation was discussed. Representatives of small businesses also provided comments about the project at a number of liaison meetings between the FASB and small business organizations, including meetings with the Technical Issues Committee of the American Institute of Certified Public Accountants Private Companies Practice Section, and the Accounting Practices Committee of the Risk Management Association. Finally, representatives of small businesses also provided comments about the project at dozens of conferences and other speaking engagements in which the FASB participated at in locations across the country.

4. **In the past, FASB has conducted field tests in connection with its proposed standards (such as the FASB's standard for financial statements of not-for-profit organizations and accounting for contributions in 1994). Has the FASB conducted field tests on the proposed stock options expensing standard?**

The Board conducted field visits as opposed to "field tests" in developing the Proposal. The FASB's Rules of Procedure do not require that the Board conduct field visits or field tests of proposed standards. In the past, field tests have generally been conducted by the Board in those circumstances in which the Board was proposing an entirely new principle or guidance in an area not previously addressed by the accounting literature. In contrast, the Proposal retains the basic principle and guidance established in FASB Statement No. 123, *Accounting for Stock-Based Compensation* ("Statement 123"), that an enterprise should measure the cost of employee services received in exchange for awards of equity instruments based on the fair value of the instruments at the grant date. The Board concluded that the field visits they conducted during the development of the Proposal provided them with a sufficient understanding of the potential costs and benefits and implementation issues raised by the tentative measurement guidance necessary to support the issuance of the Proposal for public comment. The Proposal's Notice for Recipients includes six issues seeking additional input on measurement issues. Consistent with the FASB's Rules of Procedure, the input received on those and other issues will be carefully considered by the Board at public meetings prior to the issuance of any final standard to improve the accounting for equity-based compensation.

5. **Given the importance of finding an accurate, rational and fair model for the valuation of stock options, please detail the steps FASB took to evaluate and compare valuation models, in particular, the Black-Scholes and Binomial models. Did FASB's field tests include tests of the proposed models for valuing stock options? If so, what were the results? Were small businesses invited to participate is FASB field tests of the valuation models? Did they participate? And if so, what were the results?**

   Examples of the types of input, data, and evidence that the FASB considered in developing the Proposal's measurement guidance include:

   - Extensive discussions with a variety of parties including the FASAC, the UAC, and many other groups representing preparers of financial reports, and auditors, and investors, and other users of financial information.
   - Results of discussions with many valuation experts and compensation consultants, including those on the FASB's Options Valuation Group.
   - Results of "field visits" with a number of public and private companies covering a range of industries.
   - Data relating to the information about employee stock option compensation contained in the disclosures of the audited and certified financial reports of enterprises.
   - Input from the many public enterprises that have voluntarily elected to include the expense relating to employee stock options in determining their reported net income. Those enterprises currently numbering over 575 cover a wide range of industries and include enterprises representing 41 percent of the S&P 500 index based on market capitalization. Again, this information is subject to an independent audit and management certification.
   - Information and views in the many comment letters received in response to the Invitation to Comment.

- Work done on this subject by other accounting standard setters, including the International Accounting Standards Board ("IASB") and the Canadian Accounting Standards Board ("AcSB"). In February 2004, the IASB issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment* ("IFRS 2"). IFRS 2, effective in 2005, requires the expensing of all equity-based compensation based on a measurement method generally consistent with that contained in the Proposal. Similarly, in September 2003, the AcSB issued *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870 ("Section 3870"). Section 3870, effective in 2004, also requires the expensing of all equity-based compensation based on a measurement approach generally consistent with the Proposal and IFRS 2. Of note, many of the Canadian enterprises and hundreds of other foreign enterprises that have been or will be using Section 3870 or IFRS 2 are registrants under the United States ("US") federal securities laws and, therefore, subject to the rules and regulations of the US Securities and Exchange Commission.

Several small businesses participated in the above referenced field visits that were conducted in connection with the development of the Proposal. A summary of the field visit results are included in the minutes of the February 11, 2004 public Board meeting. Those minutes are publicly available on the FASB's webpage at www.fasb.org.

**6. Has the FASB assessed the potential cost of compliance with the proposed standard on small businesses?**

The Board conducted cost-benefit procedures to assess the potential cost of compliance with the Proposal on public and nonpublic companies, including small businesses. Based on the findings of those procedures, the Board concluded that the Proposal sufficiently improves financial reporting to justify the costs it will impose. The Proposal, however, encompasses several decisions intended to mitigate the incremental costs of small businesses in complying with the proposed guidance. Those decisions include permitting most small businesses to (1) use a simpler, less costly method to measure compensation cost, (2) use a simpler, less costly method to transition to the new requirements, and (3) have a delayed effective date. The Board recently established a Small Business Advisory Committee and solicited input about the Proposal from that Committee. In addition, the Proposal's Notice for Recipients includes three issues relating to small businesses. The Board will continue to actively solicit and carefully consider the input from small businesses throughout its public due process relating to the Proposal.

**7. The exposure draft allows private companies to use what is called the "intrinsic value method." What is the rationale for allowing exercise date accounting for private companies?**

Statement 123 permits a nonpublic enterprise to omit expected volatility in estimating the value of its share options granted to employees. The result is a measure termed *minimum value.* The Board said in Statement 123 that, in concept, options granted by a nonpublic enterprise should be measured at fair value—the use of minimum value was only a practical response to the difficulties of estimating the expected volatility for a nonpublic enterprise. The Proposal would eliminate the minimum value method and instead require a nonpublic enterprise to elect whether to measure its stock options at their fair value at the grant date (as is generally required for public enterprises) or at intrinsic value through the date the options are exercised, lapse, or are otherwise settled. However, the Board believes that, in concept, public enterprises and nonpublic enterprises should use the same measurement method, and the Proposal therefore establishes the fair value method as preferable for purposes of justifying a change in accounting principle. Although the Board is reluctant to permit alternative accounting methods for the same transactions and events, it concluded that continuing to allow alternative methods is appropriate in this situation. The Board understands that relatively few small, nonpublic enterprises offer stock options to their employees, and many of those that do are emerging entities that intend to make a future initial public offering. The Board believes that the intrinsic value alternative provided by the Proposal is superior to the minimum value alternative in Statement 123. Even under the APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"), grant-date intrinsic value method, which is the method currently followed by most enterprises, an entity has to determine the intrinsic value of stock options granted. If the enterprise granted options on a regular basis, it had to measure intrinsic value at the date of each grant. It also has to measure intrinsic value at the date of each exercise in order to determine its related income tax deduction under current US tax law. In addition, the variable accounting method required by Opinion 25 for certain stock options is the same as the intrinsic value method required by the Proposal. Moreover, the final measurement of compensation cost under the intrinsic value method in the Proposal is the same as the measure of the related US income tax deduction. Thus, the intrinsic value method in the Proposal generally does not impose a significant additional computation cost on a nonpublic enterprise. The Board noted that providing an exception from the fair-value-based method for nonpublic enterprises is responsive to comments from some respondents to the Invitation to Comment and others that it would not be feasible for some nonpublic enterprises to estimate the fair value of their options. For all of the above reasons, the Board concluded that continuing to permit nonpublic enterprises to measure their equity share options at minimum value at the grant date could not be justified. If an enterprise does not measure the compensation cost based on the fair value of an employee stock option at the date it is granted, the Proposal reflects the view that an exercise date approach is superior to either permitting another measurement method at the grant date or permitting measurement based on fair value at a date between grant and exercise or other settlement.

**8. Has FASB analyzed whether the intrinsic value method is a plausible alternative to the Black-Scholes and Binomial models for public companies as well as private companies? If the intrinsic value method is not a plausible alternative for public companies, please explain why?**

The Proposal provides that if it is not possible to reasonably estimate the fair value of an employee stock option or other equity instrument at the grant date, a public company may measure such an instrument at its intrinsic value consistent with the alternative method permitted for nonpublic enterprises. The Proposal's Notice for Recipients includes a specific issue requesting comment on whether the intrinsic value method should be extended to public enterprises that are small business issuers. The Board will carefully consider the input received on that issue and other input about the alternative method in its public redeliberations of the Proposal.

**Responses to Questions Posed by Senator Mike Enzi**
**to Douglas Holtz-Eakin, Director,**
**Congressional Budget Office**

These questions were submitted to the Congressional Budget Office (CBO) following the April 28, 2004, hearing of the Senate Committee on Small Business and Entrepreneurship, "Impact of Stock Option Expensing on Small Businesses."

**Question 1.** Did the CBO conduct any independent technical accounting analysis of the complex accounting issues associated with employee stock options?

**Response.** Yes. CBO's analysis included a detailed examination of the properties of employee stock options (ESOs), their possible treatment as debt and equity instruments, and their relationship to related transactions such as grants of stock and performance-based options.

**Question 2.** Did CBO evaluate and review any studies, reports and analyses arguing that stock options do not reflect a cost to the company? If so, did any of the documents reference the impact of this proposal on small business?

**Response.** Yes. CBO reviewed numerous research papers and reports (for example, a January 30, 2003, comment letter to the Financial Accounting Standards Board [FASB] from the International Employee Stock Options Coalition), as well as Congressional testimony that opposed recognizing the fair value of ESOs as an expense. Some of those documents specifically note the possible effects of this proposal on small business. In every case, CBO evaluated the arguments from the perspective of accounting precedence, economic logic, internal consistency, and empirical verification.

For example, the notion that granting ESOs is not a cost to the firm would also imply that granting stock to employees is not an expense to the firm (since no cash is outlayed); however, CBO reasoned, although the granting of stock in exchange for goods or services results in no outlay of cash by the firm, current accounting standards require recognition of that expense, measured as the market value of the stock at the time it is granted in exchange for goods or services. Alternatively, some have argued that since ESOs do not require an outflow of cash when they are granted, they are not a cost to the firm, but extending that claim to its logical conclusion would imply that a firm could pay all of its costs by granting stock options and reduce its expenses to zero. Finally, in testimony before the Senate Subcommittee on Securities and Investment on November 12, 2003, witnesses argued that ESOs cannot be accurately valued and that investors understand the cost of ESOs. Reflection reveals that the first claim implies that the second claim is not valid, and vice versa—if employee stock options cannot be valued, how could investors understand their cost?

**Question 3.** Did CBO talk to any FASB Board members, or otherwise communicate with FASB in any way, before finishing its report? How about any communications with FASB project director, Michael Tovey?

**Response.** A CBO analyst did take the opportunity to ask Robert Herz, Chairman, Financial Accounting Standards Board, a question following a Senate hearing at which he testified on November 12, 2003. Other than that, CBO did not communicate with any FASB board members or Michael Tovey before finishing the CBO report.

However, CBO analysts did read many FASB documents (including FAS Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*) in the course of writing the report.

**Question 4.** Did CBO speak to any companies that utilize broad-based stock option plans? If so, please provide a summary of their responses (pro & con).

**Response.** CBO Director Douglas Holtz-Eakin met with TechNet, the Silicon Valley Technology Manufacturing Group, the Information Technology Association of America, and the National Association of Manufacturers in a series of briefings at which employee stock options were discussed. Many of the member companies utilize employee stock options, and their representatives expressed the view that the proposed FASB standard would affect their ability to attract employees and compete as in the past. Their primary argument focused on the absence of a cash outflow, as discussed in the response to Question 2 above.

**Question 5.** Did you conduct any independent analysis and evaluation of the accuracy and reliability of the Black-Scholes model?

**Response.** Yes. CBO investigated how sensitive Black-Scholes option prices were to changes in the volatility parameter. CBO examined several firms' disclosed information about the fair value of employee stock options granted, replicated their results, and calculated the sensitivity of option values to variations in volatility. CBO's research also included reviewing articles concerning not only the Black-Scholes model but also other option-pricing models.

The value of a call option is essentially the statistical expectation of its discounted future value. Since options are derivative assets, a central empirical question is whether option prices are consistent with the evolution of the price of the underlying assets over time. For example, the standard Black-Scholes option-pricing model assumes "geometric Brownian motion" of asset prices—essentially that very small random changes occur in the underlying stock price in each very small time interval—but option-pricing models based on other distributional assumptions (such as a jump-diffusion process, square root constant elasticity of variance, and stochastic [changing] volatility) have also been developed. Tests of such models compare the consistency between the models' option prices and the characteristics of the time series of the underlying asset prices—for example, tests for arbitrage opportunities from dynamic option replication strategies.

**Question 6.** Did you conduct any independent analysis and evaluation of the accuracy and reliability of the binomial model?

**Response.** Yes. In fact, CBO has developed several binomial models for use in valuing various types of options either written or held by the U.S. government.

A way to test the reliability and accuracy of a binomial model is to see whether the actual realized value of the underlying stock falls within the range of the values predicted by the model.

**Question 7.** What is the basis for your concluding that employee stock options can be valued accurately and reliably?

**Response.** Mathematical models to estimate the fair value of options have been developed that meet the need of investors for a wide variety of options that are contracted for in over-the-counter markets. Although few accrual-based accounting estimates can claim absolute reliability, option-pricing models afford a better estimate than zero, which is not within the range of reasonable estimates of the value of employee stock options at grant.

CBO also uses various option-pricing models in assessing the cost of federal programs, such as that under the Air Transportation Safety and System Stabilization Act, which authorizes the government to guarantee loans in exchange for fees and warrants, which are long-lived options.

**Question 8.** Does CBO typically ask a summer intern to conduct the "early investigation" of a subject as you did here? Was the intern an accountant?

**Response.** As a matter of course, CBO attracts talented, trained interns that contribute useful, productive work. In this instance, the intern was unusually well-qualified—a recent distinguished graduate of a well-known business school who had been awarded a Fulbright fellowship to study accounting and corporate governance in Japan. The intern generated correspondingly high-quality research.

**Question 9.** The CBO report says that venture capitalists and others who support start-up companies will "look past" the companies' stock option expense. But the report cites no evidence to back up that claim. Did you talk to any venture capitalists? Did you talk to any private companies? Any new public companies? How many of these companies were small businesses?

**Response.** Venture capitalists are highly informed and sophisticated investors; that is, they gather in-depth information about all aspects of a firm before they invest. CBO therefore concluded that venture capitalists would be well aware of grants of stock options and of the value that those grants represented. Consequently, the recognition of the expense of stock options should not in and of itself affect venture capitalists' valuation of a company or a decision to invest in that company. The CBO Director has met with several venture capitalists, including Vinod Khosla and Floyd Kvamme. He has also benefited from the experience of his family members, who have been involved in three start-up ventures in the United States and Taiwan, and an initial public offering in the United States.

**Question 10.** Given the government's mandate to support and protect the rights of small business, why didn't the CBO report focus some of its findings on the impact of stock expensing on small business?

**Response.** The focus of the CBO report was to evaluate whether not recognizing the expense of employee stock options resulted in an overstatement of earnings for firms, regardless of size.

**Question 11.** Your report claims that options can be estimated reliably using existing valuation models, saying that "option-pricing models are used by traders and investors . . . to value options that are much more complex than employee stock options." Are you aware that some investment banks have altogether refused to quote prices for employee stock options because of the complexities associated with valuation?

**Response.** CBO agrees that it may be possible to find investment banks that, for whatever reason, will not quote prices for ESOs. However, CBO does not believe that this is due to a lack of analytic capability.

**Question 12.** Your report states that companies and their employees "can hedge employee options." Are you aware that employee stock options cannot be hedged because of their unique and restrictive characteristics? Are you aware, furthermore, that this attribute of the Microsoft stock options had to be removed in the JP Morgan-Microsoft stock option purchase?

**Response.** It may be difficult to purchase a specific financial instrument called an ESO hedge, but it is clearly possible to take a financial position that affords the recipient of ESOs substantial protection from losses in the value of the options.

Firms may hedge their exposure resulting from writing employee stock options by engaging in a dynamic hedging strategy. As spelled out in "Hedging Employee Stock Options, Corporate Taxes, and Debt" (an article referenced in the CBO report), under one such strategy, dynamic delta hedging, firms buy back their shares and issue debt in proportion to the number of options granted and adjust their hedging portfolio in response to changes in the value of the stock options. The authors conclude, "This strategy allows a firm to lock in the ultimate cost of an option grant at its estimated grant value. . . . As time goes by, a firm adjusts its hedging position by buying shares when the value of the options increases, and selling shares (and paying down debt) when the options lose value."

**Question 13.** Your paper says that the granting of a stock option "conveys a specific amount of compensation." That suggests that CBO believes that a stock option is equivalent to cash.

**Response.** Each form of noncash compensation has a corresponding cash-equivalent value. This value represents the compensation conveyed to the employee.

**Question 14.** What I found very confusing is that CBO admitted in the report that there are fundamental differences between cash and stock options. You said that employees receiving options have only a "contingent claim" on the value of the options and that the company distributing options retains more cash than a company that pays its employees in dollars. How can you continue to conclude, then, that the accounting for these two very different circumstances should be the same?

**Response.** Of course ESOs are not cash, but like other noncash compensation such as employee or retiree health benefits, they have a cash-equivalent value. Noncash compensation can be (and is) converted to cash equivalents every time a compensation package is negotiated by an employer and employee.

**Questions submitted by Senator Mike Enzi:** Answers by Roberto Mendoza

***1: In your testimony, your accounting firm of PriceWaterhouseCoopers (PWC) reported that expensing stock options would not delay your ability to raise additional capital nor cost the firm any additional money. To date, are these statements still accurate? If so, can you provide any documentation or record that the expensing of stock options did not play a negative role in raising capital or cost the firm money to do so?***

(a) One of my statements is no longer accurate in that our decision to expense options did – to my surprise – increase our audit fee. Our auditors informed us recently that approximately $35,000 of our total audit cost of $92,000 were directly attributable to our discussions regarding the expensing of stock options. They said that this represented largely a one-time cost. Nonetheless, I now believe that both for reasons of cost and general efficiency it would be appropriate for the FASB to permit a simplified expensing methodology for small – and possibly all –companies.

(b) I can confirm that our decision to expense options did not play any negative role in our recent capital increase. On June 4, 2004 BNP Paribas invested $6,000,000 for a 8.3% stake in our firm, IFL. Our discussions with our auditors did not delay the closing, and I continue to believe that our commitment to transparency facilitated the raising of the capital. The expensing of the options served to increase the reported loss for the year ended December 31, 2003. Please feel free to confirm this directly with BNP Paribas.

***2: What percentage of stock options does your firm currently issue (employee/executive)?***

Options represent 35% of outstanding shares.

***3: Did PWC review the current FASB 123 proposal before reporting to you that stock option expensing would not cost the firm additional money?***

I understand that our auditors did review the current FASB 123 proposal, but I alone am responsible for the "no additional money" comment which proved inaccurate, but was made in good faith based on the information available to me at the time.

***4: What methodology did PWC recommend using to evaluate the value of your firm's stock? Did PWC recommend that your company should use the intrinsic value or binomial valuation methods?***

Our auditors did not recommend the application of either FASB 123 or APB 25, though they did point out that we could rely on APB 25, which would probably have resulted in a zero expense. They stressed that management is responsible for presenting the firm's financial results according to GAAP, and that the auditors are not responsible for choosing the appropriate methodology. It is precisely for this reason that I would now support a simpler, standardized valuation methodology for small – and possibly all – companies.

***5: What type of review and consideration would be given to a small business seeking financing from your investment firm if they showed a negative balance sheet based upon their expensing of stock options?***

We would support the expensing of options by any company seeking financing even if it resulted in a "negative balance sheet" – which I take to mean a negative net worth. But we are not an investment firm and do not provide or arrange financing for small companies.

***6: Has your investment firm provided capital to any small tech or biotech companies that have shown negative balance sheet because of expensing stock options?***

No. But I believe that the vast majority of small tech or biotech companies who raise start-up or early stage financing do so when they are showing losses – which would only be increased by expensing options. I do not believe that this would affect their ability to raise funds. These companies generally raise equity financing rather than loans from banks who, some believe, would be more likely than equity investors to be influenced by balance sheet considerations.

***7: Does the use of stick options by your firm differ from what small technology and/or biotechnology firms may use?***

I believe that our firm employs proportionately more restricted stock than options relative to small technology or biotechnology firms. We consider that all forms of equity compensation represent a real cost to the company – just like cash compensation – and accordingly should be expensed.

**Added Comments**

**Testimony of John D. Kavazanjian**
President and CEO
Ultralife Batteries, Inc.

**Senate Small Business and Entrepreneurship Committee**

After listening to the spirited discussion on stock option expensing, it occurs to me that there are some basic principles to settle on before deciding the question.

The major principle concerns what type of a charge against the financials of a company the exercise of a stock options represents.

On one hand, we have the view that seems to be accepted by the FASB, which is that a stock option is the grant of a financial security. Their view is that this security has value and must be considered a compensation expense. This view holds that this expense must be accounted for as a charge against the operations of the company, just as any compensation charge is, and they have promulgated rules that accomplish this. Compensation is compensation and must be charged properly against operations and since this compensation often takes the place of cash compensation, it should be accounted for in the same way.

On the other hand, we have another view, which has been underlying much of the opposition to this view, but which has not been well articulated. This view is that a stock option represents the right to make an equity investment. It is the shareholders giving the employee the right to make an investment in the firm at a current market price, but stretching the time over which the employee can make that decision. That time is extended because what an employee must give in return is their continued employment. If the employee resigns or is terminated, some or all of that right is taken away. Looking backward from a future date, when the stock may have risen, it is financially no different from an equity investment made at the time the option is granted, but for which payment was deferred.

This viewpoint sees this as a willing contract that the shareholders make with the employees of the company to give them a stake in the business and ensure that their knowledge and experience stays in the company. If the employee resigns or if the company decides not to keep their knowledge and terminates them, unvested options would have no value at all.

**Added Comments**

**Testimony of John D. Kavazanjian**
President and CEO
Ultralife Batteries, Inc.

**Senate Small Business and Entrepreneurship Committee**

While many may have a strong position that one or the other of these principles is the "true" viewpoint, there is enough substance behind either viewpoint to make the case that this is a public policy decision. As Senator Bayh has so aptly pointed out during the hearings, it is critical that before such a decision is made, we need to understand the affect that it will have, so that we do not cause unintended affects.

The FASB has already framed the debate with the assumption that this is an expense. All input and all discussion have been based on this assumption and it has taken the policy discussion out of consideration. This assumption must be questioned and considered in order to have an informed discussion of the choices and the effects. We must put on the table the public policy discussion about which of these views is in the best interests of the businesses and the investors in these businesses.

***The Purpose of Financial Reporting***

There are three main functions of our business accounting systems. The first and primary function is to provide management with information on which to make decisions. The second function, critical for a shareholder owned company, is to provide the shareholders with information on the operational performance of the company and data with which to calculate the value of the firm. The last function, near and dear to the countries in which we operate, is to provide the data on which to calculate our taxes.

Treating stock options as an expense does nothing to help financial reporting and in fact will obscure the true operating performance and value of a company. There are multiple methods for calculating the value of the firm, but most of them come down to an evaluation of the discounted present value of future cash flows. Expensing of stock options has no effect on this evaluation. In additions, as a non-cash, non-operating expense it has no value to the management in making operational decisions.

**Added Comments**

**Testimony of John D. Kavazanjian**

President and CEO
Ultralife Batteries, Inc.

**Senate Small Business and Entrepreneurship Committee**

I've talked to most of the investors in our company and several of the analysts. Virtually every one of them plans to back out this expense when doing their valuation models.

The main effect of options is to provide a cash flow from the exercise and to create more shares which figure into a per share calculation. Both of these effects are quite adequately accounted for in the Treasury method dilution calculation that we all use today. The EPS calculation is an accepted first-pass method of valuation. It already penalizes companies by increasing the shares, the denominator in the calculation, in proportion to the number of "in-the-money" options. Expensing of options will pollute this well understood metric.

From an investor information viewpoint, treating options as an expense presents no added value and in fact will make it harder to understand the financials of a company. In fact, such treatment will be especially detrimental to small companies and small investors and is not in the public interest.

There are two reasons for this. First, as a non-cash, non-operating expense, it must be backed out of the financial statements. Larger investors will be able to do this because of the resources that they have for analysis, either internally or externally. Look at this comment about the pending Google offering from the Associate Press:

"...In 2003, Google reported an operating profit of $340 million on sales of $960 million. But the 2003 figure appears to understate the company's cash profit margin, since it includes very high expenses related to stock options that will probably decline in future years. On a cash basis, Google had an operating profit of $570 million in 2003, and an operating margin of 62 percent."

Clearly, for Google, this expense will not be used for valuation, and analysts will help to provide extraction of the relevant valuation data.

**Added Comments**

**Testimony of John D. Kavazanjian**

President and CEO
Ultralife Batteries, Inc.

**Senate Small Business and Entrepreneurship Committee**

This will even be more difficult because of the way that companies will be forced to show this data. Recent rulings by the SEC make it imperative that expenses be properly split out between lines on the P&L. This means that important ratios such as gross margin, R&D expense, sales and marketing expense and general and administrative expense will all have stock option expense numbers in them which can move significantly between quarters. It will be very hard to build a consistent model of a company under these reporting rules.

Smaller investors or investors in smaller companies will have it even worse. Without adequate attention from the analyst community, investors will only see the bottom line, at first, which will include this expense, and will have to wade through extensive disclosures in the notes to be able to back out the expense and do their own valuation. This information will be buried in multiple lines in the financial statement and will also obscure the basic business model operating performance of the company. Companies would be bucking the trend at great risk if they did pro forma reporting in an attempt to illuminate this issue for shareholders.

The second disadvantage to small businesses and small investors has to do with information. Small companies are under-covered by research analysts and have to work hard to be noticed. Expensing of stock options will disproportionately affect them because it is another layer of information that has to be peeled back to understand their true value. This extra work will make it harder for analysts and in turn they will cover fewer companies. This will fall on the smaller companies. In 1987, Nobel Prize winning economist Robert Merton showed that incomplete information about the equilibrium price of an asset or uncertainty about it increases the cost of capital for that asset and decreases its price. The expensing of options will obscure the true value rather than illuminate the true value of the asset. For small companies, there will be less coverage by research analysts, not more coverage. This means that small companies will be hit with lower valuations and higher costs of capital, not due to any operational defects but due to less information.

**Added Comments**

**Testimony of John D. Kavazanjian**

President and CEO
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**Senate Small Business and Entrepreneurship Committee**

If you accept the hypothesis that it is an expense, it becomes even more compelling when you view the paradoxical effect that it will have. Imagine a company that wants to expand. It hires some employees from a larger company and issues stock options to attract them. The options are valued based on an appropriate model and are reflected in the earnings as the company moves forward. The new employees do a good job and grow the company faster than the market expected and the market responds by tripling the stock price. The company now has to re-examine its model for expensing assumptions and will likely take additional charges. These charges actually reduce the future projected earnings of the company signaling a decrease in value.

What has really happened? Has the value of the company gone down because the value of the options went up? The dilution will be the same. The amount of money the company gets from the exercise will be the same. The future cash flows of the company do not change because of the stock price change. The people still have to be employed at certain points for them to be vested. There is no change in prospects or value. Considering stock options as an expense runs counter to the market. The higher the stock goes, the more expense you take against earnings even though there is NO change to the value of the firm.

Expensing of stock options is counter to good public policy if only because they are not in the best interests of giving the investor the best information on which to judge a company.

FASB may argue that this last point is the SEC's issue. They may say that their job is to promote the standards and the SEC should dictate how this is reflected to shareholders. This ignores an important reality. The SEC would be extremely reluctant to take any accounting treatment called an "expense" and then say that we wouldn't have to put it in our statements.

This is yet another compelling reason to treat this as a matter of public policy. After all of the "accounting" scandals that have hit us, the accounting

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profession is very careful to reflect everything that could possibly be an expense or a liability wherever they can. This "principle of conservatism" is the backbone of the profession. Recent experience has taught them that they have nothing to lose and everything to gain from being as conservative as possible. You can hardly blame them for this, but what you can do is to carefully examine their pronouncements in a wider forum. Unfortunately, the SEC is not structured to be able to do this. It is hard to see how they would ever overturn an accounting standard.

As a result, someone with a wider domain and with broader responsibility must get involved. The only place to turn is to the Congress.

***The Executive Compensation Issue***

Many have argued that expensing of stock options is required in order to curb excessive executive compensation. It is hard to imagine anyone in the financial community seriously agreeing that an accounting standard is needed to do this.

It is highly unlikely that expensing will stop any compensation abuse. Most of the option vesting is over a multi-year time frame and the expense is therefore spread over that time frame as well. For larger companies the value of the Executive Compensation that it represents is inconsequential in the grand scheme of their expenses.

If curbing potential abuse is the object, it can very easily be accomplished through better corporate governance. Many suggestions have been made in this regard including additional shareholder approvals, granting of options at a uniform time in the year or limits on how much can be concentrated in one place. In the end however, companies still have to compete to attract executive talent and have compensation tied to the stock price is an attractive way to align the executive's goals with the company's goals.

**Added Comments**

**Testimony of John D. Kavazanjian**
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**Senate Small Business and Entrepreneurship Committee**

In any case, if executive compensation is the issue, trying to solve it through an accounting standard makes no sense at all. There are other ways that are more direct and more effective.

***Financial Reporting Issues***

As discussed above, treating stock options as an expense will lead to less transparent financial reporting, not more transparent. It will obscure the true performance and value of the firm.

Solving this problem would require coordination between the FASB and the SEC. Based on past history-that is unlikely to happen. This means that Congress must get involved to help a solution.

If we are still unsure of how we should view the grant of an option, there are alternatives to jumping right into a new measure of earnings per share. It would be relatively simple for FASB to require the calculation of stock option expense and the SEC to have financials posted with the "old" EPS calculation and then the EPS calculation including stock option expensing. This will give the market the time to understand the effect and to match the old and the new model.

Even if we do decide that it makes sense to treat stock options as an expense rather than an equity investment, there is another principle to be decided. That involves how the accounting treatment should be reflected in the accounting statements. As mentioned earlier, it will further obscure the operational model of the company from quarter to quarter if options expenses are embedded in each line of the financial statement.

There are two choices. The first choice is what happens if we do nothing. We will be forced by standard to show it as a charge against each line on the financial statement related to the person who is getting the compensation and the function that they perform. That means charging it against cost of goods, R&D, sales and marketing and other reporting lines. This would make it even harder for an analyst to understand the true business model of the

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company because the cost would have to be unfolded from each line in order to understand the true operational performance. It would also be hard for the company since we would have to look at every person, every quarter and the job that they perform and the effect of their options.

The other choice is to view it as a separate line, identifying it as an aggregate expense. This would make it easier to understand the company's performance. While the FASB might be in favor of this, the SEC would not. This is another area in where, if current trends are followed, companies will do more work and the end result will be even less information of relevance delivered to shareholders.

***Some Final Words-Summary***

There is an important principle at stake here. If we decide that options are to be expensed, we do not improve the amount of information that shareholders get, we only obscure the relevant information.

For larger companies it will be less of an issue because it is much less of an impact. They may, in fact worry that the viewing of a stock option exercise as an equity event would cost them the tax deduction. They may not fear expensing because they know that with extensive analyst coverage, their true results will be explained to the markets.

This will also do nothing to change executive compensation. If anything, the stock will be withdrawn from the lower paid employees, if this rule causes a cut back. There are other ways to solve this problem.

Smaller companies have much to fear. It will hit them hard in proportion to their size. It may even turn profitable quarters, in which the value of the firm has grown, into quarters reported as unprofitable, as stock option charges rise. They will spend much of their time trying to unravel the effect of options for investors in trying to explain their financial performance and they will have less time to explain the fundamentals of their business.

**Added Comments**

**Testimony of John D. Kavazanjian**

President and CEO
Ultralife Batteries, Inc.

**Senate Small Business and Entrepreneurship Committee**

As a recent news release said:

"The effects of the rule change, if approved, would probably be most pronounced in the tech sector. But the change would have an impact on the entire market, according to investment research firm Standard & Poor's.

The company said this year's earnings estimates for the S&P 500 would be 7.4 percent lower, after factoring in the cost of stock options. In addition, earnings in 2003 would have been reduced by 8.6 percent.

"A change of 7% or 8% in estimated earnings for the S&P 500 is significant, especially if investors are not fully aware of what caused the change," said David Blitzer, managing director and chairman of the Index Committee at Standard & Poor's."

This seeming reduction in earnings has nothing to do with a decrease in value, especially if investors are "not fully aware what caused the change." That is a challenge for small companies who cannot easily educate the marketplace about themselves.

Congress should establish the principle that stock option exercises are equity transactions where the shareholders have accorded the employees an extended period of time to make the investment.

If executive compensation is still an issue, then governance rules should be promulgated to fix that direct problem.

Expensing of stock options is not in the best interests of small companies.
Expensing of stock options is not in the best interests of investors.
Expensing of stock options is not in the best interests of the country.

# COMMENTS FOR THE RECORD

Statement of U.S. Senator Conrad Burns
Senate Committee on Small Business
April 27, 2004

I first would like to thank Senator Enzi for his leadership on this issue, as well as Chairwoman Snowe and her staff for their hard work on all small business-related issues. Recently, Financial Accounting Standards Board (FASB) promulgated a proposal to treat employee stock options as an accounting expense. On March 31, 2004, FASB released an exposure draft of this proposal, which is scheduled to take effect December 2004. I am opposed to treating employee stock options as an accounting expense and have cosponsored legislation introduced by my colleague Sen. Enzi to prevent this from becoming a reality.

During my tenure in the Senate and as a member of the Senate Commerce Committee, I have worked hard to bring telecommunications and technology to Montana, and I have learned that a company is only as good as the workforce it employs.

I have seen first-hand the entrepreneurial spirit of those companies that begin with a great idea and not much else. Many companies foster this entrepreneurial spirit by giving their employees an ownership interest in the company through employee stock options, but FASB, an unelected accounting oversight board, wants to bring this to an end.

In an effort to treat employee stock options as an accounting expense, FASB is ignoring unresolved issues with the proposal, and most importantly, FASB is ignoring the impact this ruling will have on small businesses and those in the tech sector.

The nature of an employee stock option is to create an incentive for the employee to work harder and more efficiently, which will hopefully return stronger growth of the company stock. Employees are given options that vest over long amounts of time—typically in small increments over four or five years. I'm not an expert on options trading, but I know enough about economics to know that it is difficult—if not impossible— to value something that has no access to a market. Yet under FASB's proposal, a value would be given to the options using an inaccurate valuation model, and the company would be forced to carry the expense forward on their books for the duration of the stock option.

While many of us here would like to believe that we are good at picking stocks that will grow in the future, I don't know anyone who is able to predict future stock prices with absolute certainty. Even the most savvy stock analyst would not be able to make future stock price predictions with 100% accuracy, but FASB apparently has that capability.

I also want to mention the effect such a rule would have on broad-based stock option plans. In the 100 largest high-tech firms that focus on the Internet, average employees hold 19% of their company's stock--17% accumulated through stock options. Top executives hold only 14%. Rank-and-file employees and lower-level managers have accumulated more of their companies than their bosses.

Moreover, 98 of these 100 companies provide options to most or all of their employees. In Intel's case, for example, 98% of the options granted between 1998-2002 went to employees other than the top 5 executive officers.

Broad-based employee stock option plans are one of the best ways to align the interests of employees and shareholders. Employees are rewarded only if the company performs well in the market, thereby rewarding shareholders simultaneously.

The approach advocated by Senator Enzi that I have supported will help correct the problems associated with the recent FASB ruling. Now is certainly not the time to begin hamstringing small companies or start-ups who try to attract a highly skilled workforce by using stock options. By providing a tangible stake in the company that stock options offer, workers can take pride in their contributions to a company as it grows. That is the essence of entrepreneurship in this country, and if it is stifled in any way, the ability of small businesses to attract and retain employees will be severely hampered.

FOR THE RECORD

Why Stock-Option Compensation Stunts Growth and Destroys Jobs.

Statement of the Coalition to Stop Stock Options
for Hearing on Impact of Stock Option Expensing on Small Businesses, April 28, 2004, U.S. Senate Committee on Small Business

Compensation with stock options has mushroomed over the last decades because current accounting standards treat stock options as if they were free. Reporting stock options as if they were free is deceptive accounting. The options have value when issued and they mature into stock that diverts significant cash from other investors. But managers have convinced themselves that stock options are free candy and they are flooding the Congress with complaints that FASB is taking away their free candy. And they can not even see why anyone worries about stock options, since they have convinced themselves that they are free. It is time to end the free candy and describe the real cost of executive stock options.

The sacred mission of accounting is to help channel capital toward the projects that are best on their merits. The lie that stock options are free gets in the way of that sacred mission. Treating options as free lures investors into bad companies. Top managers also exploit the rule by paying themselves too much, snookering more money out of their shareholders than they could otherwise get. Both effects waste precious capital. When precious capital is wasted and diverted, the growth of the whole economy is stunted. Deceptive accounting stunts growth and destroys jobs.

The worst aspect of the deceptive accounting is that it fools the companies themselves. In the compensation committee, some one will propose why not 10,000 options for Joe? And someone else will say why not a million. Why not ten million? After all they are free. The earnings statement is the budget or report card of the company and any cost that is off budget, and off ledger really is treated as free by the decision makers.

Support the FASB. The Financial Accounting Standards Board has just proposed a revision to accounting standards that would require the company to report the fair value of an option as a cost. FASB has tried to end the zero-costing rule in the past. But top management likes reporting their compensation as free (Wouldn't you?) and they have defeated prior reform. They are trying to defeat honest accounting now too.

Zero costing. Under current accounting standards, options set up to have no initial bargain at the time the option is granted can be reported by the corporation at zero cost. The rule dates back to 1972 when there were no well established markets for options nor good valuation theory and option compensation was of trivial importance.

Options aren't free. Zero cost for an option with no initial bargain is not a good faith effort at measuring cost. When the company proves successful, the holder gets the stock, and at a tremendous bargain price -- the value of the stock ten years before. If the company fails, the option holder avoids all loss, just by not exercising the option. An option is like betting on the horses, after the race is over and without having put up the capital that allowed the horse to run. For high-risk companies, the holder of the option holds most of the value of the underlying shares.

Just a proxy for cash. The stock issued in response to an option is certainly not free, from the perspective of the issuing company or its shareholders. All stock shares in the corporation's cash flow. The new shareholders divert cash of the corporation from the old shareholders. The value of stock and stock options is nothing but the discounted present value of the cash that the corporation is expected to pay. The option is no more free than the cash the corporation must ultimately pay out and divert from others.

Bad Business: Hurt the Company. Stock options are bad business, first, because they give CEOs incentives to hurt their own corporation. Option holders participate in gains, but not losses. CEOs with substantial stock options have an incentive to go into projects with too much risk. Projects that have negative expected value to the shareholders because of the loss possibilities can have very strongly positive value to the CEO option holder. An option-holding CEO, looking only to his own personal stake, will rationally send the company into ventures that should scare the flesh off a shareholder.

Bad Business: Stop Dividends. Options are also bad business because they give the CEO an incentive to stop dividends. Accumulation of earnings will enhance the value of the options. Distribution of earnings will lower the value of the option. Shareholders are often richer when they get dividends, especially under recent tax law changes which enhance the after-tax value of dividends. But a CEO with options has a personal incentive to withhold dividends even while hurting shareholder value.

Bad Business: Excessive discount rates. Options are also bad for business because the discount rate used to calculate the value of stock and stock options is brutally high. If the corporation would avoid the high discount rate, by other kinds of compensation, either executives would get more present value from the cash the corporation will pay or the company would have to pay less cash, or both.

Toxic volatility. The market demands high discount rates in valuing stock and stock options because of unwelcome volatility in the price of the stock. Executives will take anything free, but, in truth, executives hate the volatility even more than the average stockholder because executives tend to be tragically under-diversified. The volatility on employer stock hits the executives like an electrical shock. Most of the unnecessary volatility can be filtered out of compensation by subtracting industry-average performance, but only if management gives up the accounting pretense that their compensation is free. The high discount rate also comes also comes because the discount rate does not give interest deductions to the corporate employer, whereas other forms of incentive compensation do.

Measuring the bargain. The value of an option when it is granted is just an estimate and estimates turn out wrong. But that objection can be easily met just by measuring the bargain the option will give, as it arises and fluctuates. Measuring the bargain on the option as it arises is easier and more accurate than estimating the value at first. The difficulties of estimating value at first, in any event, are not a reason for using a clearly wrong and deceptive value, zero cost.

Summing up. Stock options, in sum, are bad business because they rely on excessive discount rates to determine value. Better management of the discount rate would improve the corporation's wealth or the executive's wealth or both. Stock options give the CEO a private stake in destroying shareholder value, by withholding dividends and taking on too much risk. The deceptive accounting now available for stock options are bad, not just for the company, but the country. Zero costing allows the CEO to suck too much compensation from out of the company and allows the company to sucker investors into the company. Stock options waste capital, stunt growth and destroy jobs.

Respectfully Submitted,

The Coalition to Stop Stock Options

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Statement For The Record
E*TRADE FINANCIAL
Before the Committee on Small Business
U.S. Senate

April 28, 2004

Washington, DC

**Introduction**

E*TRADE FINANCIAL provides products and services to over 2,100 corporations that offer employee stock options and stock purchase plans. We also provide services to the individual employees that participate in these benefit plans. In total, we serve over 1.3 million employees who participate in their company's employee stock option and/or purchase plans. As a service provider in this industry, we monitor developments in equity compensation practices so that we can inform our clients of new developments and ensure that our products and services are in compliance with current regulations and standards. We have followed the developments in accounting practices concerning employee stock options and stock purchase plans for over a decade, and testified at the Financial Accounting Standards Board hearings in anticipation of SFAS No. 123. We have submitted comments on the International Accounting Standards Board's exposure draft on stock compensation and we plan to submit extensive comments on FASB's current exposure draft by the June 30, 2004 deadline.

In addition to offering testimony based on our expertise as a service provider in this industry, we are also testifying today as a plan sponsor. At E*TRADE FINANCIAL, we sponsor both stock option and employee stock purchase plans for our employees. Our focus for this testimony is on employee stock purchase plans because the impending FASB ruling places these plans in jeopardy. Companies should not be required to treat the discount given to employees under a qualified ESPP as an expense for financial accounting purposes.

Qualified employee stock purchase plans, or ESPPs, are a vital benefit to the American worker. They are an important form of compensation and contribute significantly to the financial assets of rank-and-file workers through investments in the US capital markets. By giving *all* employees an opportunity to own company stock, these plans also align the interests of employees with those of shareholders. Excluding ESPPs from FASB's proposed accounting standard for stock compensation is vital to the financial well-being of American workers.

The FASB's proposed accounting standard would have particular impact on small businesses offering ESPPs as a way to attract qualified employees. As the Members of this Committee are well aware, small businesses are significant job generators in the US economy. But for small businesses to be successful, they must be able to attract talented and qualified labor force. Just as access to capital is vital to the growth and expansion of small businesses, attracting the best people is necessary for the long-term success of the business. Employees are the most valuable asset of a company. When employees, including the rank and file employees, can purchase shares of a company's stock, they have the incentive to be more efficient and productive, adding value to the company. By fostering such an ownership society, the interests of a company's employees are aligned with those of the other shareholders. This is particularly important for a small business trying to compete with large businesses.

**Background on Employee Stock Purchase Plans**

Employee stock purchase plans are qualified under Section 423 of the Internal Revenue Code. The typical plan allows employees to purchase stock at a 15% discount off the lower of the market value on the date the employees enrolled in the plan or the purchase date. Under most plans, purchases occur every three to six months.[1] The maximum length of time that can elapse from enrollment to purchase is 27 months. Employees typically pay for the stock through payroll deductions made in the period leading up to the purchase date.[2]

Under Section 423, the plan must be offered to virtually all employees of the company and all employees must be allowed to participate on an equal basis. In addition, Section 423 severely limits the amount of stock that can be purchased under the plan to no more than $25,000 of stock per year. These plans are *truly* designed to benefit rank-and-file workers—they are not a form of executive compensation. In fact, highly compensated employees are one of the few groups of employees that can be excluded from the plan.

By allowing employees to purchase stock at a discount these plans encourage investment in US companies. In addition, under Section 423, employees have a tax incentive to hold the stock for at least a year. For the ESPP sales that E*TRADE FINANCIAL processed in 2003, the stock was held for an average of 430 days. Because of the discount available under these plans, and because of the tax incentives to hold the stock, these plans represent an important savings tool for American workers. ESPPs help American families realize their financial goals by providing savings and investment opportunities for retirement plans, college tuition expenses, and home purchases.

It is also critical to note that the shares acquired under these plans generally are freely tradable upon purchase. This means that these plans are a much more appropriate way for employees to acquire company stock than a 401K or other retirement plan, where the employees may not be able to immediately sell the stock they purchased. Although our data shows that employees voluntarily choose to hold the stock acquired under an ESPP, they are not required to do so. Employees are free to diversify their holdings, if they are unable or unwilling to bear the risk associated with holding the stock.

**The Economic Impact of FASB's Proposal**

Despite the important benefits provided to rank-and-file workers by these plans, ESPPs are at risk of elimination. Under FASB's exposure draft for the new accounting standard on stock compensation, any employee stock purchase plan that offers a discount will be treated as an income statement expense. If companies are required to record an expense for these plans, many companies will no longer be able to afford to offer them. A recent survey by Deloitte & Touche revealed that 63% of companies would reduce or eliminate their ESPPs if required to recognize an expense for it.[3] There have been many high-profile companies who are already on record stating that they will eliminate their ESPP if this standard is adopted. Our informed opinion is that when expensing becomes a reality, this percentage will be much higher.

While we believe that our own ESPP is an extremely important part of our benefits package and is clearly valued by our employees, we are also forced to evaluate whether we will continue or reduce our plan under FASB's proposed accounting standard. Our employee stock purchase plan is fairly typical —employees purchase stock at six-month intervals at a discounted price. Over 57%[4] of our domestic employees participate in the plan. This shows how extensively our employees are using this plan as an important savings method, especially considering that, by comparison, only 48% of total US households use mutual funds as a primary savings option[5].

Under FASB's proposed accounting standard, ESPPs are accounted for in the same manner as stock options. On the date the employee enrolls in the plan, the company is considered to have granted a stock option to the employee, which must be valued and expensed over the purchase period. But unlike stock options, the expense is not fixed at the date of grant. Because the number of shares that are purchased under the plan vary based on participation rates and the purchase price, the actual expense the company recognizes isn't finalized until the purchase occurs. Companies must record an estimated expense before the purchase occurs and then adjust the estimate once the purchase takes place. This introduces a level of variability into the financial statements that most accountants and investors find unwelcome. A significant increase or decline in a company's stock price during the purchase period would require a significant expense adjustment in a later period.

Another problem with recognizing employee stock purchase plan expense is that the company can't control it. With stock options, companies can manage the expense by limiting who they grant options to and how many shares they grant to the chosen option recipients. But, by law, the company must allow substantially all employees to participate in the employee stock purchase plan and must allow everyone to participate at an equal rate. As a result, the company has signifigantly less opportunity to control the expense recognized for the plan.

The National Center for Employee Ownership estimates that over 4,000 companies offer ESPPs and that 12 to 15 million individuals participate in these plans.[6] These plans are not confined to technology companies in Silicon Valley. Many of the companies that you know and probably patronize offer these plans, including Best Buy, Nike, Lowes, Southwest Airlines, Whole Foods, Safeway[7]. And ESPPs are not limited to large public companies— many mid-size and small public companies also offer these plans. 50% of our public clients that offer ESPPs have under 500 employees[8].

We believe that FASB's decision could have a significant detrimental impact on the American worker, due to the number of companies that would eliminate their ESPPs if FASB requires expensing. By requiring companies to expense ESPPs, we believe that FASB will inadvertently widen the gulf between how executives are compensated compared to rank-and-file workers. The value of stock that employees can acquire under an ESPP is limited to $25,000 per year, which may not be significant to an executive. In fact, many executives voluntarily choose not to participate in these plans. Of the ESPP participants that we serve, only 1.5% are company officers[9].

To an average worker earning under $50,000 per year, the value of the stock acquired under this plan is significant. In 2003, we processed ESPP trades for over 163 million shares, with a total value of $1.8 billion. This represents an average personal savings value of $9600 per person[10]. Eliminating ESPPs, which is certain to be an inadvertent result of FASB's standard, ultimately reduces the savings opportunity available to rank-and-file workers. In addition, if companies are no longer able to offer ESPPs because of the expense associated with them, this leaves 401Ks and other retirement plans as the only non-discriminatory benefit plans under which rank-and-file workers receive company stock. We are all aware that it is not always advisable for employees to receive and hold company stock in their retirement plans. Employee stock purchase plans give employees a safer option to owning company stock.

More importantly, while the value of these plans is significant to the average American worker, the value is not typically significant to shareholders. The limits imposed under Section 423 on the number of shares that can be purchased in the plan ensure minimal dilution of shareholder value. In 2003, 53 public companies submitted proposals to their shareholders relating to ESPPs. One hundred percent of these proposals passed, demonstrating shareholder recognition of the benefits of ESPPs to the company itself.

We appreciate the opportunity to submit testimony to the committee. We urge you to take action to prevent ESPPs from being pushed under the umbrella of the stock option debate. ESPPs are a primary savings tool, vital to American workers in both large and small companies. As we have demonstrated in the above testimony, ESPPs have built in safeguards to protect shareholders from excessive executive compensation. Equity ownership is a time-tested motivational tool and an important saving mechanism that is critical to the financial health of American workers.

[1] NASPP 2000 Stock Plan Design and Administration Survey: 87% of companies offering a Section 423 qualified ESPP offer a 15% discount. 80.6% offer this discount offer the lower of the beginning or ending market value. 65.6% of companies purchase at 3 or 6 month intervals.
[2] NCEO Current Practices in Stock Plan Design Survey (© 2001): 82% of companies require shares to be purchased using the payroll deductions.
[3] *2003 Technology Stock Compensation Survey Results; Looking Beyond Options*, © 2003, Deloitte & Touche LLP.
[4] Based on internal data.
[5] Investment Company Institute: www.ici.org.
[6] NCEO: http://www.nceo.org/library/eo_stat.html.
[7] See annual reports for companies listed.
[8] Based on internal and external estimated data.
[9] Based on proprietary aggregated transaction data.
[10] Based on proprietary aggregated transaction data.

**Testimony of**

**Robert H. Herz**

**Chairman**

**and**

**George J. Batavick**

**Board Member**

**Financial Accounting Standards Board**

**Before the**

**Committee on Small Business and Entrepreneurship**

**April 28, 2004**

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**April 28, 2004**

**Prepared Statement**

Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is one of my fellow board members, George Batavick. George is heading up the FASB's newly established Small Business Advisory Committee ("Committee"). The idea for the Committee originated with Senator Enzi at a hearing he chaired late last year.

We are pleased to appear before you today on behalf of the FASB. We want to thank you for inviting us to participate in this very important and timely hearing.

The Board recognizes the importance of small businesses to job creation, entrepreneurialism, and our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost effective manner.

George and I have brief prepared remarks, and we would respectfully request that the full text of our testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the growth and stability of the United States ("US") economy because creditors, investors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002, is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report transparent and credible information about their activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views.

Our due process procedures include active participation by users, auditors, and preparers of the financial reports of small businesses. The recent formation of the FASB Small Business Advisory Committee is intended to further enhance that participation.

The Board makes final decisions only after carefully considering and analyzing the input of all interested parties. The Board must balance the often conflicting perspectives of various parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of sound, fair, and transparent financial reporting.

On March 31$^{st}$ of this year, the Board issued a proposal for public comment to improve the accounting for equity-based compensation. That proposal is the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, consultation with our advisory councils and valuation and compensation experts, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of the financial reports of small businesses, and active deliberations at 38 public Board meetings at which the provisions of the proposal were carefully developed with consideration given to the ongoing input received from all interested parties.

The Board believes the proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including eliminating the existing exception for so-called fixed plan employee stock options, which are the only form of equity-based compensation that is not currently required to be reported as an expense in financial statements. The proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such and that the existing exception for fixed plan employee stock options results in reporting that ignores the economic substance of those transactions.

The proposal also will provide greater comparability between enterprises that compensate their employees in different ways and, in the public company arena, between the nearly 500 enterprises that have voluntarily chosen to account for the cost of all of their employee stock options and the many others that have elected not to do so.

Finally, the proposal has the secondary, but important, benefit of achieving greater international comparability in the area of accounting for equity-based compensation. In that regard, our international counterpart, the International Accounting Standards Board ("IASB"), issued a final standard in February of this year requiring the expensing of all equity-based compensation. The IASB standard will be followed by enterprises in over 90 countries beginning next year.

The proposal includes several special provisions relating to small businesses. George will briefly discuss those provisions and other small business issues.

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

Before I outline the special small business provisions contained in our proposal to improve the accounting for equity-based compensation, I would first like to provide some brief background on small businesses and financial accounting and reporting standards.

First, there is no federal law requiring nonpublic enterprises to use FASB standards. Thus, for most small businesses, the use of our standards is primarily a private choice. For some small businesses, that choice may be influenced by whether they have plans to become a public enterprise, since public enterprises are required to comply with our standards under the federal securities laws.

For other small businesses, the decision to follow FASB standards may be influenced or controlled by their current or potential lenders, suppliers, other contracting parties, or State regulators. To the extent that one of those parties requires that the financial reports of a small business comply with our standards, that requirement presumably reflects that party's opinion that our standards result in better, more transparent, information for their respective purposes than the use of other existing comprehensive bases of accounting, such as tax basis, cash basis, or regulatory reporting.

Second, it is also important to note that the FASB has long recognized as part of our public due process procedures that the costs of complying with our standards can fall disproportionately on small businesses. In recognition of that fact, the Board actively solicits and carefully considers requests from users, auditors, and preparers of the financial reports of small businesses to defer effective dates, provide for differential disclosures, or provide other special provisions to alleviate the costs of implementing our standards.

With respect to our proposal to improve the accounting for equity-based compensation, it is our understanding that although the use of employee stock options is prevalent at some small businesses, particularly start-ups and venture capital backed enterprises that plan to become public enterprises, the vast majority of small businesses in the US do not grant employee stock options. As indicated earlier, however, for those small businesses that are impacted by our proposal, the proposal includes several special provisions intended to alleviate the costs of implementing the proposed requirements.

First, the proposal includes a special provision that would permit most small businesses (including all that are nonpublic enterprises) to measure compensation cost using a simpler, less costly "intrinsic value method," rather than the fair-value-based method that would be required for most public enterprises. Under the intrinsic value method, the compensation cost for any reporting period would be measured based on the difference between any excess of the fair value of the enterprise's stock and the exercise price of the employee stock options granted with final measurement of compensation cost at the settlement date. The total amount of compensation expense required to be reported under that method would generally be equivalent to the amount of the income tax deduction for stock options.

Second, the proposal includes a special provision that provides that most small businesses that are nonpublic enterprises would have a simpler, less costly "prospective" transition to the proposed new requirements. Finally, the proposal includes a special provision that provides that the effective date of the proposed standard for nonpublic enterprises would be delayed for one year until 2006, as compared to the proposed effective date of 2005 for public enterprises.

I also would like to note that the proposal includes a Notice for Recipients ("Notice") that highlights and describes these special provisions as well as other key aspects of the proposal. The Notice requests that respondents to the proposal indicate what other special provisions for small businesses might be appropriate and whether any or all such special provisions should also be extended to public enterprises that are small business issuers under the federal securities laws.

I also would note, however, that we are aware of some recent surveys and other input from investors indicating strong opposition to any exemptions from our proposed requirements for start-ups and newly public companies, respectively.

The Board currently plans to discuss the proposal's special provisions and other issues about the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee in May. We also plan to hold several public roundtable meetings with valuation and compensation experts, and users, auditors, and preparers of financial reports in June to discuss a broad range of issues about the proposal.

Following the end of the proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the proposal. Those redeliberations will address key conceptual, measurement, disclosure, and cost-benefit issues and will include careful consideration of the ongoing input received from representatives of small businesses, including ongoing input from the members of the Small Business Advisory Committee.

Only after carefully evaluating the input at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.

On behalf of myself and Bob, I would again like to express our appreciation for inviting us to participate in this hearing. All of the information we obtain in connection with this hearing will be carefully considered consistent with our mission and Rules of Procedure.

In conclusion, let me assure you, Chair Snowe, Ranking Member Kerry, and Members of this Committee, that you, and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to actively solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties and that will lead to improving the transparency and credibility of financial reports and, thus, assisting in the strengthening of the US economy.

Thank you again, Chair Snowe. Bob and I would welcome the opportunity to respond to any questions.

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Full Text of Testimony**

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is one of my fellow board members, George Batavick. George is heading up the FASB's newly established Small Business Advisory Committee ("SBAC"). The idea for the SBAC originated with Senator Enzi at a hearing he chaired late last year.

We are pleased to appear before you today on behalf of the FASB. We want to thank you for inviting us to participate in this very important and timely hearing.

The Board recognizes the importance of small businesses to job creation, entrepreneurialism, and our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost effective manner.

Our testimony includes a brief overview of (1) the FASB, including the importance of the Board's independence and the ability to conduct its work in a systematic, thorough, and objective manner, (2) the process the FASB follows in developing accounting standards, (3) the application of our standards to small businesses generally, (4) how the FASB identifies the concerns of small businesses about our activities; (5) how the FASB evaluates the input from small businesses as part of our public due process procedures; (6) the background and basis for the Board's unanimous decision to issue a proposal to improve the accounting for equity-based compensation, (7) the key provisions of the proposal, (8) the special provisions of the proposal applicable to small business, (9) how the proposal would improve financial reporting, (10) the current status of, and the FASB's plans relating to, the proposal, and (11) some observations about some of the more common arguments offered by some opponents of the proposal.

***The FASB***

The FASB is an independent private-sector organization.[1] We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses.[2] Those standards are essential to the

[1] See Attachment 1 for information about the Financial Accounting Standards Board ("FASB" or "Board").
[2] See Attachment 2 for excerpts from recent materials about the importance of the FASB's independence and concerns about proposed legislation.

efficient functioning of the capital markets and the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[3] is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting standard is harmful to investors, creditors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[4]

The Policy Statement, consistent with the language and intent of the Act, also reemphasizes the importance of the FASB's independence described earlier.[5] It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of

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[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

[4] "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

[5] Sarbanes-Oxley Act of 2002, Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

> issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[6]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"),[7] maintains active oversight of the FASB's activities.

***What Process Does the FASB Follow in Developing Accounting Standards?***

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including small businesses.

Our Rules of Procedure require an extensive and thorough public due process.[8] That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. As discussed further below, many of our due process activities include active outreach to, and participation by, users, auditors, or preparers of the financial reports of small businesses. The Board makes final decisions only after carefully considering and analyzing the input of all interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

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[6] Policy Statement, Page 5 of 8.
[7] See Attachment 1 for information about the Financial Accounting Foundation.
[8] See Attachment 1 for information about the FASB's due process.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.[9] Over the past two years, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures. Some of those actions were intended to increase the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses. Those particular actions include the following:

- Consistent with a suggestion made by Senator Enzi, establishing a SBAC in order to increase involvement by the small business community in developing accounting standards.[10] The SBAC, whose members represent diverse perspectives and experiences, comprises lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community.

- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

- Making our public Board meeting announcements available to interested parties more broadly through an email subscription service.

- Making our public Board meetings available to interested parties for monitoring via the telephone and, again, consistent with a suggestion made by Senator Enzi, via web cast on our website free of charge.

- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website.

[9] The Securities and Exchange Commission ("SEC") also recently reviewed the FASB's due process and concluded that "the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . ." Policy Statement, page 5 of 8.
[10] See Attachment 3 for press release and listing of members of the Small Business Advisory Committee.

***Are Small Businesses Required to Comply with FASB Standards?***

The US federal securities laws generally require that any enterprise, including any small business, that lists its shares on a national securities exchange or has $10 million or more in assets and 500 or more owners of any class of equity securities be deemed a "registrant."[11] All registrants generally are required to file periodic reports with the SEC.[12]

The SEC has required, since the FASB's inception in 1973, that the preparation of the financial statements contained in the periodic reports comply with generally accepted accounting principles ("GAAP"), including FASB standards.[13] As indicated above, the SEC recently reevaluated and reaffirmed that requirement as a result of the provisions of the Act.[14]

Excluding those small businesses that are SEC registrants, there is generally no federal law requiring that small businesses file financial reports or comply with GAAP. Thus, for most small businesses, the use of FASB standards is a private choice.

Some small businesses may choose to comply with GAAP at the request or demand of current or potential lenders, suppliers, customers, or other contracting parties, or at the request of State regulators. Other small businesses may choose to comply with GAAP because they are funded by venture capital firms with the goal or expectation of becoming a public enterprise. In any event, the decision by one or more of those parties to require that the financial reports of a small business comply with GAAP instead of another basis of accounting is presumably dictated by the quality of FASB standards versus the other available alternatives.

***How Does the FASB Identify the Concerns of Small Business about FASB Activities?***

The FASB actively solicits the views of all interested parties, including the views of users, auditors, and preparers of financial reports of small businesses. Some of the ways in which the FASB currently attempts to identify the concerns of representatives of small businesses include the following:

- Establishing the SBAC to obtain more active involvement by the small business community in the development of financial accounting and reporting standards.

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[11] 15 U.S.C. Section 781(g).
[12] 17 C.F.R. Section 249.310.
[13] Policy Statement, page 2 of 8.
[14] *Id.*

- Including representatives of small businesses on the UAC, the Financial Accounting Standards Advisory Council ("FASAC"), the Emerging Issues Task Force ("EITF"), and other project task forces and working groups.[15] Both the UAC and FASAC are formal parts of our independent structure and have responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, and other matters as may be requested by the FASB. The mission of the EITF is to assist the Board in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. Several current members of the UAC, FASAC, and EITF are primarily users, auditors, or preparers of the financial reports of small businesses.

- Participating in liaison meetings with representatives of small businesses. The FASB holds annual liaison meetings with several such organizations, including the Technical Issues Committee of the American Institute of Certified Public Accountants Private Companies Practice Section and the Accounting Practices Committee of the Risk Management Association. FASB members or staff also frequently meet less formally with other organizations and individuals representing small businesses upon request or at the initiation of the FASB members or staff.

- Participating at conferences and other speaking engagements that are sponsored by or primarily attended by representatives of small businesses. For example, FASB members or staff annually participate at dozens of State CPA society conferences across the country.

***How Does the FASB Evaluate the Input from Small Business as Part of Its Due Process Procedures?***

The FASB's conceptual framework guides the Board in its development of financial accounting and reporting standards. That framework states that the objectives of financial reporting are to provide information (1) that is useful to present and potential users, i.e., investors and creditors, in making investment and credit decisions; (2) to help the users to assess amounts, timing, and uncertainties

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[15] See Attachment 1 for information about the Financial Accounting Standards Advisory Council and the Emerging Issues Task Force.

of prospective cash flows from their investments; and (3) about the economic resources of and claims against enterprises, and the effects of transactions changing such resources and claims.[16]

The Board has long recognized that those objectives are not static and that since the reporting by nonpublic or small businesses caters to a different set of users, the same objectives, defined identically, may mean different things. For many small businesses, the relevant financial statement users include both current and potential lenders, suppliers, and customers. Some of those users may focus more heavily on an enterprise's ability to meet its debt or performance obligations. Their needs may vary in some respects from the needs of other users of financial reports.

The Board's conceptual framework also describes the qualitative characteristics of accounting information.[17] In the hierarchy of accounting qualities, the FASB conceptual framework rates "decision usefulness" as the most important quality, and "relevance" and "reliability" as the two primary qualities necessary to provide such usefulness, subject always to the constraints of a cost-benefit evaluation.[18]

In applying the above concepts to the financial accounting and reporting of nonpublic or small businesses, the Board has generally differentiated between financial information appearing on the face of the financial statements and the additional, analytical, and collateral information appearing in the footnotes to those statements.[19] With respect to the former, the Board has generally concluded that all enterprises, including nonpublic and small businesses, should be subject to

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[16] Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978), paragraphs 32-54.
[17] Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (May 1980).
[18] *Id.* paragraphs 32-110, 133-44. The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small enterprises because of their limited accounting resources and need to rely on outside professionals. "FASB Analyzes Small Business Concerns about Accounting Standards," FASB *Status Report*, No. 181 (November 3, 1986).
[19] Statement of Financial Accounting Standards No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (December 1996), paragraph 10 (stating that in considering the costs and benefits of a new standard the Board has a commitment to consider potential disclosure differences between small and large companies on a case-by-case basis).

the same recognition and measurement requirements.[20] That conclusion has been generally supported by the stated needs of users of financial reports of nonpublic or small businesses. The Board, however, has on a number of occasions provided deferred effective dates for nonpublic enterprises to alleviate the costs and other burdens that may be associated with the more rapid implementation of new requirements.[21]

With respect to the latter information disclosed in the financial statement footnotes, the FASB has on a case-by-case basis decided in some circumstances to reduce[22] or eliminate[23] the disclosure requirements for nonpublic enterprises. Those decisions have generally been the result of input from users, auditors, or preparers of financial reports of nonpublic or small businesses indicating that the users of those reports did not need some or all of the disclosures[24] or that the cost of preparing the disclosures outweighed the usefulness of the information to those users.[25]

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[20] FASB *Status Report,* No. 181, page 4. There have been some limited exceptions. As discussed further in the text of this testimony, in the October 1995 standard to improve the accounting for stock-based compensation, the Board permitted nonpublic enterprises to use the minimum value method for measuring stock-based compensation because of the difficulties of estimating expected volatility. Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 20. Another example is in the November 2002 Interpretation to improve the accounting and disclosure for guarantees. The Board provided a scope exception for the initial recognition and measurement of guarantees issued between parents and subsidiaries and certain other related parties. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002), paragraph 7. One of the reasons given for the scope exception was to alleviate nonpublic enterprises' concerns about the cost of complying with the new requirement. *Id.* paragraph A29.

[21] Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (December 1991), paragraph 79 (concluding that allowing smaller enterprises additional time to comply with the provisions of the Statement will reduce their costs of compliance); Emerging Issues Task Force Topic No. D-1, "Implications and Implementation of an EITF Consensus" (May 15, 2003), page 4965A, footnote 2 (establishing operating procedures that provide nonpublic enterprises a later effective date than public enterprises).

[22] Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Retirement Benefits* (February 1998), paragraphs 57-59 (concluding that a reduced disclosure set would be appropriate for nonpublic enterprises as a result of comments by users of financial statements of nonpublic enterprises about the usefulness of the disclosures).

[23] Statement of Financial Accounting Standards No. 141, *Business Combinations* (June 2001), paragraph B201 (concluding that nonpublic enterprises should continue to be exempt from pro forma disclosure requirements because of arguments by preparers and auditors that costs of the information exceed the benefits); Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997), paragraph 115 (concluding to continue to exempt nonpublic enterprises from the requirement to report segment information because few users of nonpublic enterprises' financial statements have requested that those enterprises provide segment information); Statement 126, paragraph 14 (concluding that certain nonpublic enterprises should be exempt from fair value disclosure requirements because of the likely limited utility of the disclosures to certain users).

[24] Statement 132, paragraphs 57-59.

[25] Statement 141, paragraph B201; Statement 131, paragraph 115; and Statement 126, paragraph 14.

The FASB and its constituents have over the years periodically examined the issue of whether financial accounting and reporting standards should be different for small businesses.[26] Some of the reasons frequently cited in opposition to a so-called Big GAAP/Little GAAP approach to financial accounting and reporting include:

- Similar economic transactions and events should be reported consistently regardless of the size of the reporting enterprise.

- Differential standards for enterprises of different sizes would reduce the benefits to users of financial reports by impairing comparability more than they would reduce the costs of financial statement preparation.

- It would be virtually impossible for an accounting standards-setting body to decide which economic transactions and events should be permitted to be recognized and measured differently by large versus small businesses.

- Dual standards would represent additional costs to preparers, accountants, advisors, and others in the areas of continuing education, authoritative resources, and quality control systems.[27]

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[26] *Status Report*, No. 181, page 4 (concluding that the most constructive effort to alleviate the concerns of small businesses regarding generally accepted accounting principles ("GAAP") is to ensure that the views of privately held companies and smaller certified public accounting firms are adequately included in the Board's consideration of specific accounting issues); FASB Research Report, A. Rashad Abdel-khalik, *Financial Reporting by Private Companies: Analysis and Diagnosis* (August 1983), page 1 (stating that surveyed bankers that are users of the financial reports of private companies do not believe that a special set of GAAP would be beneficial for private companies considered to be small in size); FASB Invitation to Comment, *Financial Reporting by Private and Small Public Companies* (November 20, 1981) (soliciting input on several concerns about the existing financial reporting by private and small public companies); "Report of Task Force on GAAP Requirement of Concern to Small or Closely Held Businesses, to Small Business Advisory Committee, Financial Accounting Advisory Council" (December 1978), page 3 (finding that most individuals surveyed reported that there were no areas of particular concern to them with respect to current reporting requirements of small or closely held businesses); Abraham M. Stanger & Samuel P. Gunther, Article, "Big GAAP—Little GAAP: Should There Be Different Financial Reporting for Small Business?" N.Y.U. L. Rev. 1209 (Nov. – Dec. 1981) (concluding that different disclosure requirements, but not recognition and measurement standards, should apply to small businesses, but that there should remain a unitary system of GAAP).

[27] J. E. McCahey & A. L. Ramsay, "Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its Resolution," Australian Accounting Research Foundation (June 26, 1989), pages 10-11, 12-13.

Significantly, the users of small business financial reports have historically been generally supportive of uniform accounting standards for both nonpublic or small businesses and larger public enterprises.[28]

Notwithstanding this history, the Board recognizes the continuing interest by some parties in the Big GAAP/Little GAAP approach. The Board plans to utilize the SBAC to again consider issues raised by that approach.

***What Are the Background and Basis for the Board's Unanimous Decision to Issue a Proposal to Improve the Accounting for Equity-Based Compensation?***

A Brief History of the Accounting for Equity-Based Compensation

*APB Opinion 25*

US accountants and accounting standard setters have long debated the issue of the best way to report employee stock options. In 1972, the Accounting Principles Board ("APB"), the predecessor of the FASB, issued APB Opinion No. 25, *Accounting for Stock Issued to Employees.* Partly because techniques to estimate the value of stock options did not yet exist, the drafters of Opinion 25 created an exception to the normal financial reporting model.[29] That model encompasses the general principle that all of an enterprise's costs should be included in the enterprise's financial statements; otherwise, the enterprise's income is overstated.

Under the Opinion 25 exception, only stock options granted to employees that meet certain specified criteria (so-called fixed plan employee stock options) are not reported as an expense. All other options and all other forms of equity-based transactions result in expenses to be included in the financial statements consistent with the general principle.

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[28] FASB Research Report, A. Rashad Abdel-khalik, page 1. Of note, the FASB's counterpart internationally, the International Accounting Standards Board ("IASB") recently added a project to its agenda to develop IASB accounting standards for small or medium-sized entities ("SME"). Under the IASB planned approach there would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles of International Financial Reporting Standards for SME standards. Similar to the general approach taken by the FASB, the IASB approach would generally be limited to disclosure modifications. As part of its international convergence efforts, the FASB will be closely monitoring the IASB project.

[29] Opinion 25 measures stock issued to employees using the "intrinsic value based method." Under that method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Opinion 25, paragraph 10. The consequence of using the intrinsic value based method is that stock options are frequently issued with the quoted market price of the stock at grant date equal to the amount an employee must pay to acquire the stock and, thus, no expense is reported in the financial statements.

*Statement 123*

Many parties agreed that the Opinion 25 exception was not the best approach to transparent financial reporting for employee stock options, and, in 1984, the FASB undertook a project to reconsider the issue. In 1993, after several delays in the project, the FASB issued an Exposure Draft, *Accounting for Stock-based Compensation,* for public comment. The Exposure Draft proposed to replace Opinion 25 and require recognition of compensation cost for all awards that eventually vest, based on their fair value at the grant date. For nonpublic enterprises, the Board decided to permit those enterprises to omit expected volatility from the fair value determination (so-called minimum value method) because "estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible."[30]

In 1995, however, when the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation,* it permitted companies to continue to apply Opinion 25, while also requiring annual footnote disclosures of the fair values (or minimum value for nonpublic enterprises) of fixed plan employee stock options otherwise omitted from the financial statements. The following paragraphs of Statement 123 summarize the basis for the Board's decision to only *encourage*, rather than *require*, that all stock-based compensation be measured at fair value at date of grant and reported as an expense in determining an enterprise's net income:

> The Board continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments. . . . However, in December 1994, the Board decided that the extent of improvement in financial reporting that was envisioned when this project was added to its technical agenda . . . was not attainable because the deliberate, logical consideration

[30] Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 174.

> of issues that usually leads to improvement in financial reporting was no longer present. Therefore, the Board decided to specify as preferable and to encourage but not to require recognition of compensation cost for all stock-based employee compensation, with required disclosure of the pro forma effects of such recognition by entities that continue to apply Opinion 25.
>
> The Board believes that disclosure of the pro forma effects of recognizing compensation cost according to the fair value based method will provide relevant new information that will be of value to the capital markets and thus will achieve some but not all of the original objectives of the project. However, the Board also continues to believe that disclosure is not an adequate substitute for recognition of assets, liabilities, equity, revenues, and expenses in financial statements. . . . *The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting.*[31]

In 2002, in Congressional testimony before the Committee on Banking, Housing and Urban Affairs, Dennis R. Beresford, who was the FASB chairman at the time Statement 123 was issued, shared his views about that Statement and the reasons for the Board's decision:

> As many of you may recall, the FASB had proposed that companies account for the expense represented by the fair value of stock options granted to officers and employees. The business community and accounting firms strongly opposed this proposal and a number of corporations engaged in a lobbying effort to stymie the FASB's initiative.
>
> Certain members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB's proposal. The legislation would have prohibited public companies from following any

[31] Statement 123, paragraphs 61 and 62 (emphasis added).

> final FASB rule on this matter. More importantly, the legislation would have imposed requirements that the SEC repeat the FASB's process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a footnote to the financial statements but not record the expense in the income statement.[32]

*Pertinent Events Following the Issuance of Statement 123*

For many years following the issuance of Statement 123, only a handful of companies elected to adopt the fair value method of reporting employee stock options as an expense in the income statement. In addition, few investors and other users of financial statements expressed significant concerns with that practice.

Beginning in 2001, however, following the highly publicized bankruptcies of several major enterprises including Enron Corp., Global Crossing Ltd., and WorldCom, Inc., many investors and other users of financial statements began questioning enterprises' accounting and reporting for employee stock options. Moreover, many enterprises began considering whether to voluntarily expense all equity-based compensation consistent with the requirements of Statement 123. As of March 2003, when the Board added the project on equity-based compensation to its agenda, 179 public companies had adopted or announced their intention to adopt the fair-value-based accounting method in Statement 123.[33]

In 2001, the FASB's international counterpart, the International Accounting Standards Board ("IASB") took up the subject of the accounting for stock options. It needed to do so, not only because of the growing use of employee stock options around the world, but also because there was no existing literature in the international standards on this topic.

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[32] Prepared statement at a hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles (February 26, 2002), page 5 (emphasis added).
[33] FASB Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraph C5.

In November 2002, it proposed, as the FASB decided almost 10 years ago in developing Statement 123, that the appropriate accounting for employee stock options is to measure compensation for the fair value of the options at the date granted and to recognize the cost over the period the option vests.[34] And, also as the Board decided in developing Statement 123, the IASB proposed that the best way to measure the fair value at grant date is to use established option-pricing models and then make certain adjustments for the unique features of employee stock options. However, the IASB's particular set of adjustments and allocation methods were somewhat different from those under the fair value method developed by the FASB in Statement 123. There also were some other important differences between the IASB's proposal and the Statement 123 approach. Nevertheless, the fundamental conclusions were the same.

As the IASB released its exposure draft, the FASB issued an Invitation to Comment that explained in detail the similarities of and differences between the IASB proposal and the existing US standards and that solicited comments on those differences.[35] The purpose of the Invitation to Comment was twofold: (1) to solicit comments on certain issues that the Board would discuss when, in accordance with its objectives of improving US financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, it considered whether it should propose any further improvements to the US accounting standards on equity-based compensation and (2) to assist constituents that were planning to respond to the IASB's proposal.

The FASB received 302 comment letters in response to the Invitation to Comment. Most commentators from industry that made general observations about the accounting for equity-based compensation, many of whom were from the high-technology industry, were generally against mandatory expense recognition of all equity-based compensation. Those commentators raised a number of issues including (1) whether mandated expensing of fixed plan employee stock options has a clear or widely accepted rationale; (2) whether existing option pricing models, including Black-Scholes and binomial models, even when adjusted, produce inaccurate and misleading information; and (3) whether mandated expensing of fixed plan employee stock options will discourage broad-based compensation plans.

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[34] IASB Proposed IFRS, *Share-based Payment* (November 2002); FASB Exposure Draft, *Accounting for Stock-based Compensation* (June 1993).

[35] FASB Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment (November 2002).

In contrast, most commentators that were users of financial statements, including creditors, individual investors, pension funds, mutual funds, and financial analysts, were generally supportive of mandatory expense recognition of all employee stock options. Some representative examples include the following:

> Stock options have become a disgrace insofar as accurate reporting of expenses is concerned for corporation[s].
>
> I strongly recommend that there be a requirement for stock options to be expensed.
>
> *Benham M. Black, Partner, Black, Noland & Read, PLC, and Director, Virginia Financial Group, Inc. (an independent bank holding company with total assets of $1.04 billion), 1/31/03*

> [A]s a fiduciary, I continue to be infuriated with the tech industry . . . and their blatantly self-serving position on stock options. Options have contributed mightily to the current crisis of confidence that we have in the stock market, and I view the expensing of options as a long-overdue and necessary step towards restoring both confidence and rationality in the market. . . . The tech industry has been masterful at marshalling their shareholders own capital against them, given their vociferous lobbying against the proper accounting treatment of options, but the time has come to treat options for what they are—compensation—and force them to be treated on par with all other forms of compensation.
>
> *Kenneth F. Broad, CFA, Portfolio Manager, Transamerica Investment Management, LLC (a registered investment adviser managing $12.5 billion in equity and fixed-income assets for mutual funds, funds for funds, separately managed accounts, retirement plans and various for-profit and nonprofit enterprises), 1/31/03*

CPF . . . supports the view that stock options are compensation, have a cost, and that those costs should be included on reported income statements.

*Michael R. Fanning, Chief Executive Officer, Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of over 150,000 participants of the CPF), 1/23/03*

Investors support the core conclusions by the IASB and the FASB that stock based compensation should be recognized as an expense and that the amount of compensation expense should be based on the fair value of stock-based awards at grant date.

*James E. Heard, Chief Executive Officer, Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide), 1/31/03*

The Institute urges the Board to move forward with a reconsideration of Statement No. 123 as soon as practicable. We continue to believe that accounting standards should (1) require the issuers to treat the fair value of stock options granted to employees to be recognized as expense in the income statement and (2) ensure uniformity in how stock options are valued for this purpose.

*Gregory M. Smith, Director – Operations/Compliance & Fund Accounting, Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies and 6 sponsors of unit investment trusts; its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders), 1/31/03*

> The Council supports the principles outlined in the IASB's exposure draft, and we urge the Financial Accounting Standards Board to propose and approve similar rules. The IASB proposal is in line with the Council policy on the issue, which states that 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 and disclose their valuation assumptions.
>
> *Sarah A. B. Teslik, Executive Director, Council of Institutional Investors (an association of more than 130 corporate, public and union pension funds with more than $3 trillion in pension assets), 1/21/03*

In addition, the Board received many letters and emails from individual investors and other members of the general public from around the country urging the Board to mandate expense recognition for all equity-based compensation. Representative examples include the following:

> I strongly recommend that employee stock options be mandated as an expense on corporate financial statements. As long as these options can be passed out like funny money, thereby encouraging those on the receiving end to manipulate the financial records to their advantage – people like me will stay away from the market.
>
> *John S. Clauss, Jr., Glendale, California, 2/10/03*

> We encourage you to . . . require employee stock options to be counted as an expense. If you don't take this action who do you think will make these greed-monger's start accounting for their massive profits? Do the RIGHT THING, Damn it! . . .
>
> *David and Nancy Gabrielsen, Beavercreek, Oregon, 2/11/03*

> Companies are not required to expense options, which means they can give out as many as they want.
>
> I urge the FASB to require employee stock options to be counted as an expense. . . .
>
> *Rob Rocco, Avon Lake, Ohio, 2/12/03*

*FASB's Current Project to Improve the Accounting for Equity-Based Compensation*

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to equity-based compensation. That decision was based largely on three reasons.

The first reason was the high level of public concern expressed by creditors, individual and institutional investors, pension funds, mutual funds, financial analysts, and other users of financial statements about the need to improve the financial accounting and reporting for equity-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists *only* for fixed plan employee stock options. Those users of financial statements that have been urging the FASB to eliminate the exception for fixed plan employee stock options include:

- The Council of Institutional Investors (an association of more than 130 corporate, public, and union pension funds with more than $3 trillion in pension assets)
- Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide)
- The Office of the State Comptroller of New York (an investor, shareholder, and sole trustee of the nation's second largest pension fund at approximately $100 billion in assets)
- Moody's Investor Services
- The Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of more than 150,000 participants of the CPF)
- The Teachers Insurance and Annuity Association College Retirement Equities Fund (a financial services company with approximately $262 billion in assets under management, serving nearly 3 million education and research employees at 15,000 institutions)

- The Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies, and 6 sponsors of unit investment trusts; its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders)

- The Association for Investment Management and Research (a nonprofit professional organization of 61,600 financial analysts, portfolio managers, and other investment professionals)[36]

- The American Federation of Labor and Congress of Industrial Organizations (representing 13 million of America's workers in 65 member unions)

- The Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Peterson, chairman of the Blackstone Group, former Secretary of Commerce and chairman of the Federal Reserve Bank of New York, and John W. Snow, (former) chairman, CSX Corporation and former chairman, Business Roundtable).

As indicated above, fixed plan employee stock options are the *only* form of employee stock options that *are not* required to be reported as an expense in the income statements of the enterprises that grant them. All other forms of employee compensation, including cash salaries, bonuses, fringe benefits, restricted stock, stock warrants, performance-based stock options, indexed-based stock options, employee stock ownership plans, are (and have long been) required to be reported as an expense. Moreover, when equity-based grants of any form are issued to nonemployees for goods or services, they also are (and have long been) required to be reported as an expense. The exception for fixed plan employee stock options is clearly an anomaly in today's financial accounting and reporting.

Also as indicated above, creditors, investors, and other users of financial reports have urged the Board to address the exception for fixed plan employee stock options. Many have pointed to the negative impact that exception has had on promoting excessive awards of such options, particularly to corporate executives, and the negative behavioral aspects that it has had on corporate responsibility.[37]

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[36] A 2001 survey conducted by the Association for Investment Management and Research found that more than 80 percent of financial analysts and portfolio managers responding to the survey believed that stock options granted to employees are compensation and should be recognized as an expense in the income statements of the enterprises that grant them. AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows" (November 19, 2001).

[37] The Conference Board, "Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation" (September 17, 2002), page 10.

Clearly, many creditors, investors, and other users of financial reports want this issue addressed and resolved in the near term.[38]

In 2002, President Bush announced a ten-point plan to improve corporate responsibility.[39] That plan including the following statement: "The authors of accounting standards must be responsive to the needs of investors."[40] There is no other issue on the Board's agenda on which investors have been clearer about the need for an improvement in the existing accounting standards.

The second reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was because of the complexity and noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting equity-based compensation. That lack of transparency has been magnified by the recent trend noted above of enterprises adopting the voluntary fair value provisions of Statement 123. Some of those enterprises, including Citigroup Inc. and J.P. Morgan Chase & Co., have requested that the Board mandate the expensing of all employee stock options. It is also interesting to note some of those enterprises, including Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that adopting fair value expensing for all employee stock options will not result in a curtailment of those programs.[41]

The third reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was the opportunity to achieve convergence to a common, high-quality international accounting standard in this area. As noted earlier, the IASB issued a proposal in November 2002 that would require that all stock options be expensed at their fair value at grant date. To maximize the opportunity for international convergence, the FASB concluded that it needed to consider the US accounting requirements for equity-based compensation concurrently with IASB's consideration of its proposal.

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[38] The major US accounting firms also are generally supportive of expensing of all employee stock options. Letter from Jack A. Weisbaum to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski (March 19, 2004); Letter from Dennis M. Nally, Eugene O'Kelly, James H. Quigley, and James S. Turley to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski (March 17, 2004); Letter from Edward Nusbaum to the Honorable Richard H. Baker (March 17, 2004); "Big Four Shift View on Expensing Options," *Financial Executive's News* (May 1, 2003).

[39] Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders (March 7, 2002).

[40] *Id.*

[41] News from Carl Levin, U.S. Senator, Michigan, "Stock Option Roundtable Dismissed as One-Sided" (May 8, 2003), page 2; Reed Hastings, "Expense It!" *The Wall Street Journal* (April 5, 2004).

The FASB has long been committed to actively working with the IASB and other national accounting standard setters to promote international convergence of accounting standards concurrent with improving the quality of financial reporting.[42] Both the Act[43] and the Policy Statement[44] indicate the support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

Since March 2003, the Board has held 38 public meetings to discuss the project. Preparations for those meetings included thousands of hours of research on issues relating to the project, including the review of the results of many research studies on the topic.

In addition, the Board and staff have participated in public and private discussions about the project with hundreds of individuals, including members of the FASAC, the UAC, the Option Valuation Group,[45] and other groups and organizations representing preparers, auditors, and users of financial reports. The Board also has conducted field visits with a variety of enterprises of various sizes, including small businesses, covering a range of industries to discuss issues relating to the project.

In February 2004, at a public meeting, the Board unanimously agreed to the issuance of a proposal for public comment. That proposal was issued on March 31, 2004.[46]

***What Are the Key Provisions of the Proposal?***

<u>Scope</u>

The scope of the proposal is very broad addressing the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services, including employee stock purchase plans. It also addresses transactions in which an enterprise incurs liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of those equity instruments in exchange for employee services. The proposal does not change the accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans. The Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

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[42] FASB, *Rules of Procedure* (December 1, 2002, as amended), page 2.
[43] Act, Section 108(a)(2).
[44] Policy Statement, page 4 of 8.
[45] The Board established the Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of stock options. Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, paragraph C37.
[46] See Attachment 4 for a summary of the proposal.

*Recognition*

For public enterprises, the proposal would require that the cost of employee services received in exchange for equity instruments be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost would be recognized over the requisite service period (often the vesting period). Generally, no compensation cost would be recognized for equity instruments that do not vest.

*Measurement*

The proposal would require that the grant-date fair value of employee stock options and similar instruments be estimated using existing option-pricing models adjusted for the unique characteristics of those options and instruments.

*Disclosures*

The proposal would require that the footnotes to financial statements of both public and nonpublic enterprises disclose the information that users of financial information need to understand the nature of the equity-based compensation transactions and the effects of those transactions on the financial statements.

*Transition and Effective Date*

The proposal would be applied to public enterprises prospectively for fiscal years beginning after December 15, 2004, as if all equity-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting.

***What Are the Special Provisions of the Proposal Applicable to Small Business?***

Consistent with the requirements of its mission and due process, when the Board developed the proposal it evaluated whether the proposal would fill a significant need and whether the costs imposed to apply the provisions of the proposal, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of the proposal on nonpublic enterprises (most small businesses are nonpublic enterprises).

The Board noted that the available statistical data about small businesses and employee stock options appears to indicate that very few small businesses operate stock option plans and, therefore, are unlikely, to be affected by the proposal.[47] For those small businesses, however, that do operate such plans the Board concluded that the proposal should include special provisions that mitigate the incremental costs those enterprises would incur in complying with the proposal's provisions.

Those special provisions include permitting most small businesses to (1) use a simpler, less costly method to measure compensation cost; (2) use a simpler, less costly method to transition to the new requirements; and (3) have a delayed effective date.

*Simpler, Less Costly Measurement Approach*

Most nonpublic enterprises would be permitted (and public enterprises, in the limited circumstances where it is not possible to reasonably estimate the fair value of an equity instrument at the grant date, would be required) to measure compensation cost using a simpler "intrinsic value method," rather then the fair-value-based method that would be required for other enterprises.[48]

Under the intrinsic value method, the compensation cost for any reporting period would be measured based on the difference between any excess of the fair value of the enterprises' stock and the exercise price of the employee stock options granted, with final measurement of compensation cost at settlement date. The total amount of compensation expense reported under the intrinsic value method would generally be equivalent to the total amount of income tax deduction for option grants presently reported by those enterprises.

The Board believes that applying the intrinsic value method described above lessens incremental costs that nonpublic enterprises may incur in applying the proposed requirements. The Board noted that nonpublic enterprises must

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[47] Beth Levin Crimmel and Jeffrey L. Schildkraut, "Stock Option Plans Surveyed by NCS," *Compensation and Working Conditions* (Spring 2001), Table 3, page 11 (referencing 1999 survey indicating that 2.1 percent of enterprises with 100 employees or fewer offered stock options); Andrew Pendleton, Joseph Blasi, Douglas Kruse, Erika Poutsma, and James Sesil, "Theoretical Study on Stock Options in Small and Medium Enterprises," Final Report to the Enterprise-Directorate General, Commission of the European Communities (October 2002), page 45 (indicating that the incidence of any form of share scheme among small and medium size businesses is very low).

[48] The International Accounting Standards Board's International Financial Reporting Standard (IFRS) 2, *Share-based Payment* (February 2004), paragraph 24, does not permit the use of the intrinsic value method for nonpublic or public enterprises, but does require that that method be used by nonpublic or public enterprises in the rare circumstance that the fair value of the equity instrument cannot be estimated reliably.

currently calculate the intrinsic value method whenever employee stock options are granted (for financial reporting purposes) and whenever employee stock options are exercised (for income tax deduction purposes). The Board also noted that most nonpublic enterprises only prepare audited financial reports once a year. Finally, to the extent that a nonpublic enterprise is funded by a venture capital firm, the Board noted that those firms are required to determine the fair value of their investments for financial reporting purposes.

After considering the input from users, auditors, and preparers of nonpublic enterprises' financial reports, the Board concluded that the intrinsic value method provided more meaningful information than other alternatives, including the minimum value method alternative permitted in Statement 123.[49] In rejecting the minimum value method alternative, the Board noted that that method ignores a key element of what makes options valuable, that is the ability of the holder for a potentially lengthy period of time to capture the appreciation in the value of the underlying stock.[50] As such, it results in a measurement that is not representationally faithful to the underlying economics of the transaction. It also was noted that the minimum value method could be easily manipulated to result in zero compensation expense being recognized.[51]

*Simpler, Less Costly Transition Approach*

All nonpublic enterprises would apply the proposed standard prospectively and not be required (as other enterprises) to apply the requirements to any nonvested portion of awards that were granted before the date of adoption of the proposed standard.

*Delayed Effective Date*

The effective date of the proposed standard for most nonpublic enterprises would be delayed for one year (fiscal years after December 15, 2005), as compared with the proposed effective date for other enterprises (fiscal years after December 15, 2004).

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[49] Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, paragraphs C68-C72.
[50] *Id.* paragraph C72.
[51] Mark Rubinstein, "On the Accounting Valuation of Employee Stock Options," *Journal of Derivatives* (Fall 1995), page 21.

<u>*Solicitation of Comments on Special Provisions*</u>

The Board specifically highlighted the special provisions applicable to small businesses in the following issues contained in the proposal's Notice for Recipients ("Notice") to encourage respondents to provide further input on those issues:

> *Issue 14(a):* This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?
>
> *Issue 14(b):* Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not?

> Should other modifications of this proposed Statement's provisions be made for those entities?
>
> . . . .
>
> *Issue 15:* Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?[52]

Also as noted above, the Board plans to discuss the views of individuals representing small and medium-sized businesses regarding the above issues and other aspects of the proposal at the inaugural meeting of the SBAC.

The Board will carefully consider during its public redeliberations of the proposal the input received from users, auditors, and preparers of small business financial reports and carefully consider whether the proposed requirements are cost effective and meet the demands of those parties and the marketplace.

***How Would the Proposal Improve Financial Reporting?***

The proposal would improve financial reporting by requiring for the first time the recognition of all compensation cost incurred as a result of receiving services in exchange for valuable equity instruments issued by the employer. Recognizing all compensation cost relating to equity-based compensation in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Such information specifically will help users of financial reports understand the impact that equity-based compensation arrangements have on an enterprise's financial condition and operations.

That Board view was confirmed in a recent survey of 302 buy-side portfolio managers and research professionals, who by a four-to-one margin indicated that they believe the proposal, will improve transparency in financial reporting.[53] **That same survey found that "an overwhelming majority -- 90% -- of respondents said they are opposed to any exemptions from the options expensing rule for 'start-ups' or technology companies."[54]**

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[52] Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, pages iii and iv; see Attachment 4 for the complete Notice for Recipients.
[53] Broadgate Consultants, Inc., "Institutional Investors Support FASB Options Expensing Proposal" (April 7, 2004).
[54] *Id.*; See Attachment 5 for additional excerpts from materials about the proposal and small business.

In addition, a recent survey of 30 institutional technology investors found that more than 90 percent support the Board's effort to require firms to report employee stock option expense in their income statements.[55] **That same survey also found that nearly 70 percent of technology investors opposed exceptions from the proposal for "newly public companies."**[56]

Both surveys are consistent with a 2001 survey of more than 18,000 analyst and portfolio managers in which 83 percent of respondents agreed that employee stock options are compensation and should be recognized as an expense in the income statements of the enterprises that grant them.[57]

The proposal also would improve comparability by eliminating one of the two different methods of accounting for equity-based compensation transactions that were available to most enterprises (the Opinion 25 method) and would also thereby simplify existing US GAAP. The existing accounting for equity-based compensation had been specifically identified by many parties, including the SEC, as an example of a "rules-based standard" that has "fueled the demand for increased guidance" and that has led to further complex, detailed, and form-driven rules.[58] Eliminating different methods of accounting for the same transaction leads to improved comparability of financial statements because similar economic transactions are accounted for similarly. That should, in turn, result in accounting information that is more decision useful to creditors and investors.

The proposal also results in greater international comparability in the accounting for equity-based compensation. In February 2004, the IASB issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment.*[59] Converging to a common set of high-quality financial accounting standards on an international basis for equity-based compensation improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both US GAAP and international accounting

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[55] Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment (February 3, 2004), page 7.

[56] *Id.* page 11 (emphasis added).

[57] AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows."

[58] Staff of the US SEC, "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System" (July 25, 2003), pages 24 and 25.

[59] Of note, in September 2003, the Accounting Standards Board ("AcSB") of Canada issued *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870. Section 3870, consistent with IFRS 2 and the FASB proposal, requires the expensing of all equity-based compensation. Significant concerns in Canada about the inadequacies of the existing accounting for equity-based compensation led the AcSB to take the unusual action of requiring that Section 3870 become effective in 2004, prior to completion of the related FASB project and prior to the effective date of IFRS 2.

standards. As indicated above, both the Act and the Policy Statement indicate support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

***What Is the Current Status of, and the FASB's Plans Relating to, the Proposal?***

As indicated above, the Board issued the proposal for public comment on March 31, 2004. Also as indicated above, the proposal includes a Notice that highlights and describes twenty-two specific issues (three of which are related to small businesses) that respondents might wish to consider in developing their comments.[60] The comment period ends on June 30, 2004.

The Board plans to hold public roundtable meetings with interested users, auditors, preparers, and compensation and valuation experts to discuss the issues related to the proposal. Those roundtable meetings are scheduled to take place on June 24, 2004, in Palo Alto, California, and June 29, 2004 in Norwalk, Connecticut. The Board plans to seek participants for each meeting that represent a wide variety of users, preparers, and auditors of financial reports, and compensation and valuation experts. The Board also plans to discuss the views of interested parties representing small and medium-sized businesses regarding the proposal at the inaugural meeting of the SBAC to be held on May 11, 2004, in Norwalk, Connecticut.

Following the end of the comment period, the Board will redeliberate at public meetings the issues raised by the proposal. Those public redeliberations will be thorough and objective.

The redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal and will include careful consideration of the input received by all parties. The redeliberations also will benefit from the FASB staff and Board's ongoing discussion of the key issues with interested parties from a broad range of perspectives, including valuation and compensation experts that the FASB has been consulting with and will continue to consult with throughout the entire process.

Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

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[60] See Attachment 4 for the Notice for Recipients.

The Board's current plans are to issue a final standard in the fourth quarter of this year. As with all of the FASB's activities, the FAF and the SEC will closely monitor and oversee the Board's due process on this important project.

***Some Observations about Some of the More Common Arguments Offered by Some Opponents of the Proposal.***

Four of the more common arguments made by some of the opponents of the Board's proposal to improve the financial accounting and reporting for equity-based compensation are (1) employee stock options do not represent a cost and, therefore, should not be required to be expensed, (2) the cost of employee stock options cannot be reliably estimated, (3) mandatory expensing of employee stock options will eliminate broad-based stock option plans, and (4) mandatory expensing of fixed plan employee stock options will have negative economic consequences, including harmful implications to US technology leadership and job creation. The following presents some observations about each of those arguments.

<u>Employee Stock Options Do Not Represent a Cost</u>

In connection with the development of the proposal, the Board, after public deliberations, decided by a unanimous vote that goods and services received from any party in exchange for equity-based compensation should result in a cost that is recognized in the financial statements. That decision led to the proposed elimination of the existing exception that permits fixed plan employee stock options to avoid expense recognition.

The basis for the Board's proposed decision is that the Board agreed that all employee stock options, including fixed plan stock options, have value and those valuable financial instruments given to employees give rise to compensation cost that is properly included in measuring an enterprise's net income. Employee stock options provide an employee a valuable right to buy an enterprise's stock for a fixed price during a fixed time period. Similar rights are bought and sold in organized markets by speculators and other parties.

Furthermore, companies issue similar options and warrants to outside parties to acquire goods and services and in connection with acquisitions and financing transactions (and the fair value of those exchanges are always reported on the face of the financial statements without exception). If such rights were not valuable, employees, speculators, and other parties would not purchase them. Because employees purchase those rights with services, those consumed services represent an expense that is properly included in measuring an enterprise's net income.

The Board also discussed and disagreed with the related argument made by some parties that equity-based compensation should not be reported as a cost and deducted from earnings, but instead should only be reflected in diluted earnings per share when the options are exercised. The Board noted that the argument ignores the fact that all equity-based compensation, other than fixed plan employee stock options, is currently reported as a cost and deducted from earnings.

The Board believes that information about dilution from stock and stock option issuances is relevant information for investors. Diluted earnings per share, however, do not reflect all of the effects of equity-based compensation transactions.[61]

In addition to potential dilution, equity-based compensation transactions also affect the amount of the enterprise's employee compensation costs. As noted earlier, under existing accounting standards, all forms of equity-based compensation, except for fixed plan employee stock options, are reported as part of an enterprise's employee compensation costs.

The Board believes that all compensation costs, including fixed plan employee stock options costs, must be reported as an expense and deducted from earnings in order to provide investors with sound, fair, and credible information about an enterprise's net income. As the Congressional Budget Office recently concluded in its paper analyzing the accounting for employee stock options, **"[i]f firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' reported net income will be overstated."**[62] More recently, in expressing support for the proposal in testimony before the Joint Economic Committee last week, Federal Reserve System Chairman Alan Greenspan commented that **not expensing employee stock options gives a distorted view of profitability**.[63]

*The Cost of Employee Stock Options Cannot Be Reliably Estimated*

In its public deliberations leading to the development of the proposal, the Board did not find persuasive the argument that the estimated fair value of employee stock options based on currently available valuation techniques would be so unreliable as to impair the credibility and comparability of financial statements.

[61] Of note, the diluted earnings per share calculation takes into account only those stock options that are in-the-money and ignores the potential dilutive impact of options that are either at- or out-of-the-money. FASB Statement No. 128, *Earnings per Share* (February 1997), paragraphs 20-23.

[62] Congressional Budget Office, "Accounting for Employee Stock Options," Summary, Section 2 of 3, pages 1 and 2 (emphasis added).

[63] Stephen Taub, "Greenspan Endorses Expensing Options," *CFO.com* (April 22, 2004).

To the contrary, the Board believes that use of the Opinion 25 intrinsic value method has and would continue to impair not only the relevance and reliability, but also the credibility, of financial statements by omitting a potentially significant component of the total cost of employee services.

The Board notes that thousands of public enterprises have been estimating the fair value of employee stock options, generally consistent with the approach contained in the proposal, and have been reporting those amounts in their audited financial statement footnotes for eight years. Moreover, 483 enterprises, 113 of which represent 41 percent of the S&P 500 index based on market capitalization, have estimated and reported or will soon estimate and report all of their employee stock options as an expense in their audited and certified financial statements generally consistent with the proposal's approach.[64]

In addition, many valuation experts and many other parties, including the Congressional Budget Office, agree that employee stock options can be reliably valued.[65] It is widely acknowledged that far more complicated financial instruments, including long-dated and complex derivatives, and convertible bonds containing embedded long-dated options, are valued in the marketplace daily and that value is routinely reported by enterprises.[66]

Uncertainties inherent in estimates of the fair value of equity-based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations.[67] For those items, as well for many other items in accounting involving the use of estimates, enterprises are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements.[68] Few accrual-based accounting measurements can claim absolute

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[64] Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Options Using the Fair Value Method," Bear Stearns (February 12, 2004).

[65] Congressional Budget Office, "Accounting for Employee Stock Options," Summary, Section 2 of 3, page 2, and Section 3 of 3, pages 5 and 6.

[66] Hearing on "H.R. 3574: Stock Option Accounting Reform Act," Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004).

[67] Michael B. Clement, "Accounting: The Case for Expensing Stock Options," Goldman Sachs Global Equity Research (April 7, 2004), page 1.

[68] As an example, Intel Corporation's ("Intel") Form 10-K for fiscal year ended December 27, 2003, includes a disclosure of "Critical Accounting Estimates" in Management's Discussion and Analysis of Financial Condition and Results of Operations. That disclosure describes "difficult and subjective judgments" in five specific areas that Intel acknowledges "have a significant impact on the results we report in our financial statements." Those five areas include goodwill, non-marketable equity securities, inventory, long-lived assets, and income taxes. Intel Form 10-K, pages 32-34.

reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing no amounts.[69]

*Mandatory Expensing of Employee Stock Options Will Eliminate Broad-Based Stock Option Plans*

If broad-based employee stock option plans are a good business decision, meaning that the benefits derived from those plans exceed their costs, mandatory expensing of fixed plan employee stock options should not lead to the elimination of broad-based stock option plans. Many other forms of compensation, including pension plans and Employee Stock Purchase Plans, have been and continue to be "broad-based" at many enterprises, notwithstanding that those and other forms of compensation, other than fixed plan employee stock options, are reported as an expense.

As indicated above, Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that voluntarily adopting fair value expensing for all employee stock options will not result in any curtailment of those programs. The CEO of Netflix Inc. recently commented:

> Thoughtful Silicon Valley CEO after CEO lines up to say that closing the stock option loophole will curtail the innovation economy as we know. But Amazon, Microsoft and my company, Netflix, all voluntarily converted last year to expensing, have continued to give broad-based equity incentives, and innovation continues unabated. Stock options may be the symbol of the Silicon Valley culture, but it is not the essence. We innovate because it thrills us, not because of some accounting treatment."[70]

[69] Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment, page 5.
[70] Reed Hastings, "Expense It!" *The Wall Street Journal.*

<u>*Mandatory Expensing of Employee Stock Options Will Have Negative Economic Consequences*</u>

Some opponents of the proposal argue that the recognition of compensation cost based on fair value may have undesirable economic consequences, including harmful implications for US technology leadership and job creation.[71] As indicated above, they often suggest that the required recognition of compensation cost from equity-based payment arrangements is likely to cause some enterprises to reduce, eliminate, or otherwise revise those arrangements. Some also contend that recognition of compensation cost for employee stock options will raise the cost of capital for enterprises that make extensive use of those options. All of those assertions seem to be based on the presumptions that (1) most, if not all, current equity-based arrangements are inherently desirable regardless of their cost and (2) Opinion 25's accounting requirements have only desirable economic consequences. The Board considers neither presumption to be either supportable or relevant in establishing accounting standards for equity-based payment arrangements.

The Board's operating precepts require it to consider issues in an evenhanded manner, without attempting to encourage or to discourage specific actions. That does not imply that improved financial reporting should have no economic consequences. To the contrary, a change in accounting standards that result in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences. For example, required recognition of compensation cost based on the provisions of the proposal would result in comparable accounting for all forms of employee compensation. The Board believes that any decision to reassess and modify existing equity-based payment arrangements would be based on information that better represents the costs and benefits of various forms of compensation.

Some investors and others have noted the dramatic increase in the number of stock options awarded to employees during recent years. The Board understands that the vast majority of stock options awarded to employees are fixed plan employee stock options for which enterprises that continued to use the accounting

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[71] Some commentators have found it ironic that defending US jobs is used as an argument against the FASB proposal, when many high technology and venture capital enterprises are at the same time trying to convince Congress and other State legislators not to impose restrictions on outsourcing as they actively promote the movement of jobs overseas. Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment, page 6. Some recent articles discussing support of outsourcing by representatives of the high technology or venture capital industries include Don Clark, "Another Lure of Outsourcing: Job Expertise," *The Wall Street Journal* (April 12, 2004); Ann Grimes, "Venture Firms Seek Start-Ups That Outsource," *The Wall Street Journal* (April 2, 2004); and Karl Schoenberger, "Fears Over Offshoring Inflated, Says AeA," *Mercury News* (March 24, 2004).

requirements of Opinion 25 recognized no compensation expense. The accounting under Opinion 25 treats most fixed plan employee stock options as though they were a "free good," which implies that the services received in exchange for those options are obtained without incurring a cost. But employee services received in exchange for stock options are not free. Stock options are valuable equity instruments for which valuable consideration is received—consideration that should be recognized regardless of whether it is in the form of cash, goods, or services from employees or other suppliers. Accounting for fixed plan employee stock options as though they imposed no cost on the enterprise that issues them may encourage their substitution for other forms of compensation, such as stock options or other instruments with performance or market conditions that may be preferable in a particular situation. Requiring recognition of compensation cost based on fair value increases the neutrality of financial reporting and removes an accounting incentive for an entity to choose a form of incentive compensation—fixed plan employee stock options—that may not be the most advantageous in its circumstances.

Many would agree that an enterprise's expenditures for a broad range of items, such as pensions, education and training, environmental remediation, or occupational, health, and safety programs, are expenditures that should be encouraged. Those items, however, like all forms of employee compensation, are a cost of the enterprise and properly reported as expenses in financial reports.

Of note, the above observations have generally been supported by many economic experts who have reviewed the issue, including Federal Reserve Chairman Alan Greenspan,[72] former Federal Reserve Chairman (and current chairman of the Trustees of the International Accounting Standards Committee Foundation) Paul A. Volcker,[73] Nobel Prize winning economists Robert C. Merton[74] and Joseph E. Stiglitz,[75] the Financial Economist Roundtable,[76] the Republican Staff of the Joint

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[72] Stephen Taub, "Greenspan Endorses Expensing Options," *CFO.com;* Federal Reserve System Chairman Alan Greenspan, Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (May 3, 2002), pages 5 and 6.

[73] Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Testimony of Paul A. Volcker (June 3, 2002), pages 3 and 4.

[74] Hearing on "H.R. 3574: Stock Option Accounting Reform Act," Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton.

[75] Joseph E. Stiglitz, "The Roaring Nineties" (October 2003), pages 115-139.

[76] Statement of Financial Economist Roundtable on the Controversy over Executive Compensation (November 24, 2003).

Economic Committee of the US Congress,[77] the Conference Board Commission on Public Trust and Private Enterprise,[78] and the Congressional Budget Office.[79]

***Conclusion***

In conclusion, let me assure you, Chair Snowe, Ranking Member Kerry, and Members of this Committee, that you, and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to actively solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties and that will lead to improving the transparency and credibility of financial reports and, thus, assisting in the strengthening of the US economy.

Thank you again, Chair Snowe. Bob and I would welcome the opportunity to respond to any questions.

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[77] Joint Economic Committee, Republican Senate Staff, Economic Policy Research, "Understanding the Stock Option Debate," Report 107-04 (July 9, 2002), page 18.

[78] The Conference Board, "The Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation," page 6.

[79] The Congressional Budget Office, "Accounting for Employee Stock Options," Section 3 of 3, pages 4 and 5.

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 1**

**FACTS about FASB**

# FACTS about FASB 2003–2004

401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 • www.fasb.org

*Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.*

*The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.*

## THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;

- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and

- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

□ *To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

□ *To weigh carefully the views of its constituents* in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board's judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.

□ *To promulgate standards only when the expected benefits exceed the perceived costs.* While reliable, quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.

□ *To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.* Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.

□ *To review the effects of past decisions* and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

## AN INDEPENDENT STRUCTURE

***Financial Accounting Standards Board (FASB)***
The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–1959) and then by the Accounting Principles Board, also a part of the AICPA (1959–1973). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

***Financial Accounting Standards Advisory Council (FASAC)***
The FASAC has responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces and such other matters as may be requested by the FASB or its Chairman. At present, the Council has more than 30 members who are broadly representative of preparers, auditors and users of financial information.

***Financial Accounting Foundation (FAF)***
The FAF, which was incorporated to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its advisory council, ensuring adequate funding of their activities and exercising general oversight with the exception of the FASB's resolution of technical issues.

**Governmental Accounting Standards Board**
In 1984, the Foundation established a Governmental Accounting Standards Board (GASB) to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, ensuring adequate funding and exercising general oversight.

**Trustees**
The Foundation is separate from all other organizations. However, its Board of Trustees is made up of members from constituent organizations having interest in financial reporting. Nominees from constituent organizations are approved by the Trustees. There also are Trustees-at-large who are not nominated by those organizations, but are chosen by the sitting Trustees. The constituent organizations are:

*FAF Constituent Organizations*

- American Accounting Association
- American Institute of Certified Public Accountants
- Association for Investment Management and Research
- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

The members of the FAF Board of Trustees are:

- Manuel H. Johnson (Chairman of the Board and President, FAF), Co-Chairman, Johnson Smick International;
- Stephen C. Patrick (Vice President, FAF), Chief Financial Officer, Colgate-Palmolive Company;
- Judith H. O'Dell (Secretary and Treasurer, FAF), President, O'Dell Valuation Consulting LLC;
- Robert E. Denham, Senior Partner, Munger, Tolles & Olson, LLP;
- Samuel A. DiPiazza, Jr., Chief Executive Officer, PricewaterhouseCoopers;
- Douglas R. Ellsworth, Director of Finance, Village of Schaumburg, Illinois;
- Barbara H. Franklin, President and Chief Executive Officer, Barbara Franklin Enterprises;
- William H. Hansell, Executive Director Emeritus, International City/County Management Association;
- Richard D. Johnson, Former Auditor of State, Iowa;
- Duncan M. McFarland, President, Chief Executive Officer and Managing Partner, Wellington Management Company;
- Frank C. Minter, Retired Vice President and Chief Financial Officer, AT&T International;
- Eugene D. O'Kelly, Chairman and Chief Executive Officer, KPMG LLP;
- Lee N. Price, President and Chief Executive Officer, Price Performance Measurement Systems, Inc.; and
- Jerry J. Weygandt, Andersen Alumni Professor of Accounting, University of Madison-Wisconsin.

## AN OPEN DECISION-MAKING PROCESS

Actions of the FASB have an impact on many organizations within the Board's large and diverse constituency. It is essential that the Board's decision-making process be evenhanded. Accordingly, the FASB follows an extensive "due process" that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and, in several respects, is more demanding.

## HOW TOPICS ARE ADDED TO THE FASB'S TECHNICAL AGENDA

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The auditing profession is sensitive to emerging trends in practice and, consequently, it is a frequent source of requests. Requests for action include both new topics and suggested review or reconsideration of existing pronouncements.

The FASB is alert to trends in financial reporting through observation of published reports, liaison with interested organizations and discussions with the EITF—see page seven. In addition, the staff receives many technical inquiries by letter and telephone, which may provide evidence that a particular topic, or aspect of an existing pronouncement, has become a problem. The FASB also is alert to changes in the financial reporting environment that may be brought about by new legislation or regulatory decisions.

The Board turns to many other organizations and groups for advice and information on various matters, including its agenda. Among the groups with which liaison is maintained are the Accounting Standards Executive Committee (AcSEC) and Auditing Standards Board of the AICPA, the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as the Association for Investment Management and Research (AIMR), Financial Executives International (FEI) and Institute of Management Accountants (IMA). As part of the agenda process, the Board may make available for public comment agenda proposals that concisely describe the scope of potential projects. The Financial Accounting Standards Advisory Council (FASAC) regularly reviews the Board's agenda priorities and consults on all major projects added to the technical agenda.

After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics.

Those factors include consideration of:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);

- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability and comparability are likely to be developed;

- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;

- *Practical consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;

- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;

- *Cooperative opportunities*—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and

- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the IASB or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

***Board Meetings***

The core of the Board's due process is open decision-making meetings and exposure of proposed standards for public comment. Every technical project involves a number of Board meetings. The Board meets as many times as necessary to resolve the issues. A major project generally includes dozens of meetings over several years. All meetings are open to public observers, although observers do not participate in the discussions. The agenda for each meeting is announced in advance.

The staff presents written material, including analysis and recommendations, to the Board members in advance as the basis for discussion in a Board meeting. The written material is the result of extensive research by the staff, including a detailed review and analysis of all of the significant alternative views for each issue to be discussed at the meeting. The meeting format calls for oral presentation of a summary of the written materials by the staff, followed by Board discussion of each issue presented and questioning of the staff on the points raised. The Board may reach conclusions on one or more of the issues presented. Any conclusions reached are tentative and may be changed at future Board meetings.

***The Exposure Draft***

When the Board has reached conclusions on the issues, the staff is directed to prepare a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote by written ballot to issue the Exposure Draft. A majority vote of the Board is required to approve a document. Alternative views, if any, are explained in the document.

The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information and an explanation of the basis for the Board's conclusions.

At the end of the exposure period, generally 60 days, all comment letters and position papers are analyzed by the staff. This is a search for new information and persuasive arguments regarding the issues; it is not intended to be simply a "nose count" of how many support or oppose a given point of view. In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions.

***Further Deliberation of the Board***

After the comments have been analyzed and studied, the Board redeliberates the issues. As in earlier stages of the process, all Board meetings are open to public observation. The Board considers comments received on the Exposure Draft, and often incorporates suggested changes in the final document. If substantial modifications appear to be necessary, the Board may decide to issue a revised Exposure Draft for additional public comment. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board. A vote is taken on the final document, again by written ballot. Four votes are required for adoption of a pronouncement.

***Statements of Financial Accounting Standards***

The final product of most technical projects is a Statement of Financial Accounting Standards (SFAS). Like the Exposure Draft, the Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents.

***Additional Due Process***

For major projects, the Board generally goes significantly beyond the core due process described above. Soon after a major project is placed on the Board's technical agenda, a task force or working group usually is appointed, including preparers, auditors and users of financial information who are knowledgeable about the subject matter. Experts from other disciplines also may be appointed. Care is taken to ensure that various points of view on the issues involved are represented.

The task force meets with and advises the Board and staff on the definition and scope of the project, the nature and extent of any additional research that may be needed and the preparation of a discussion document and related material as a basis for public comment. Task force meetings are open to public observers. Task forces and working groups play an important role in the standard-setting process by providing expertise, a diversity of viewpoints and a mechanism for communication with those who may be affected by proposed standards.

Before it begins deliberations on a new major project, the Board often asks the FASB staff to prepare a Discussion Memorandum or other discussion document. The task force provides significant assistance and advice in this effort. The discussion document generally sets forth the definition of the problem, the scope of the project and the financial accounting and reporting issues; discusses research findings and relevant literature; and presents alternative solutions to the issues under consideration and arguments and implications relative to each. The discussion document is published to invite constituents to comment on the project before the Board begins deliberations.

After a discussion document or an Exposure Draft is issued for public comment, the Board may decide to hold a public hearing or a public roundtable meeting. These meetings provide an opportunity for the Board and staff to ask questions about information and viewpoints offered by constituents who participated in the comment process. Any individual or organization may request to be heard at a public hearing, and the FASB attempts to accommodate all such requests. Public observers are welcome.

***Statements of Concepts***

In addition to Statements of Financial Accounting Standards (SFAS), the FASB also issues Statements of Concepts. Those do not establish new standards or require any change in the application of existing accounting principles; instead, they are intended to provide the Board and constituents with a foundation for setting standards and concepts useful as tools for solving problems. The framework defined in the Statements of Concepts helps the Board identify the right questions to ask in structuring technical projects and contributes to a consistent approach over time. Because of their long-range importance, Statements of Concepts are developed under the same extensive due process the FASB follows in developing Statements of Financial Accounting Standards on major topics.

***Other Documents***

In addition to broad issues of financial accounting and reporting, the Board considers narrower issues related to implementation of existing standards and other problems arising in practice. Depending on their nature, application and implementation problems may be dealt with by the Board in Statements or Interpretations, by the staff in Technical Bulletins or in Implementation Guidance in question-and-answer form. All of those are subject to discussion at public Board meetings and to exposure for comment, although Technical Bulletins and Implementation Guidance are exposed more narrowly.

***Emerging Issues Task Force (EITF)***

The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. EITF members are drawn primarily from public accounting firms but also include representatives of large companies. The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the privilege of the floor. Lawrence W. Smith, FASB Director, Technical Application and Implementation Activities, also serves as Chairman of the EITF.

Composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by the FASB as an indication that no Board action is needed. A consensus is defined as an agreement, provided that no more than two of the thirteen voting members object. Consensus positions of the EITF are considered part of GAAP. If consensus is not possible, it may be an indication that action by the FASB is necessary.

The EITF meets six times a year. Meetings are open to the public and, generally, are attended by substantial numbers of observers. Because interest in the EITF is high, the FASB has separate subscription plans for keeping up-to-date on the issues.

***Availability of Publications***
To encourage public comment, Exposure Drafts and other discussion documents are distributed primarily through the FASB website.

Statements of Standards, Statements of Concepts and Interpretations also are distributed broadly when published through FASB subscription plans and may be purchased separately by placing an order at the FASB website.

The FASB strives to keep the public informed of developments on its projects through a monthly newsletter, *The FASB Report,* and a weekly notice, *Action Alert,* which provides notice of upcoming Board meetings and their agendas with brief summaries of actions taken at previous meetings. *Action Alert* is available by e-mail subscription at the FASB website.

***FASB Website***
The FASB website includes general information about the Board and its activities, information on upcoming public meetings, announcements of Board actions, summaries and status of all active technical agenda projects, summaries of previously issued FASB Statements and Interpretations, the quarterly plan for FASB projects and information about membership in the Foundation, as well as information on how to order publications online, by phone or mail.

The website can be accessed at www.fasb.org.

***The Public Record***
Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record. The public records on all projects are available for inspection in the public reference room at FASB headquarters in Norwalk, Connecticut. Copies of public records also may be purchased at prices that vary according to the volume of material that has to be copied by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for more information.

## ADDITIONAL INFORMATION

***General Information***
For further information about the FASB, including Board meeting schedules, access the FASB website at www.fasb.org, call or write Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700 or via e-mail at director@fasb.org.

***To Order Publications***
Statements, Interpretations, Exposure Drafts and other documents published by the FASB may be obtained by placing an order on the FASB website at www.fasb.org or by contacting the FASB Order Department at 1-800-748-0659, weekdays 9:00 a.m. to 5:00 p.m. EST.

***Public Hearings and Comment Letters***
For information about submitting written comments on documents or about public hearings, access the FASB website at www.fasb.org or contact the FASB Project Administration Department at (203) 847-0700, ext. 389.

***Public Reference Room and Files***
The FASB maintains a public reference room open during office hours, Monday through Friday. The public reference room contains all FASB publications, comment letters on documents and transcripts of public hearings. Copies of this material may be obtained for a specified charge by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for an appointment.

* * *

To order additional copies of *FACTS about FASB* without charge, contact Public Relations at (203) 847-0700, ext. 252, or fax a request to (203) 849-9714.

## MEMBERS OF THE FASB

The seven members of the FASB serve full time and are required to sever all connections with the firms or institutions they served prior to joining the Board. While collectively they represent diverse backgrounds, they also must possess "knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting."

Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Expiration dates (at June 30) of current terms are indicated in captions beneath the members' photographs.

***Robert H. Herz** was appointed FASB Chairman, effective July 1, 2002. He was a Senior Partner with PricewaterhouseCoopers, its North America Theater Leader of Professional, Technical, Risk & Quality and a member of the firm's Global and U.S. Boards. He also served as a part-time member of the IASB.*

*He joined Price Waterhouse upon graduating from the University of Manchester in England with a B.A. degree in economics. He later joined Coopers & Lybrand as its Senior Technical Partner and later held a similar position with PricewaterhouseCoopers.*

*He has authored numerous publications and chaired the AICPA SEC Regulations Committee, the Transnational Auditors Committee of the International Federation of Accountants and was a member of the EITF.*

***G. Michael Crooch** was a Partner with Arthur Andersen and Director of the firm's International Professional Standards Group before joining the FASB on July 1, 2000. Mr. Crooch was the American Institute of Certified Public Accountants' (AICPA) delegate to the International Accounting Standards Committee (IASC) and served on the IASC's Executive Committee. He also served on the Institute's Accounting Standards Executive Committee, including three years as the Committee Chairman. He earned bachelor's and master's degrees from Oklahoma State University and a Ph.D. from Michigan State University.*

***Leslie F. Seidman*** *was named to the FASB, effective July 1, 2003. Prior to joining the Board, she managed her own financial reporting consulting firm. Among the previous posts she held were Vice President at J.P. Morgan & Company, where she was responsible for establishing accounting policies, and Assistant Director of Implementation and Practice Issues at the FASB. She started her career as an auditor at Arthur Young & Company. She earned a B.A. degree from Colgate University and an M.S. degree from New York University.*

***Edward W. Trott*** *was appointed as a member of the FASB, effective October 1, 1999. Since 1992, he headed the Accounting Group of KPMG's Department of Professional Practice. Before joining the Board, he was a member of the FASB's Emerging Issues Task Force, the Financial Reporting Committee of the Institute of Management Accountants, the FASB's Advisory Council and the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA. He holds a bachelor's degree from the University of North Carolina and an M.B.A. degree from the University of Texas.*

***Katherine Schipper*** *was appointed to the FASB, effective September 2001. Prior to joining the FASB, she was the L. Palmer Fox Professor of Business Administration at Duke University's Fuqua School of Business. She has served the American Accounting Association (AAA) as President and as Director of Research. She was a member of the FASB's Advisory Council (FASAC) from 1996 to 1999. Ms. Schipper holds a B.A. degree from the University of Dayton and M.B.A., M.A. and Ph.D. degrees from the University of Chicago.*

***Gary S. Schieneman*** *was appointed to the FASB, effective July 1, 2001. Prior to joining the FASB, Mr. Schieneman served as Director, Comparative Global Equity Analysis, of Merrill Lynch. He is a member of the American Institute of Certified Public Accountants (AICPA), the New York Society of Security Analysts and the Association for Investment Management and Research (AIMR). He received a bachelor's degree in accounting from the University of Illinois and earned an M.B.A. degree from New York University.*

***George J. Batavick*** *was named a member of the FASB, effective August 1, 2003. He was previously Comptroller of Texaco Inc. where he had company-wide responsibility for strategy and policy matters covering all aspects of accounting and financial reporting. Prior to this post, he held a number of key positions, including Deputy Comptroller and Director of Internal Auditing. Before joining Texaco, he was with Getty Oil Company. He began his career at Arthur Andersen. He is a graduate of St. Joseph's University in Philadelphia where he earned a B.S. degree.*

***FASB Staff***

The Board is assisted by a staff of approximately 40 professionals drawn from public accounting, industry, academe and government, plus support personnel. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public and prepares recommendations and drafts of documents for consideration by the Board.

FASB Fellows are an integral part of the research and technical activities staff. The Fellowship program provides the Board the benefit of current experience in industry, academe and public accounting and offers the Fellows first-hand experience in the accounting standard-setting process. Fellows take a leave of absence from their firms or universities and serve as project managers or consultants on a variety of projects.

***Suzanne Q. Bielstein*** *is Director, Major Projects and Technical Activities for the FASB. Previously, she served in various capacities at the FASB, including Assistant Director of Technical Research and Project Manager on the business combinations and combinations for not-for-profit organizations. Prior to joining the FASB in early 1999, she spent five years with Caradon plc in two different roles—Vice President of Planning, North America, and Vice President and Corporate Controller of Clarke American Checks, Inc. (a subsidiary of Caradon). Before joining Caradon, Ms. Bielstein was an Audit Partner at KPMG in Boston. Ms. Bielstein earned a B.B.A. degree in accounting from the University of Notre Dame.*

***Kimberley Ryan Petrone,*** *who has been a member of the FASB staff since 1989, was named Director, Planning, Development and Support Activities in April 2002. Previously, Ms. Petrone was a Project Manager on the Board's business combinations project from 1997 through issuance of Statements 141 and 142 in July 2001 and has been involved in a number of other FASB projects. Before joining the FASB, Ms. Petrone was a Corporate Accounting and Financial Reporting Manager with Savin Corporation. Prior to Savin, she was with AMAX Inc. She earned a B.S. degree in accounting from the University of Bridgeport and an M.B.A. degree from the University of Connecticut.*

***Lawrence W. Smith*** *was named Director, Technical Application and Implementation Activities of the FASB in August 2002. Prior to assuming this post, he was a Partner with KPMG for 14 years, headquartered most recently in Stamford, Connecticut. From 1992–1996, Mr. Smith served as a Partner in KPMG's Department of Professional Practice in New York. During his 25-year tenure with KPMG, he served as Engagement Partner and SEC Reviewing Partner on a number of international* Fortune *1000 clients. He is a past member of the Technical Standards Subcommittee of the Professional Ethics Committee of the AICPA. Mr. Smith received an M.S. degree in accounting from Northeastern University.*

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 2**

**:xcerpts from Recent Materials about the Importance of the FASB'**
**Independence and Concerns about Proposed Legislation**

**Excerpts from Recent Materials about the Importance of the FASB's Independence and Concerns about Proposed Legislation**

Enron, WorldCom, and other corporate governance failures demonstrate the dangers of not having independent accounting and auditing standards.

. . . .

If Congress interferes with the FASB proposal, the dangerous precedent of intervention into accounting standards will be set. Congressional interference is detrimental to the independent nature of the FASB and the accounting treatment of stock options is a matter best left to FASB to determine.

*The Honorable Daniel K. Akaka, Ranking Member, Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 20, 2004*

I know there are several bills in Washington that could erode confidence in the FASB, including the Enzi-Reid Stock Option Accounting Reform Act. While I personally won't tell you how to vote on that specific piece of legislation, it is absolutely critical that . . . you do everything you can to keep accounting standard setting in the private sector and preserve the role of the FASB. No accounting body has ever worked so well and it is unlikely that any replacement or increased government oversight will improve upon its performance.

*W. Steve Albrecht, Professor of Accounting and Associate Dean, Marriott School of Management, Brigham Young University, March 5, 2004*

**Politics and financial-reporting standards don't mix.** Accounting standards should be set by an independent and objective group of experts, free from political pressure, after careful study and an open comment period in which feedback is invited from all constituents. That is FASB's mandate. Elected officials must overcome the temptation to intervene and set a "politically correct" agenda for an independent standard-setter.

*The Association for Investment Management and Research (a worldwide, non-profit professional association of 70,000 securities analysts, fund managers, and investment advisors), April 9, 2004*

Financial markets' credibility and health would be best served if options were treated as an expense and Congress respected the independence of the FASB.

*The Baltimore Sun, April 16, 2004*

By and large FASB would be better off if Congress just stayed out of the rulemaking process.

*Dennis R. Beresford, Executive Professor of Accounting, The University of Georgia, and former Chairman of the Financial Accounting Standards Board, March 22, 2004*

It is very disappointing to see that members of Congress are again threatening to veto FASB on accounting for stock options. It is in no one's best interest to politicize accounting, and I hope that there will be a more evenhanded debate this time.

*Dennis R. Beresford, Executive Professor of Accounting, The University of Georgia, and former Chairman of the Financial Accounting Standards Board, July 2003*

I urge you to support the Financial Accounting Standards Board, its due process and the importance of maintaining the continuation of independent private-sector initiatives in the development and setting of accounting and financial standards.

*Richard H. Booth, President and Chief Executive Officer, HSB Group, Inc., March 3, 2004*

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.

*The Honorable Michael N. Castle, United States House of Representatives, March 3, 2004*

I would like to reiterate my support for an independent FASB to bring this project to a timely conclusion with the accounting they have proposed.

*Jack T. Ciesielski, President, R.G. Associates, Inc., April 21, 2004*

In my years of observing the standard setting process, I've seen the Board develop improved accounting standards with an unmatched level of openness and fairness. Their standards will not make everyone happy – in addressing the complicated issues they're charged with, it's impossible to satisfy all parties involved. The reason we're here is because some of the FASB's constituents are so unhappy with their attempts to reform the accounting for option compensation that they've pulled Congress into the process. They're seeking a legislative answer to an accounting rule they oppose, and in doing so, usurping the FASB's authority to set standards. I believe that the FASB's ability to develop impartial standards resulting in robust information for investors to use would be seriously hampered if legislative intervention becomes the norm for disagreeing with their pronouncements, and a blueprint for such behavior was created the last time the Board attempted to remedy option compensation accounting ten years ago. While it may benefit a few of the Board's constituents to preserve the broken accounting model, in the long run our capital markets would likely suffer – and result in capital being misallocated in the economy.

*Jack T. Ciesielski, President, R.G. Associates, Inc., April 20, 2004*

Which brings me to the deeper and far more troubling core of what is wrong with this bill: the compromising of the FASB's independence. I oppose the injection of Congressional bias into the independent standard-setting process of the FASB – a process that was strongly endorsed by Congress during the development of the Sarbanes-Oxley Act, and ultimately embedded in the Act itself.

*Jack T. Ciesielski, President, R.G. Associates, Inc., March, 1, 2004*

The eagerness of lawmakers to work with Silicon Valley executives on legislation to control accounting standard-setting is a frightening sight to behold; it provides more evidence of the need for standard-setting that's out of their direct political grasp. An independent FASB is the best hope of America's individual investors, who don't have a well-oiled lobbying machine and aren't well-represented by elected officials.

*Jack T. Ciesielski, President, R.G. Associates, Inc., May 5, 2003*

Until the properly authorized expert independent organization, FASB, acts to correct this problem, many companies will hide behind differing earnings treatments and disdain performance-based options even while recognizing that they are the better approach to executive compensation. Congress should be careful not to politicize this issue and should permit FASB to take on this issue on its intrinsic merits. The recent support of the FASB by SEC Chairman Donaldson is encouraging as to the view at the SEC.

*Peter C. Clapman, Senior Vice President and Chief Counsel of Corporate Governance, TIAA-CREF (a full-service financial services provider with approximately $262 billion in assets under management supporting the pensions of nearly 3 million individuals at nearly 15,000 institutions in the educational and research field), May 20, 2003*

The Securities and Exchange Commission long ago recognized the private sector's role in establishing accounting standards. We believe it would be a shame for this Congress to undo almost 70 years of independent thinking in this critical area.

*Scott Curtin, Managing Partner, Grant Thornton LLP, Kansas City, April 13, 2004*

The integrity of financial reporting requires that U.S. companies expense all stock options, contrary to the proposal of the Stock Option Accounting Reform Act (S. 1890 & H.R. 3574). The expensing of only stock options held by the five most highly compensated executive officers has the effect of overstating the profitability and assets of a corporation, and thereby misleading investors.

*Richard A. Curtis, Executive Director, The Highway Patrol Retirement System (a $625 million pension fund), February 5, 2004*

It is critical for the FASB to debate and make decisions without government intervention.

*Donald P. Delves, President, The Delves Group, April 20, 2004*

While I am passionate about requiring the expensing of stock options, the principal purpose of this letter is to ask that the FASB be allowed to do its job. Congress should stay out of the debate. Congress has also been bashing auditors (partly justified) for not standing up to their clients. It is alleged that the auditors champion the interests of their clients for fear of losing fees. They are criticized of this even when the clients' interests prove to be correct. Many members of Congress are guilty of championing the interests of their constituents, regardless of how senseless the cause, for fear of losing political contributions. A pretty safe, if not honorable, thing to do 10 years ago. Now, however, when (it is estimated) 500 companies are voluntarily adopting the expensing of stock options and many investor advocates have favored expensing, those in Congress must realize it isn't only the ones that pass out all the contributions that have a vote!

*Raymond L. Dever, CPA (Retired), Tucson, AZ, February 26, 2004*

The supporters of this bill insult the intelligence of anybody with knowledge of accounting or finance. Not expensing employee stock options is accounting *FRAUD*. Chairman Alan Greenspan says options "should be expensed," and the argument that they can't be accurately valued is "flat wrong." When it comes to options Silicon Valley will only be happy with options having a value of zero, anything else is not acceptable to TechNet. The Black-Scholes options' pricing model is time tested, elegant, and accurate.

*Andrew H. Dral, Sacramento, CA, December 30, 2003*

Allow the Experts to Require Expensing of Options—Keep Politics Out. Options are a critical compensation tool, but they are not free. Current rules allow companies to choose not to list options as an expense on their financial statements. When options are not expensed, financial statements do not accurately reflect a company's true financial state. In addition, current rules can encourage executive pay packages bloated with options grants that appear "free" to the company. The Financial Accounting Standards Board has stated its intent to require companies to list the cost of stock options in their financial statements. In 1994, Congress blocked a similar effort. . . . [T]his time, Congress must keep out and allow FASB to require options expensing.

*The Honorable John Edwards, United States Senate, July 7, 2003*

. . . [P]olitical interference with the private-sector accounting board is a dangerous precedence.

*The Honorable Peter G. Fitzgerald, Chairman of the Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 20, 2004*

Congress should not substitute political decisions for the technical accounting decisions of our private sector independent accounting standards board. I will use every option at my disposal to fight any legislation that would undo the new rule or otherwise threaten independence.

*The Honorable Peter G. Fitzgerald, Chairman of the Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 1, 2004*

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.

As we discuss FASB's proposal, I continue to 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.

*The Honorable Paul E. Gillmor, United States House of Representatives, April 21, 2004*

After the disastrous financial accounting scandals of ENRON and TYCO, it is best for accounting standards to be determined by the experts, not politicians. We urge you to oppose H.R. 3574 or any legislation that interferes with the full adoption of FASB's new draft rule and their independence.

*The Honorable Paul E. Gillmor, The Honorable Michael Castle, and The Honorable Pete Stark, United States House of Representatives, April 1, 2004*

H.R. 3574 would undo the progress made by the Sarbanes-Oxley Act of 2002 and recent Securities and Exchange Commission (SEC) Policy Statement reaffirming the Financial Accounting Standards Board (FASB) as the nation's accounting standard setter. Protecting the standard-setting process from political intervention was an important reason for these recent steps. The role of FASB is to pursue transparency and accuracy in accounting standards, not to choose among competing public policies. The FASB designs the ruler. It is for others to decide what to do with the measurements.

*The Honorable Paul E. Gillmor, United States House of Representatives, March 4, 2004*

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 report the true costs to the company and shareholders, which explains the broad support for stock options expensing by financial experts such as SEC Chairman William Donaldson, Federal Reserve Chairman Alan Greenspan, former Fed Chairman Paul Volcker and Warren Buffett.

*The Honorable Paul E. Gillmor, United States House of Representatives, March 3, 2004*

Some members of Congress say they need to "protect" stock options to protect American technological leadership. That is a useful goal, and there are many things lawmakers could do to help attain it. Adequately funding federal research is one of them; conspiring with tech companies to perpetuate an accounting fiction isn't.

*Lee Gomes, The Wall Street Journal, March 22, 2004*

I think it would be a bad mistake for Congress to impede FASB.

*The Honorable Alan Greenspan, Chairman, Federal Reserve System, April 21, 2004*

We are writing to you to again express our views on H.R. 3574, "Stock Option Accounting Reform Act" and to urge Congress not to prevent the Financial Accounting Standards Board from doing its job of independently setting U.S. accounting standards. We believe that this pending legislation should be withdrawn and that the authority of FASB not be undermined by this legislation.

*Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System (a $58.7 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S.), April 5, 2004*

Requiring companies to expense only options granted to the CEO and the next four highest compensated executives, as proposed in S. 1890, is insufficient, and it appears to be based on a desire to report overly optimistic numbers rather than report comprehensive financial information. However, this is a decision that should not be made in Congress. Rather, the Financial Accounting Standards Board (FASB), an[] independent entity, is where this decision making should take place.

*Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System (a $56 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S.), December 18, 2003*

Congress should keep out of the accounting principles debate because most members of Congress are not schooled in accounting as an information science or as a behavior catalyst or as an economic measurement.

*Mark E. Haskins, Professor of Business Administration, Darden School of Graduate Business Administration, University of Virginia, March 22, 2004*

To make the problem worse, my industry is now trying to get Congress to compromise the independence of the accountants on accounting policy. Hopefully Congress will demur. The SEC and FASB are not perfect, but they are good accountants and need to retain their independence.

*Reed Hastings, CEO, Netflix Inc., April 5, 2004*

Allowing FASB to determine the proper accounting treatment for stock options will mean that the treatment will be fairly reflected in the financial statements. For Congress to intervene in the issue of the proper treatment of stock options would mean that the accounting rules would reflect considerations other than fairly representing the financial condition of the business. This does not promote transparency in financial statements and thus is not in the best interests of the investor. Therefore, we urge you to oppose . . . [S. 1890/H.R. 3574].

*J. Thomas Higginbotham, American Institute of Certified Public Accountants (the national, professional organization of CPAs, with more than 330,000 members in business and industry, public practice, government and education), March 11, 2004*

It may seem attractive to put off this fight once again, but it is not going away. H.R. 1372 is an understandable effort, but the studies contemplated by H.R. 1372 are no answer to the problem. They are only a reason for another delay.

*The Honorable Roderick M. Hills, former Chairman of the United States Securities and Exchange Commission, June 3, 2003*

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 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.

*James P. Hoffa, General President, International Brotherhood of Teamsters (representing 1.4 million active members and over 600,000 retirees, and individual pension and health and welfare benefit trusts with assets over $100 billion), March 3, 2004*

The exposure draft by the Financial Accounting Standards Board, recommending that stock options be expensed on the income statement . . . produced an even greater howl of outrage from the tech sector and its tame politicians than had been expected. . . .

. When politicians . . . . start setting accounting rules, the U.S. financial system is in trouble!

*Martin Hutchinson, United Press International, April 5, 2004*

As we proceed today, I must caution my colleagues once again 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.

*The Honorable Paul E. Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, April 21, 2004*

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 set 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 for is the job of the Financial Accounting Standards Board, not the Congress.

*The Honorable Paul E. Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, March 3, 2004*

The expensing of stock options is long overdue. It will help bring corporate balance sheets into line with reality, and allow investors to measure the true value of executive compensation packages. . . . In the name of transparency, this bill would actually allow corporations to continue to obscure critical information. It is dramatically out of step with the increasing demand for openness and transparency in the wake of the corporate scandals of the last two years.

*Adam Kanzer, Director of Shareholder Advocacy, Domini Social Investments, August 13, 2003*

Although Congress has an important oversight role with respect to financial accounting and reporting for public enterprises, Congress should not be getting involved in writing specific accounting standards. The FASB must be allowed to exercise its independence to study the issues and promulgate appropriate accounting standards under a full due process open to public debate. Congress should not override FASB's expertise in accounting matters. The Board was established as an independent body to try and avoid undue influence by any single party. The Board's thorough, open, and public due process is subject to active oversight by the private sector Financial Accounting Foundation and the United States Securities and Exchange Commission. We would be very concerned if political influence was brought to bear on a financial statement line item.

*Claude Lamoureux, Interim Chair, Accounting and Auditing Practices Committee, The International Corporate Governance Network (an international network of institutional investors, shareholder advocates and corporate governance experts collectively holding more than $10 trillion in assets), February 2, 2004*

The bill, which purports to bridge the gap between expensing and antiexpensing factions, does nothing of the sort. It would require expensing only of options granted to each company's chief executive and the four other highest-paid executives – and mandate the use of a valuation method that amounts to a cure worse then the disease.

*Louis Lavelle, BusinessWeek, November 26, 2003*

FASB . . . resisted enormous pressure from corporate executives when they decided to end the accounting that keeps stock options off corporate books as an expense, thereby making a company's earnings look better than they are. Hopefully, Congress will also stand up to the powerful political forces being brought to bear to overrule FASB. Congress should protect FASB's independence and its resolution of controversial accounting issues based on accounting expertise rather than political considerations. That's what we committed to do two years ago when we enacted the Sarbanes-Oxley Act, and it is critical that, in this first big test, we continue to champion, preserve, and fortify FASB's independence.

*The Honorable Carl Levin, United States Senate, April 20, 2004*

Some in Congress are proposing to overrule FASB, but many industry leaders and investors have already spoken out against legislation that would interfere with FASB's independent judgment on accounting issues, including Alan Greenspan, William Donaldson, John Snow, Paul Volcker, Arthur Levitt, Charles Bowsher, Warren Buffett, John Biggs, the Investment Company Institute, Council of Institutional Investors, AFL-CIO, and Consumer Federation of America, to list a few.

*The Honorable Carl Levin and The Honorable John McCain, United States Senate, March 31, 2004*

Stock options are the 800 pound gorilla that has yet to be caged by corporate reform. Corporate scandals have shown how current U.S. accounting rules are fueling stock option abuses linked to deceptive accounting, excessive executive pay, and nonpayment of taxes by profitable corporations. Honest accounting of stock options would strengthen the accuracy of U.S. financial statements and help restore investor confidence in our financial markets. FASB and the International Accounting Standards Board have already proposed treating stock options as an expense, and over 275 U.S. companies have begun doing so on a voluntary basis. Legislation blocking requirements for stock option expensing is not only wrong on the issue, it is also an attack on FASB's independence. The legislation would take the unprecedented step of directing the SEC, once FASB exercises its independent judgment on an accounting issue, not to recognize or enforce that accounting judgment. It sends exactly the wrong message to investors about our commitment to accounting reform.

*The Honorable Carl Levin, United States Senate, May 1, 2003*

Naturally, Congress also has opinions. On the House side, a significant number of Representatives (many no doubt influenced by campaign contributions) think that FASB should be stopped in its tracks. But on the Senate side, Richard Shelby (R-Alabama), chairman of the Banking Committee, which has jurisdiction over the matter, seems determined to keep Congress out of it. The setting of accounting standards, he says, "should be left to the professionals."

*Carol J. Loomis, Fortune, April 19, 2004*

A lobbying blitz has begun to derail the FASB once again. Two bills have been introduced in Congress. One would deter the FASB from acting for three years while the issue was "studied," as if it hadn't been studied to death. The other would dictate a compromise rule change that would leave the issued hopelessly muddled.

. . . .

Congress, which has the ultimate say on whether Washington intervenes, is divided. Write your congressman: Don't let the silicon pigs skin you again.

*Roger Lowenstein, author of "Origins of the Crash: The Great Bubble and Its Undoing" and an outside director of the Sequoia Fund, SmartMoney, April 2004*

While I may suggest a different model than FASB ultimately adopts, let me be clear: *anything* FASB does on this is better than the existing approach, and *anything* Congress does to stand in the way is nothing but thuggery. FASB's interest is to optimize information flow. Congressional machinations to limit this flow are ultimately a cost to all of us for the benefit of the few. That's wrong.

We're not talking about a change in economics, but rather a change in information flow. Where Congress is seeking to restrict information flow for the benefit of few flies in the face of what a non-political entity like FASB is chartered to do in the first place.

*Bill Mann, Senior Analyst, The Motley Fool, and Member of the FASB's User Advisory Council, March 17, 2004*

The Senate holds hearings today to discuss a bill that would once again place political limitations on the FASB's ability to make decisions on what constitutes good accounting. AeA and other well-heeled lobbying groups have already spent enormous sums pressing their cases on why this is a disaster for American entrepreneurial spirit – as is their right to do. While I find their arguments bankrupt and their attitude decidedly anti-shareholder, they've got the kind of currency that counts in the halls of Washington: big dollars.

*Bill Mann, Senior Analyst, The Motley Fool, and Member of the FASB's User Advisory Council, November 12, 2003*

FASB has the expertise and independence to resolve stock option accounting, and Congress should not be legislating accounting rules or threatening FASB's independence.

*The Honorable John McCain, United States Senate, March 31, 2004*

The expensing of stock options allows investors, analysts, corporate executives and employees, and auditors to properly understand the bottom line of corporations. This legislation blocking stock option expensing not only undermines FASB's independence, but undermines the effort to restore confidence in our financial markets as well.

*The Honorable John McCain, United States Senate, May 1, 2003*

Any politician who touches this is touching a real third rail now. They'd be promoting bad accounting and kowtowing to rich C.E.O.'s of tech companies dangling campaign contributions.

*Patrick S. McGurn, Special Counsel, Institutional Shareholder Services, March 21, 2004*

This is tech-executive protectionism masquerading as reform.

*Patrick S. McGurn, Special Counsel, Institutional Shareholder Services, November 20, 2003*

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.

*Robert C. Merton, John and Natty McArthur University Professor, Harvard Business School, and 1997 recipient of the Alfred Nobel Memorial Prize in Economic Sciences, March 3, 2004*

As a Certified Public Accountant, I am very concerned over the government intervention in the setting of accounting standards. At present two bills (S 1890 and HR 3574) are before Congress that attempt to implement a political remedy to the highly publicized stock option controversy.

I urge you to support the accounting and financial community's efforts to pursue a comprehensive and reasonable course in setting accounting standards. The Financial Accounting Standards Board is currently considering the accounting issues related to stock options in a national as well as global context.

I ask that you support private sector standards settings and oppose the S 1890.

*Russell V. Meyers, Certified Public Accountant, Witt Mares Eggleston Smith, PLC, March 16, 2004*

**The tech lobby continues to argue against expensing options; we disagree and expose the flawed logic.** . . .

**Investors we surveyed don't accept the tech lobby's argument that job creation and U.S. competitiveness require keeping option expense out of the income statement.** Investors also shun creative legislative attempts such as limiting expense to five executives and exempting newly public companies for three years.

*Steven Milunovich, CFA, First Vice President, and Richard Farmer, Assistant Vice President, Merrill Lynch Global Securities Research & Economics Group, Global Fundamental Equity Research Department, Merrill Lynch, February 3, 2004*

Consider the 10-year war over stock options accounting. Even the scarecrow can see that options should be deducted from revenues along with employee costs. But some technology titans, who like being able to siphon off shareholder wealth, continue to battle against truth in financial statements. They urge employees to write to Congress and they pay lobbyists to sprinkle money in all the right places on Capitol Hill.

*Gretchen Morgenson, The New York Times, March 21, 2004*

Investors and the capital markets rely on transparent financial reporting and an independent accounting standard-setting process. As we have previously stated in other contexts, we urge Congress to preserve the independence of the Financial Accounting Standards Board (FASB) and to avoid legislation that would have the effect of restricting the FASB's ability to establish accounting standards.

Further, we reaffirm our support, already expressed to the FASB, for the mandatory expensing of all employee stock options, whose fair value would be determined in a manner suitable for the reporting company.

*Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, Eugene O'Kelly, Chairman and Chief Executive Officer, KPMG LLP, James H. Quigley, Chief Executive Officer, Deloitte & Touche USA LLP, and James S. Turley, Global Chairman and CEO, Ernst & Young LLP, March 17, 2004*

I firmly believe that Congress should continue to leave accounting standard setting in the private sector, with the understanding that the SEC already has ultimate authority with respect to accounting at publicly traded companies.

By not supporting this legislation, you would be acting to maintain high-quality independent private-sector financial-accounting standard setting in the United States.

*Mark W. Nelson, Eleanora and George Landew Professor of Management and Professor of Accounting, Cornell University's Johnson Graduate School of Management, March 3, 2004*

THE stock market bubble might have been less severe. The wild swings in federal budget deficits might have been reduced. Companies would owe a lot less money. Less wealth would have been transferred from shareholders to managers, then perhaps less paper wealth would have been created. Richard A. Grasso might still be running the New York Stock Exchange.

All that might have happened if American politicians, a decade ago, had not forced the Financial Accounting Standards Board to back down from its proposal to force companies to record as a compensation expense the value of stock options given to employees.

Now the accounting standards board is trying again, and this time it will probably succeed, although there is no guarantee. Some companies are pushing a "compromise" that would deduct the expense – at ridiculously low values – of only those options given to high executives. There is no logical reason options given to one employee would be an expense while those given to another would not. But the hope is that politicians will be able to claim they are voting for little-guy recipients, not greedy corporate bosses.

*Floyd Norris, The New York Times, April 2, 2004*

Congressional action on this issue will ultimately only damage the FASB's credibility and will make it even more difficult in the future for the FASB to adopt standards with which any constituency disagrees. The ultimate losers if that occurs will be investors, who play a significant role in our economy by investing in companies debt and equity securities, and, ironically, those who oppose the FASB's efforts to improve the accounting for stock-based compensation. As noted in the FASB's mission statement, accounting standards "are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information." If investors do not have confidence in the accounting standards used in preparing financial statements, they either will not invest or will charge a significant premium for the capital they provide. Either outcome would have an adverse economic consequence, both for the companies attempting to raise capital as well as for our economy as a whole.

*Edward Nusbaum, CEO, Grant Thornton LLP, March 17, 2004*

. . . EDS is withdrawing its membership in the Employee Stock Option Expensing Coalition. EDS supports the Financial Accounting Standards Board's (FASB) current project to improve the accounting for equity-based compensation, including the mandatory expensing of all employee stock options. It is expected that the FASB project will result in a final standard in November 2004. We are committed to fully complying with the language and intent of the requirements of that standard when issued. EDS supports the independence of the FASB. We are not interested in participating in any effort that might be viewed as undermining FASBs standard setting process. Please refrain from using EDS' name as a supporter of the Coalition's efforts.

*Michael E. Paolucci, Vice President, Global Compensation and Benefits, EDS, March 4, 2004*

HR 3574 would for the first time directly insert Congress into the FASB's independent, objective, thorough, and open accounting standard setting process. It would establish a precedent that would surely prompt others to seek political intervention in future technical activities of the FASB, irrespective of the public good that results from credible, transparent financial reporting.

*Ned Regan, President, Baruch College, and Trustee of the Financial Accounting Foundation, March 23, 2004*

As the 10th largest institutional investor in the U.S., OPERS has a fiduciary duty to protect the financial futures of its retirees and members. The bill would allow corporations to continue to report overly optimistic numbers rather than report more accurate and comprehensive information. . . . Any effort to diminish the important role of FASB as an independent body will only serve to further harm investors who have already experienced a loss of both money and confidence in the U.S. capital markets.

*Cynthia Richson, Corporate Governance Officer, The Ohio Public Employees Retirement System (with assets of approximately $58.7 billion, OPERS is the largest state pension fund in Ohio, the 10th largest state pension system in the U.S. and the 17th largest in the world), January 14, 2004*

This bill is a bad idea for three fundamental reasons:

- It undermines the authority of the FASB at a time when it is essential that we restore faith in our financial reporting system,
- The bill does not reflect the economic substance of the transaction taking place and provides a political, rather then an economic answer to an important valuation problem, and
- It undermines the faith of young people in the integrity of our political system.

*Larry Rittenberg, PhD, CPA, CIA, Professor of Accounting, University of Wisconsin, and Terry Warfield, PhD, Associate Professor of Accounting, University of Wisconsin—Madison, March 10, 2004*

Just a year after giving near unanimous approval to legislation designed in part to allow FASB to develop accounting rules free from the threat of outside interference, some members of Congress have already reneged on that promise and are trying to prevent FASB from adopting a stock options expensing rule that it believes is in investors' best interests. . . . If they succeed, they will not only undermine the transparency of corporate financial disclosures, they will deal a fatal blow to the independence of the accounting standard-setting process.

*Barbara Roper, Director of Investor Protection, Consumer Federation of America, August 13, 2003*

Congress should not politicize or interfere with FASB's independence and professionalism in setting accounting standards to improve the accounting for equity-based compensation or for any other project. As CPAs, we urge you to strongly oppose H.R. 3574 and H.R. 1372, and any other legislation that would override the independent judgment of FASB. We hope you will agree with our view that the accounting standard setting process is best left to independent experts in the private sector.

*The Honorable E. Clay Shaw, Jr. and the Honorable Collin Peterson, United States House of Representatives, March 23, 2004*

I don't think we should make those rules in the Banking Committee or even in Congress. . . . [FASB] understands the implications. There are economic implications here, but it also gets into corporate governance and honesty in financial statements.

*The Honorable Richard C. Shelby, Chairman of the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 30, 2003*

For these reasons, we strongly oppose the "Broad-Based Stock Option Plan Transparency Act of 2003" ("HR 1372"), which would prohibit the SEC from recognizing as GAAP any new accounting standards related to the treatment of stock options for more than three years. More is at stake here then just option accounting or executive compensation. Our markets will be damaged if it appears that our accounting standards are still being held hostage to the political dynamics that prevented effective regulation in the 1990s. The credibility of the American capital markets is at stake.

*Damon Silvers, Associate General Counsel, AFL-CIO (representing more than 66 national and international unions and their membership of more than 13 million working women and men, and with union-sponsored pension plans with $400 million in assets), June 3, 2003*

In 1993, Congress stepped in and pressured FASB into revising a similar proposal to expense stock options. Some in Congress would again limit FASB's rule making abilities. I strongly urge members not to support legislation that would prevent FASB from implementing its new rule. It was a mistake in 1993; it would be a mistake now, and a continuing disservice to investors.

*The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, April 20, 2004*

This new bill doesn't do anything. . . . This is just a veiled attempt to try and let them [the tech industry] off the hook.

*The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, November 20, 2003*

With all due respect, the appropriate process and forum for setting technical and high-quality standards for financial accounting and reporting is not lobbying in the halls of Congress. Rather, the standard-setting process needs to stay with an independent and expert FASB, solely dedicated to that fair, unbiased and transparent financial reporting essential to the growth and stability of the nation's economy. Enactment of H.R. 3574 can only undermine investor trust and confidence in the market, and frustrate that proper deployment of capital critical to our economic prosperity.

*Edward J. Theobald, Chairman, Board of Trustees, The New Hampshire Retirement System (a trusteed, employee-contributory pension plan, covering over 60,000 New Hampshire public workers: fire, police, teacher, state and local public employees; the fund invests billions of dollars in publicly traded companies solely for the purpose of funding the retirement benefits of its members), March 15, 2004*

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 reported reports. Congress should let FASB do its job.

*Richard L. Trumka, Secretary-Treasurer, American Federation of Labor and Congress of Industrial Organizations (representing 13 million members, benefit plans with $5 trillion in assets, and pension plans holding almost $400 billion in assets), March 3, 2004*

Convergence is extremely important to us. We will be horrified if politicians stepped in and forced FASB to alter standards.

*Sir David Tweedie, Chairman, International Accounting Standards Board, April 19, 2004*

I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:

Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?

Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet the need, in a world of globalized finance, for a common set of international standards?

*The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, and former Chairman of the Federal Reserve System, April 20, 2004*

To put the matter most pointedly. If the U.S. Congress, or political authorities in other countries, seek to override the decisions of the competent professional standard setters – including those of the IASB for which I have responsibility – accounting standards will inevitably lose consistency, coherence and credibility, weakening the fabric of the international financial system.

*The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, and former Chairman of the Federal Reserve System, June 3, 2003*

Speaking not only as a constituent but also as an advisory credit union professional to the FASB, the importance of this issue is paramount to millions of Americans who desperately need confidence in the accounting rules for American businesses. The independence of the standard setting process is vital to their best interests.

Please do not support legislation that seeks to circumvent this process.

*Scott M. Waite, Senior Vice President, Chief Financial Officer, Patelco Credit Union, March 17, 2004*

We are quite concerned that overt actions, however, well-intentioned they may be, that have the effect of undermining the authority of the FASB to set accounting standards will be detrimental to the Board and its constituents. As we cannot envision a viable alternative to the private sector standard setting process we have today, it is important that Congress not undertake actions that would undermine and potentially cripple that process. We believe that the legislation should be withdrawn and that responsibility for the resolution of this matter be left to the FASB, with vigilant oversight by the Securities and Exchange Commission.

*Kim R. Wallin, CMA, CFM, CPA, Chair, Institute of Management Accountants (the largest organization in this country devoted exclusively to management accounting and financial management professionals inside the corporation, with approximately 65,000 members), March 31, 2004*

Opponents of expensing also claim that Congress must act because the green-eyeshade types aren't taking into account the devastating effect they say expensing will have on the economy; the legislation they are pushing would block the FASB rule while an economic impact study is conducted. Yet the CBO says requiring expensing "is unlikely to hurt the overall economy" and in fact could make it more productive. The anti-expensing forces are running out of arguments.

*The Washington Post, April 7, 2004*

The good news is that the Senate, where Banking Committee Chairman Richard C. Shelby (R-Ala.) opposes the measure, doesn't seem inclined to succumb to the opponents' unpersuasive arguments – or their (perhaps more persuasive) campaign contributions. The risk is that the anti-expensing forces, unable to get their measure through the Senate on its own, will try to attach it to a spending bill or some other must-pass legislation. Anyone who remembers the recent corporate scandals should guard against that.

*The Washington Post, April 2, 2004*

Worse still, Mr. Enzi's bill would in effect block FASB's own expensing rule from taking effect while a "comprehensive economic impact study" is conducted. And Mr. Enzi would require FASB to adopt a "truing-up" requirement under which the actual cost of the option (once it's exercised, expires or is forfeited) is ultimately reflected on the corporate books. There are legitimate criticisms of the complexity and manipulability of the expensing models that FASB is considering, and truing-up may be a reasonable approach, but isn't this just the kind of decision that ought to be left to the accountants at FASB – not the non-accountants in Congress?

*The Washington Post, January 2, 2004*

At the same time, there are disturbing signs of backsliding. Less than a year after affirming the importance of maintaining the independence of the Financial Accounting Standards Board, which writes the non-auditing rules for accountants, lawmakers are foolishly weighing interfering with the board's move to require expensing of stock options.

*The Washington Post, July 30, 2003*

You don't need to know where you come out on this arcane dispute to know who ought to be deciding it – and who ought to keep their noses out of it. This is a matter for accountants, not politicians, and it would have been handled by the accountants long ago were it not for the political clout (and the campaign checks) of high-technology companies.

*The Washington Post, May 21, 2003*

Investors expect and deserve accounting standards that promote transparency and meaningful financial reporting, and an independent standards-setting process best satisfies their needs.

We urge Congress to recognize the critical contribution of an independent FASB to the effective operation of the capital markets, and to reject any proposal that would substitute legislation for the FASB's independent standards-setting process.

*Jack A. Weisbaum, Chairman of the Board, BDO Seidman, LLP (a national professional services firm providing assurance, tax, financial advisory and consulting services to private and publicly traded businesses), March 19, 2004*

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.

*Daniel K. Weiss, CPA, JD, Chief Financial Officer, Highway Patrol Retirement System, On Behalf of the State of Ohio Public Employee Pension Funds (representing one-and-a-quarter million members and beneficiaries, and combined invested assets of 135 billion dollars), March 3, 2004*

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.

*Ann Yerger, Deputy Director, 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), March 2, 2004*

Requiring companies to expense only options granted to the CEO and the next four highest compensated executives, as proposed in S. 1890, is insufficient, and it appears to reflect an interest rooted more in attractive numbers then comprehensive information. But this is a decision that should not be made in Congress in the first place.

*Ann Yerger, Deputy Director, 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), November 21, 2003*

As a partner in a Wall Street law firm and the author of the text *Accounting Irregularities and Financial Fraud*, I have been becoming increasingly concerned over the prospect of political considerations potentially influencing the formulation of generally accepted accounting principles. That is particularly the case with S. 1890, insofar as the political analysis is apparently to include an assessment of the "economic impact" of the accounting standard rather than solely the overriding objective of reporting the truth. At public companies, allowing the "economic impact" of an accounting decision to influence the public reporting of financial results is often labeled "fraud."

*Michael R. Young, Partner, Wilkie Farr & Gallagher LLP, March 8, 2004*

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 3**

**Press Release and Listing of Members of the Small Business Advisory Committee**

**NEWS RELEASE 03/18/04**

**FASB Establishes Small Business Advisory Committee**

**Norwalk, CT, March 18, 2004**—In an effort to increase involvement by the small business community in developing U.S. accounting standards, the Financial Accounting Standards Board (FASB) has established a Small Business Advisory Committee. Committee members will be a resource to the FASB in providing additional and ongoing input on accounting issues before the Board.

While the FASB has met with members of small business in the past as part of its due process procedures, establishment of a formal committee that provides the perspectives of this group will offer greater opportunity to share ideas, knowledge and experience with the Board as well as with the other group members.

"The FASB has always recognized small businesses as an important constituency," commented FASB Chairman Robert H. Herz. "Formation of the Small Business Advisory Committee should be a win-win for everyone involved, and the Board looks forward to working with the group."

The Committee, whose members represent diverse perspectives and experiences, comprises 24 lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community.

The Committee's inaugural meeting is slated for May at the FASB's offices in Norwalk, Connecticut.

**<u>About the Financial Accounting Standards Board</u>**

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information. For more information about the FASB, visit our website at www.fasb.org.

***<u>The Financial Accounting Standards Board</u>***

*Serving the investing public through transparent information resulting from high-quality financial reporting standards developed in an independent, private-sector, open due process.*

**Small Business Advisory Committee Members**

**Mr. Michael S. Cain**
Senior Executive Vice President
Frost National Bank

**Mr. Daniel J. Donoghue**
Managing Director
Private Capital Group
Piper Jaffray Inc.

**Mr. Robert A. Dyson**
Director of Quality Control
Friedman Alpren & Green LLP

**Mr. Mark Ellis**
Chief Financial Officer
Michael C. Fina group of companies

**Mr. Richard E. Forrestel, Jr.**
Treasurer and Secretary
Cold Spring Construction Company, Inc.

**Mr. William G. Hall**
Chairman and Chief Executive Officer
William G. Hall & Company

**Mr. Michael L. Hansen**
Partner and Board Member
Mid-States Construction Company and Eagle Metal Finishing, LLC

**Mr. Gregory P. Hanson**
Vice President and Chief Financial Officer
Avanir Pharmaceuticals

**Ms. Jane Hoffman**
Chief Financial Officer
National Cooperative Business Association

**Mr. W. Stephen Holmes**
General Partner
InterWest Partners

**Mr. Joe Joseph**
Managing Director
Putnam Investments

**Mr. Francis C. Jumonville, Jr.**
Chief Financial Officer and Secretary-Treasurer
Airtrol, Inc.

**Mr. Mauricio Kohn**
Principal
Kohn Financial Consulting, L.L.C.

**Mr. Steven C. Mayer**
Executive Vice President & Chief Financial Officer
Human Genome Sciences, Inc.

**Mr. Russell V. Meyers**
Partner/Member of the Firm
Witt Mares Eggleston Smith, PLC

**Mr. Edward E. Nusbaum**
Executive Partner & Chief Executive Officer
Grant Thornton LLP

**Mr. Darrel L. Posegate**
Executive Vice President & Chief Financial Officer
Home Federal Bank

**Mr. Charles L. Saeman**
President/Chief Executive Officer
State Bank of Cross Plains

**Mr. Edgar Anson Thrower**
Chief Financial Officer
Contec, Inc.

**Mr. Scott M. Waite**
Senior Vice President and Chief Financial Officer
Patelco Credit Union

**Mr. Grafton H. Willey, IV**
Managing Partner
Tofias PC

**Ms. Deborah Anne Wilson**
Chief Financial Officer
Utility Service Co., Inc.

**Ms. Candace Wright**
Audit Director
Postlethwaite & Netterville

**Ms. Lark E. Wysham**
Executive Vice President and Chief Financial Officer
Citizens Bank/Citizens Bancorp

**Testimony of**
**Robert H. Herz**
**Chairman**
**And**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 4**

**Notice for Recipients and Summary of the Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal")**

NO. 1102-100 | MARCH 31, 2004

# Financial Accounting Series

EXPOSURE DRAFT

## Proposed Statement of Financial Accounting Standards

**Share-Based Payment**

**an amendment of FASB Statements No. 123 and 95**

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Major Projects
File Reference No. 1102-100

Comment Deadline: June 30, 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by June 30, 2004. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1102-100. Those without email may send their comments to the "Director of Major Projects—File Reference No. 1102-100" at the address at the bottom of this page. Responses should *not* be sent by fax.

Any individual or organization may obtain one copy of this Exposure Draft without charge until June 30, 2004, by written request only. Please ask for our Product Code No. E177. For information on applicable prices for additional copies and copies requested after June 30, 2004, contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116



Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116

**Notice for Recipients**
**of This Exposure Draft**

This proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and generally would require instead that such transactions be accounted for using a fair-value-based method.

This proposed Statement would neither change the accounting in FASB Statement No. 123, *Accounting for Stock-Based Compensation,* for transactions in which an enterprise exchanges its equity instruments for services of parties other than employees nor change the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. The Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The Board invites comments on all matters in this proposed Statement, particularly on the specific issues discussed below. Respondents need not comment on all of the issues presented and are encouraged to comment on additional issues as well. It would be helpful if respondents comment on the issues as stated, include any alternatives the Board should consider, and explain the reasons for the positions taken. Where appropriate, it would be useful if respondents identified the specific paragraph or group of paragraphs to which their comments relate.

**Recognition of Compensation Cost**

*Issue 1:* The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

*Issue 2:* Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

**Measurement Attribute and Measurement Date**

*Issue 3:* This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

**Fair Value Measurement**

*Issue 4(a):* This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

*Issue 4(b):* Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements.

In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

*Issue 4(c):* Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

*Issue 4(d):* This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

*Issue 5:* In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

**Employee Stock Purchase Plans**

*Issue 6:* For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

**Attribution of Compensation Cost**

*Issue 7:* This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

*Issue 8:* Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

*Issue 9:* For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

**Modifications and Settlements**

*Issue 10:* This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

**Income Taxes**

*Issue 11:* This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

**Disclosures**

*Issue 12:* Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

**Transition**

*Issue 13:* This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

**Nonpublic Entities**

*Issue 14(a):* This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

*Issue 14(b):* Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

**Small Business Issuers**

*Issue 15:* Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

**Cash Flows**

*Issue 16:* For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, *Statement of Cash Flows,* to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

**Differences between This Proposed Statement and IFRS 2**

*Issue 17:* Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

**Understandability of This Proposed Statement**

*Issue 18:* The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

**Public Roundtable Meetings and Small Business Advisory Committee Meeting**

The Board plans to hold several public roundtable meetings with constituents to discuss issues related to this proposed Statement. Those roundtable meetings tentatively are scheduled to take place around the end of the comment period in the San Francisco Bay area of California, and in Norwalk, Connecticut. The specific dates of the public roundtable meetings and instructions for constituents interested in participating in them will be announced in a future issue of FASB *Action Alert.* Each roundtable meeting can accommodate a limited number of participants. The Board plans to seek participants for each meeting that represent a wide variety of constituents including investors, preparers of financial statements, auditors, valuation experts, and others to ensure that it will receive input from diverse views. The Board also plans to discuss the views of constituents representing small and medium-sized businesses regarding this proposed Statement at the inaugural meeting of the Small Business Advisory Committee on May 11, 2004, in Norwalk, Connecticut.

**Summary**

This proposed Statement addresses the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services. It also addresses transactions in which an enterprise incurs liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of those equity instruments in exchange for employee services. This proposed Statement does not change the accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans;* the Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The objective of the accounting required by FASB Statement No. 123, *Accounting for Stock-Based Compensation,** as it would be amended by this proposed Statement, is to recognize in an entity's financial statements the cost of employee services received in exchange for valuable equity instruments issued, and liabilities incurred, to employees in share-based payment transactions. Key provisions of this proposed Statement are as follows:

a. For public entities, the cost of employee services received in exchange for equity instruments would be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost would be recognized over the requisite service period (often the vesting period). Generally, no compensation cost would be recognized for equity instruments that do not vest.

*Unless the text indicates otherwise, all references to Statement 123 in this summary are to that Statement as originally issued—that is, before the effects of this amendment.

b. For public entities, the cost of employee services received in exchange for liabilities would be measured initially at the fair value of liabilities and would be remeasured subsequently at each reporting date through settlement date. The pro rata change in fair value during the requisite service period would be recognized over that period, and the change in fair value after the requisite service period is complete would be recognized in the financial statements in the period of change.

c. The grant-date fair value of employee share options and similar instruments would be estimated using option-pricing models adjusted for the unique characteristics of those options and instruments (unless observable market prices for the same or similar options are available).

d. If an equity award is modified subsequent to the grant date, incremental compensation cost would be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately prior to the modification.

e. Employee share purchase plans would not be considered compensatory if the terms of those plans were no more favorable than those available to all holders of the same class of shares and substantially all eligible employees could participate on an equitable basis.

f. Excess tax benefits, as defined by this proposed Statement, would be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits would be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost would be reported as income tax expense.

g. This proposed Statement allows nonpublic entities to elect to measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement. That election also would apply to awards of liability instruments. This proposed Statement also requires that public entities measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement if it is not reasonably possible to estimate their grant-date fair value.

h. The notes to financial statements of both public and nonpublic entities would disclose the information that users of financial information need to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

**Background**

APB Opinion No. 25, *Accounting for Stock Issued to Employees,* was issued in 1972. Opinion 25 required that compensation cost for awards of share options be measured at their intrinsic value, which is the amount by which the fair value of an equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award's intrinsic value should be measured; that criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring fixed awards' intrinsic values at the date of grant generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, which resulted in a large amount of specialized and complex accounting guidance.†

Statement 123 was issued in 1995 and was effective for share-based compensation transactions occurring in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the

†That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System,* March 25, 2003 [www.sec.gov]).

application of the fair-value-based method to fixed awards results in compensation cost being recognized when services are received in exchange for valuable equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board's decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

**Reasons for Issuing This Proposed Statement**

There are four principal reasons for issuing this proposed Statement:

a. **Addressing concerns of users and others.** Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for valuable equity instruments. Financial statements that do not faithfully represent the economic transactions affecting an issuer can distort the reported financial condition and operations of that issuer and can lead to the inappropriate allocation of resources. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information.

b. **Improving the comparability of reported financial information through the elimination of alternative accounting methods.** During the summer of 2002, a number of public companies announced their intention of voluntarily adopting Statement 123's fair-value-based method of accounting for share-based compensation transactions with employees. Since then, approximately 500 public companies have voluntarily adopted or announced their intention to adopt the fair-value-based method. Despite the many public companies that have voluntarily adopted the fair-value-based method of accounting, there remains a large number of companies that continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in Statement 123, the Board believes such transactions should be accounted for using the fair-value-based method.

c. **Simplifying U.S. GAAP.** This proposed Statement would simplify the accounting for share-based payments. The Board believes that U.S. GAAP should be simplified whenever possible. Requiring the use of a single method of accounting for share-based payment would result in the elimination of Opinion 25's intrinsic value method and the many related detailed and form-driven rules.

d. **International convergence.** This proposed Statement would result in greater international comparability in the accounting for share-based payment. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by enterprises in many countries throughout the world, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. IFRS 2 requires that all enterprises recognize an expense for all employee services received (and consumed) in exchange for the enterprise's equity instruments. The IASB concluded that share-based compensation transactions should be accounted for using a fair-value-based method that is similar in most respects to the fair-value-based method established in this proposed Statement. Converging to a common set of high-quality financial accounting standards on an international basis for share-based payment transactions with employees improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both U.S. GAAP and international accounting standards.

The Board believes that this proposed Statement addresses users' and other parties' concerns by requiring enterprises to recognize an expense in the income statement for employee services received (and consumed) in exchange for the enterprises' equity instruments, thereby reflecting the consequences of the economic transaction in the financial statements. By requiring the fair-value-based method for all public companies, this proposed Statement would eliminate an alternative accounting method and the accounting guidance associated with that method; consequently, similar economic transactions would be accounted for similarly. Finally, requiring the use of Statement 123's fair-value-based method is convergent with IFRS 2.

**Differences between This Proposed Statement and Current Practice**

This proposed Statement would affect current practice in a number of ways, but chief among them is that it would eliminate the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments, based on the grant-date fair value of those instruments (with limited exceptions).

This proposed Statement would affect current practice in other ways, including the measurement attribute for nonpublic entities, the pattern in which compensation cost would be recognized, the accounting for employee share purchase plans, and the accounting for income tax effects of share-based payment transactions. Paragraphs 6–15 of this proposed Statement summarize those as well as other differences.

**How This Proposed Statement Would Improve Financial Reporting**

This proposed Statement would require the recognition of compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer. Recognizing compensation cost in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the impact that share-based compensation arrangements have on an enterprise's financial condition and operations.

This proposed Statement also would improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and would also thereby simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions are accounted for similarly.

**How the Conclusions in This Proposed Statement Relate to the FASB's Conceptual Framework**

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing information about the costs incurred by the employer to obtain employee services in the marketplace.

With respect to the notion of *comparability,* FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* states that information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly. That will improve the usefulness of financial information. Neutrality is another important characteristic of accounting information. Establishing that method also eliminates the accounting bias toward using employee share options for compensation, which results in accounting that is neutral for different forms of compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. Thus, to faithfully represent the total cost of employee services to the enterprise, compensation cost relating to valuable equity instruments issued by the employer to its employees in exchange for their services should be recognized in the employer's financial statements.

Concepts Statement 6 defines *assets* as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services cannot be stored and are received and used simultaneously. Those employee services are assets of an enterprise only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the enterprise. When an employer exchanges its valuable equity instruments for employee services, the receipt of those employee services creates an asset that should be either capitalized as part of another asset of the enterprise (as permitted by U.S. GAAP) or expensed when consumed.

**Costs and Benefits**

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this proposed Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members, valuation experts, compensation consultants, and numerous other constituents. Based on the findings of those cost-benefit procedures, the Board concluded that this proposed Statement will sufficiently improve financial reporting to justify the costs it will impose. Paragraphs C40–C47 provide a discussion of the Board's cost-benefit assessment with respect to this proposed Statement.

**The Effective Dates of This Proposed Statement**

This proposed Statement would be applied to public entities prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting. Nonpublic entities that had adopted the fair-value-based method of accounting for recognition or pro forma disclosures would use the same transition and effective date as public entities. All other nonpublic entities would apply this proposed Statement prospectively for fiscal years beginning after December 15, 2005.

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 5**

**Excerpts from Recent Materials about the Proposal and Small Business**

**Excerpts from Recent Materials about the Proposal and Small Business**

Many new and growing companies genuinely need to be able to grant options to attract talent. I have no problem with that, and I think it is a great way to build a company. Nonetheless, these companies must take the cost of doing so on the chin, and not hide it in the footnotes.

If they take the risk of paying too much for talent, they need to account for the cost of that risk in the financial statements. Options should be treated like any other business expense.

*Rick Ashburn, La Jolla Light, April 8, 2004*

A survey of institutional investors indicates that a vast majority back the proposal issued recently by the Financial Accounting Standards Board (FASB) that would require all public companies to list stock options as an expense in the income statement.

By a four to one margin, the 302 buy side portfolio managers and research professionals surveyed . . . said they believe the FASB proposal will improve transparency in financial reporting . . . .

More than three quarters (77%) of respondents said the FASB proposal should not be modified. . . .

An overwhelming majority -- 90% -- of respondents said they are opposed to any exemptions from the options expensing rule for "start-ups" or technology companies.

*Broadgate Consultants, Inc., April 7, 2004*

But do we really want to preserve the practices that led to the internet-stock bubble? How many of those pie-in-the-sky start ups attracted employees with visions of options-based fortunes that never materialized? We should not be using accounting gimmicks to encourage the formation of companies that have virtually no hope of success.

*Jeff Brown, The Philadelphia Inquirer, April 4, 2004*

I am deeply troubled by . . . assertion[s] that the proposed FASB standard on equity-based compensation imposes great costs on small businesses. I have a hard time seeing just how this could be true. The vast majority of small, privately-held businesses– . . . should be totally unaffected by this pronouncement for the simple fact that they do not usually issue stock options. There may be facts available from the Bureau of Labor Statistics that bear this out; but in my experience, stock option plans simply do not exist in these kinds of firms.

*Jack T. Ciesielski, President, R.G. Associates, Inc., April 21, 2004*

ARGUMENT 4: THE ECONOMIC CONSEQUENCES OF MANDATORY EXPENSING WILL ADVERSELY AFFECT SMALL FIRMS AND INNOVATIVE FIRMS. . . . We agree that the expensing of stock options could cause a change in capital allocation, but the role of accounting is to report the underlying economic substance of transactions. Once investors understand the economic substance of a firm's transactions, they can decide how to efficiently allocate their capital.

*Michael B. Clement, Global Equity Research, Goldman Sachs Group, Inc., April 7, 2004*

Experience has also shown that it is unnecessary for firms to overstate their net income in order to raise capital. Investors that perceive opportunities for growth in a firm's revenue and earnings have shown themselves willing to invest despite a less-than-outstanding current income statement. Furthermore, many companies in the start-up phase of their operations turn to venture capitalists and private equity firms for fund-raising. Those organizations are made up of skilled investors who will be able to look past the stock options' expense to see the firm's potential.

*Congressional Budget Office, April 2004*

. . . [A] study by Towers Perrin, a consulting firm, found that the share prices of 300 firms that had chosen to treat stock options as an expense were not affected by the change—a sign that the stockmarket may weigh options efficiently. Venture capitalists, who make their living from financing start-up companies, might also be expected to see past the cost of stock options.

*The Economist, April 10, 2004*

It is also important to remember that most U.S. employers, including many private companies, small businesses, and partnerships, don't offer stock option compensation to their employees; a nationwide survey by the Bureau of Labor Statistics in 2000, a banner year for stock options, found that only 1.7 percent of non-executive U.S. workers actually received any options that year. In short, honest accounting does not hurt average workers.

*The Honorable Carl Levin, United States Senate, April 20, 2004*

[Phillips Smith, Chairman of Taser], just like a long line of folks who oppose expensing, is using the argument that a change in measurement is going to change his (and thousands of start-up companies') behaviors. Isn't it a sign of what this is really about that a noneconomic change will alter their behavior? If options are so valuable to companies, if they are so necessary to attract talent, then why in the world would they *dare* change their behavior unless there is a real, tangible economic impact?

We're talking about measurement, folks. Not taking food out of the mouths of babies, not ending entrepreneurship as we know it. Not stealing from the working class. Measurement, and making accounting fair.

*Bill Mann, The Motley Fool, April 21, 2004*

**Fiction:** Expensing will depress the earnings of start-up companies, make it difficult for high-tech companies to raise capital, and hurt the economy.

. . .

Economic studies show that there is no effect on stock value of firms that voluntary switch to expensing of employee stock options. There is no evidence to support the notion that start-up companies and high-tech firms need to misrepresent themselves in order to raise capital. Capital markets are highly sophisticated and already factor in stock option expense in their valuations. This is particularly true for venture capitalists who supply funding for start-ups.

*The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, April 20, 2004*

**Testimony of**
**Robert H. Herz**
**Chairman**
**and**
**George J. Batavick**
**Board Member**
**Financial Accounting Standards Board**
**before the**
**Committee on Small Business and Entrepreneurship**
**April 28, 2004**

**Attachment 6**

**Materials Excerpted in Attachments 2 and 5**

**Materials Excerpted in Attachments 2 and 5**

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**STATEMENT OF SENATOR JOHN KERRY,**
**RANKING MEMBER OF THE**
**U.S. SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP**

**HEARING ON THE IMPACT OF STOCK OPTION EXPENSING ON**
SMALL BUSINESSES
April 28, 2004

Senator Enzi, I want to thank you for calling this hearing. The issue of stock ɔtion expensing has generated substantial attention and today's hearing is a good ɔportunity to examine the matter more closely.

In March 2004, the Financial Accounting Standards Board, also called FASB, :oposed a standard, or "exposure draft," to require companies to treat the issuance of nployee stock options as an expense in their financial statements. It is important to :member the underlying rationale for this action, including protection of shareholders ıd investors, ensuring integrity in a company's reported financial statements and :omoting transparency in corporate accounting.

I am pleased that FASB is here to discuss its proposed standard. FASB has evoted a substantial amount of time, effort and expense to resolve this difficult issue. ow that the exposure draft has been released, we have an opportunity to assess and valuate the proposal and the process. It is also an opportunity to provide comment and ıggestions to FASB. It is critically important that FASB propose a fair and accurate andard as small business and high technology are great engines of the American conomy, and these businesses must prosper.

Today, we will hear from small businesses that will share their unique erspective. I am interested in learning from these businesses how they believe an xpensing standard will affect their ability to recruit and retain talented staff, execute ıeir business plans, and ultimately create jobs. I want to hear their views about nplementing the proposed standard, both its accuracy and cost to the business. And I ant to hear their views on the process and whether or not they feel FASB has listened to ıeir concerns. I am glad FASB has created a Small Business Advisory Committee and I ould like to hear about how it will assist in this process.

We will also hear from FASB itself, the Congressional Budget Office and other xperts about the need for expensing and the merits of the proposed standards and the rocess. Many business professionals, investors, analysts and venture capitalists have oncluded that options should be expensed and can be expensed accurately, and they ave applauded FASB's proposal. Some firms, like Netflix and others, have already ıoved to voluntarily expense options.

We will hear some divergent views today, which is of course often the purpose of good Committee hearing. I have concluded that stock options are compensation and should be expensed. That doesn't mean that I agree with all that FASB has done or agree with every word of the exposure draft. I have questions about whether FASB has paid sufficient attention to the concerns of small business. I have questions about whether the exposure draft will provide a fair, rational, consistent and accurate expensing.

The comment period, today's hearing and the other public hearings FASB has scheduled provide the opportunity for Congress, businesses and investors to critique these proposals and ask questions. In addition, the comment period provides FASB with an opportunity to answer those questions, listen to good and bad reviews, address criticisms, and consider changes to the exposure draft if appropriate.

Again, I thank Senator Enzi and Chair Snowe for calling this important hearing. I also want to thank our witnesses who are participating in today's hearing and I look forward to your testimony.

By ROBERTO MENDOZA, PETER HANCOCK and ROBERT MERTON

Microsoft's recent decision to substitute restricted stock for stock option grants in the future and to deduct the cost of options from historic profits ends the accounting fiction that such incentives are not an expense.

More importantly, it also removes a significant psychological barrier to the introduction of even more effective design features that could produce substantial value for both shareholders and employees.

Across corporate America, the distortion of income statements caused by the failure to treat options as expenses has helped to create false expectations and perverse incentives. In some cases, the misuse of options encouraged senior management to take excessive risks. It also stifled innovation in the design of efficient and transparent compensation systems.

But Microsoft and others still need to deal with the legacy of problems created by previously granted options, many of which are "underwater" because the stock is still trading below the option exercise price. The existing gulf between the interests of shareholders and employees will be exacerbated by differing incentives within the workforce. For example, option-holders will always favour earnings retention or share buy-backs over dividends. Many shareholders take a different view.

The existence of outstanding legacy options is also demotivating because option-holders find them difficult to value. This is particularly true of financially unsophisticated employees who receive the incentives as part of a broad-based plan. Many tend to value options at close to their intrinsic value (the difference between the stock price and the exercise price of the option) plus something for "hope value". This often significantly understates the "fair value" of the option.

Simply put, the fair value of an option is the price at which it makes no difference to the company whether it compensates the employee in cash, stock or options.

The problem is that, at the time of grant, most employees do not value options at their fair value, because at that stage the incentives typically have an intrinsic value of zero. This problem only gets worse if the stock price declines, at which point the intrinsic value is negative, even though the fair value is positive. Under such circumstances, many employees consider their incentives as basically worthless, even though a third party would readily pay cash for the options, given the opportunity to do so.

The plan devised by Microsoft and JPMorgan Chase allows option-holders to benefit from precisely this opportunity by selling the options to the bank for cash. This is a serious attempt to deal with the legacy option issue, but we think that it is possible to address this issue in a considerably more effective manner for both shareholders and employees.

Assume that the company offered to exchange restricted stock for options at fair value, for example. This exchange alternative would yield several benefits compared with the cash sale plan.

Such an exchange would be tax free to the employee, whereas the cash sale would trigger an immediate taxliability.

An exchange would tend to align the interests of shareholders, recipients of future restricted stock grants and current option-holders.

Option-holders would be able to calculate the value of their restricted stock at any time because the stock is publicly traded. The exchange would thus keep in place the original goals of the option grant to retain and motivate employees while the cash sale would eliminate them.

An exchange plan would eliminate the transaction costs that employees would incur in selling their options to a third party. The cash purchaser would inevitably offer to buy the options at a hefty discount to fair value, because of the risks involved.

An exchange alternative would also cover both in-the-money and out-of-the money options, unlike the cash sale plan, which addresses only the latter. This represents a significant advantage because option-holders also tend to undervalue in-the-money options, further exacerbating the misalignment of employee and shareholder interests.

Last, an exchange would reduce the amount of options outstanding, perhaps radically, whereas the cash plan would not. The cash plan could also increase the economic cost to the company because the options would probably be held until expiration.

An exchange plan would be only one step in the design of more effective compensation systems. Too many ad hoc plans have been developed in recent years, leading to inconsistency and a failure to meet the long-term objectives of companies, their shareholders and their employees.

A compensation plan should be one of the most important strategic priorities for management, directors and shareholders. Our hope is that Microsoft's bold action will unleash a wave of creativity and innovation in companies as they decide how to cultivate their most valuable resource their people in a new environment of fairness and transparency.

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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 signing a lease, exchanging stock for assets, 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 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

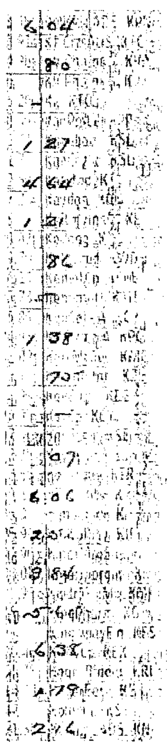
Some opponents of option expensing defend their position on practical, not conceptual, grounds. Option-pricing models may work, they say, as a guide for valuing publicly traded options. But they can't capture the value of employee stock options, which are private contracts between the company and the 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 option 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, independent of the stock price. In reality, how-

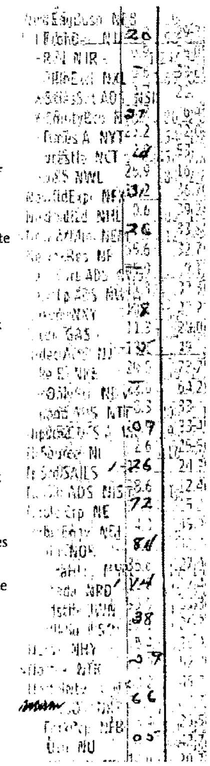
Estimates of the magnitude of this employee risk discount – or "deadweight cost," as it is sometimes called – range from 20% to 50%, depending upon the volatility of the underlying stock and the degree of diversification of the employee's portfolio. The existence of this deadweight cost is sometimes 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, by the way, that this reasoning validates our earlier point that options are indeed 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 to another customer. The company records the purchase price as the cash or cash equivalent it sacrificed to acquire the good or service.

ever, 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 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 discussion in the Fall 1995 *Journal of Derivatives* article, "On the Accounting Valuation of Employee Stock Options." The actual magnitude of these adjustments needs to be based on specific company data but we expect that, for most firms, the impact of these provisions, when properly assessed, will turn out to be small. In that case, a calculation that ignores forfeiture and early exercise altogether *could* come closer to the true cost of options than the calculation (apparently endorsed by the FASB and the IASB) that ignores the impact of the stock price and the size of employees' option and stock holdings on their probabilities of forfeiture and early exercise.



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 individual employees might place on it. The cost of the fitness center is recorded as a periodic expense, loosely matched to the expected revenue increases and reductions in employee-related costs.

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.")

The people who claim that expensing options creates a double-counting problem are themselves creating a smoke screen to hide the economic reality of stock option grants.

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 stock options 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?

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.

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.

## 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 believe, therefore, 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.

• • •

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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To order, see page xxxx.


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.

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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, $8.20, must be a compensation expense for past effort. The option was granted and vested in 4$^{th}$ Q 2003 and thus we would allocate the entire $8.20 expense to that quarter. It is difficult to justify allocating any of the expense to an earlier quarter unless there was a specific allocation of the option prior to the 4$^{th}$ 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, $8.20, as a 4$^{th}$ 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 $22.54. How much of that option value did *B* earn as a consequence of being employed by *XYZ* during the 4$^{th}$ 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 1$^{st}$ 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 = $2.54 and that is the compensation expense for *B*'s option in the 1$^{st}$ 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

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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.

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.

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<br>$100 strike price<br>vests immediately<br>maturity truncated to 90 days if terminated<br>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<br>stock price $100<br>90 day option value = $8.20<br>expense = $8.20 x 3 options = $24.60 |
| January 1, 2004 | resigns<br>now owns an option expiring March 31, 2004 | | | |
| March 31, 2004 | option expiring<br>option value $20 | employed | employed | expenses the extension of two options for 90 days<br>stock price $120<br>90 day option value = $22.54<br>time value of 90 day option = $2.54<br>expense = $2.54 x 2 options = $5.08 |
| April 1, 2004 | | terminated without cause<br>now owns an option expiring June 30, 2004 | | |
| June 30, 2004 | | option expiring<br>option value $0 | employed | expenses the extension of one option for 90 days<br>stock price $90<br>90 day option value = $3.72<br>time value of 90 day option = $3.72<br>expense = $3.72 x 1 option = $3.72 |
| September 30, 2004 | | | employed | expenses the extension of one option for 90 days<br>stock price $140<br>option value = $40.92<br>time value of 90 day option = $0.92<br>expense = $0.92 x 1 option = $0.92 |
| December 31, 2004 | | | employed | expenses the extension of one option for 90 days<br>stock price $160<br>option value = $60.57<br>time value of 90 day option = $0.57<br>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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**le 2 - Example: Stock Expense during Vesting Period**

| | |
|---|---|
| Option Description: | 10 year maturity<br>$100 strike price<br>1 year vesting period<br>option surrendered if terminated prior to vesting<br>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 quar<br>stock price $100<br>option value (maturity of March 31, 2005) = $18.75<br>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<br>stock price $120<br>option value (maturity of March 31, 2005) = $30.40<br>expense = $30.40 / 5 x 2 quarters x 2 options = $24.32, less $11.25 previously expensed = $1: |
| ;econd Quarter 2004 | | terminated without cause | | |
| June 30, 2004 | | | employed | expenses the accrued value of one option maturing on March 31, 2005<br>stock price $90<br>option value (maturity of March 31, 2005) = $9.14<br>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<br>stock price $140<br>option value (maturity of March 31, 2005) = $42.75<br>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<br>stock price $160<br>option value (maturity of March 31, 2005) = $60.57<br>expense = $60.57 / 5 x 5 quarters = $60.57, less $34.20 previously expensed = $26.37<br><br>Total expense = $60.57 |

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# FOR THE RECORD

Dr. Craig Smith
Chairman, President, and CEO
Guilford Pharmaceuticals
Baltimore, Maryland

Testimony for the hearing of the United States Senate Committee on Small Business & Entrepreneurship on "The Impact of Stock Option Expensing on Small Businesses."

April 28, 2004

Mr. Chairman, distinguished members of the Senate Committee on Small Business & Entrepreneurship, ladies and gentlemen, thank you for giving me the opportunity to provide testimony about the impact of expensing stock options on my company, Guilford Pharmaceuticals.

Guilford is an 11-year-old pharmaceutical company in Baltimore, Maryland. We market two products, one is a treatment for brain cancer called GLIADEL Wafer and the second is a treatment for patients about to have a heart attack called AGGRASTAT Injection. We are developing several other drugs, including treatments for Parkinson's disease, prostate cancer, and certain complications of diabetes. We employ about 300 highly skilled and dedicated professionals and will spend in the neighborhood of $100 million this year building our business. In our business new product development takes about 12 to 15 years and many hundreds of millions of dollars. In large pharmaceutical companies this is a daunting challenge, in small entrepreneurial companies like ours it's a constant threat to our survival. We have lost money every year but 1 for the last 11 years and expect to see additional losses for at least the next three years. We survive because we have talented employees who have discovered and developed very promising new medicines and we have investors with a high risk-tolerance who have provided us more than $300 million in capital to advance these new drugs toward the market. Without the ability to attract and retain highly skilled employees and the ability to attract investment capital we would simply go out of business.

I am here today because I believe the proposed expensing of stock options, however well intentioned and consistent with accounting theory it may be, is a direct threat to our ability to attract and retain talented employees and our ability to attract investment capital. I urge you to consider the following points in deciding whether or not to support Senator Enzi's Bill:

1. Our ability to grant stock options without adding expense to our Statement of Operations (Profit & Loss statement) has helped us recruit and, at times, retain talented employees.

   We have attracted a large number of key employees from much larger pharmaceutical and biotechnology companies. We have offered competitive salaries, challenging jobs and stock options as a means to convince people to join our company. The final stage of recruitment often hinges on the question of how many options are going to be granted. We recognize that professionals who come to work for our company may be taking substantial incremental risk because we are not yet a profitable company. Our use of options is a means to offset this risk and align the long-term interests of our employees with the interests of our shareholders. If granting stock options becomes very expensive, we will simply have to reduce the number of options we grant. The fewer options we grant, the less competitive we will be for the talent in our industry. It's that simple.

The competition for talent does not stop after a new employee is hired. As a company grows and prospers, other companies often actively recruit its employees. If a company has done well and its stock price has appreciated, it becomes difficult to recruit employees from that company because the value of future stock option vesting can be substantial. This future value is often referred to as "golden handcuffs" and it's an important element of employee retention in small companies.

2. Our ability to attract and retain investment capital is directly related to our ability to generate future earnings that are meaningful.

   Expensing stock options will add yet another "non-cash" expense to our statement of operations. Already, the accounting world has created a "fog" that in many cases results in considerable disparity between cash flow and net income. This "fog" is so well entrenched that often sophisticated investors are more concerned with EBITDA (Earnings Before Income Tax, Depreciation, and Amortization) than they are with net income. Add to this the effect of non-cash items ( ie. "good will" in an asset acquisition) related to certain types of extraordinary transactions, and it can be very difficult to tell how a business is doing financially by looking at the "net income" line. If you expense stock options you will add to the financial "fog" faced by many individual investors and create, I predict, a new term, EBITDAS (EBITDA plus stock option valuation), which will be used by sophisticated investors.

   Small high-technology companies need to raise a lot of capital before they become profitable. This need is particularly acute in the biotechnology/pharmaceutical industry. In the last 30 years only a handful of companies have become sustainably profitable out of the thousands that have been formed and the hundreds that have become public companies. On average, the few profitable companies raised hundreds of millions of dollars over more than a decade before they became sustainably profitable. Investors want to know what your "cash burn rate" is. Cash burn rate is not a GAAP number. In my view net income (plus capitalized expenses) should at least approximate a company's cash burn rate. If a company's net income is artificially inflated by expensing stock options, investors may mistakenly think the company is consuming more cash than it actually is. Thus, expensing stock options will add another burden to the net income of small companies and potentially threaten the ability of these companies to attract investment capital.

   The number of issued stock options is not a secret; it is fully disclosed in financial statements. Shareholders have to approve stock option plans. The putative financial impact of stock options is fully disclosed in annual financial reports. What new information will expensing stock options provide? What new controls over the granting of options will be added? I believe the answer is nothing! What it will do is distort the financial performance of small companies and make it more difficult for them to attract investment capital.

3. The choice of the method for valuing stock options is very important if options are going to be expensed.

   Stock options granted in our industry are usually granted at the price the stock closed at the day before the grant, vest ratably over 3-4 years, and have term of 10 years. They also have a few other characteristics:

   - They are not liquid. They cannot be sold to others and can only be transferred to immediate family members, if at all.
   - There is no market for these options
   - There are frequently long periods during which employees (especially senior executives) are prevented from trading in the company's securities (so called "black-out" periods).

   These and other considerations make valuing options in our industry very difficult. Methods that do not take these issues into consideration will substantially over value options and compound the effect of expensing options.

In summary, granting stock options has helped us build Guilford Pharmaceuticals. Had we expensed these options using standard valuation models, we would have had to reduce or eliminate our use of options. Without options we would have been at a serious disadvantage in recruiting and retaining our best employees. Many larger companies have realized this and have advocated for or adopted the expensing of options.

If we had continued to grant options after adopting the current expensing proposals, the financial performance of the company would have been distorted in the company's financial statements, making it more difficult to raise investment capital.

I believe current practice need not and should not be changed. The number of stock options granted, including the number granted to the highest paid executives, is fully disclosed in the company's financial statements, as is the theoretical financial impact of these grants. Expensing stock options will only place an onerous non-cash financial burden on small development stage companies and could hinder the growth of a very important segment of our economy.

TechNet New England

Written Statement

United States Senate Small Business and Entrepreneurship Committee

April 28th, 2004

As members of TechNet New England and employers of more than 2,500 Massachusetts employees, we write to urge the Senate Small Business and Entrepreneurship Committee to support a sound solution to one of the most critical issues facing America's technology industries: the threat of stock option expensing and its impact on broad-based employee ownership. We strongly urge the Committee to support the Stock Option Accounting Reform Act, S.1890.

The Committee's support for this legislation is imperative. The FASB's March 31 exposure draft proposes mandatory expensing of employee stock options using valuation methods that will significantly distort financial statements in a way that threatens the trend toward broad-based employee ownership. Fourteen million American workers or 13% of the entire private sector workforce hold stock options according to a recent national study. Mandatory expensing using the Black-Scholes or binomial valuation models, as proposed by the FASB, will result in gross overvaluation of employee stock options. The resulting inaccuracies will have their biggest impact on the financial statements of companies with broad-based stock option plans, including technology companies. If the FASB proposal is enacted, these companies will have little choice but to severely curtail or eliminate stock options to rank and file employees.

Employee stock purchase plans (ESPPs) are also threatened by the FASB proposal, which would require companies to treat as an expense the discount given to employees when they purchase shares under these plans. The result will likely be the reduction or elimination of one of the primary savings vehicles for millions of average American employees.

Our nation's economy and international competitiveness will be harmed by these changes. At a time when Congress and the President are focused on domestic job growth, mandated expensing threatens the broad-based employee ownership that has been a hallmark of the technology industries and an engine of U.S. innovation and economic growth. All while some of our overseas competitors, such as China, are accelerating efforts to offer stock options without mandated expensing. Mandatory expensing is bad accounting that threatens our nation's continued global competitiveness.

We urge the Committee to support the Stock Option Accounting Reform Act -- a solution to the stock options issue that will not have a detrimental impact on broad-based stock option plans and the national economy. We urge the Committee to act now to protect rank and file employees and economic growth.

Sincerely,

The Members of TechNet New England

Joe Baerlein
President
Rasky/Baerlein Group

Rick Burnes
Partner
Charles River Ventures

Barry Bycoff
Chairman & CEO
Netegrity

David Campbell
Managing Director
Innovation Advisors

Arthur W. Coviello
President & CEO
RSA Security

Paul Deninger
Chairman & CEO
Broadview, A Jefferies Company

Ralph Folz
President & CEO
Molecular

Phil Greenough
President
Greenough Communications

Peter Gyenes
Chairman & CEO
Ascential Software

Matt Harris
CEO
Village Ventures

Steve Kaufman
President & CEO
Avici Systems

Tod Loofbourrow
Chairman & CEO
Authoria

John McEleney
CEO
SolidWorks

Udi Mokady
Co-Founder & COO
Cyber-Ark Software

Patrick Morley
President & CEO
Imprivata

Paul Sagan
President
Akamai Technologies

Chris Zannetos
President & CEO
Courion Corporation

Mr. Chairman, distinguished members of the Senate Banking Committee, ladies and gentlemen, thank you for giving me the opportunity to provide testimony about the impact of expensing stock options on my company, Guilford Pharmaceuticals.

Guilford is an 11-year-old pharmaceutical company in Baltimore, Maryland. We market two products, one is a treatment for brain cancer called GLIADEL Wafer and the second is a treatment for patients about to have a heart attack called AGGRASTAT Injection. We are developing several other drugs, including treatments for Parkinson's disease, prostate cancer, and certain complications of diabetes. We employ about 300 highly skilled and dedicated professionals and will spend in the neighborhood of $100 million this year building our business. In our business new product development takes about 12 to 15 years and many hundreds of millions of dollars. In large pharmaceutical companies this is a daunting challenge, in small entrepreneurial companies like ours it's a constant threat to our survival. We have lost money every year but 1 for the last 11 years and expect to see additional losses for at least the next three years. We survive because we have talented employees who have discovered and developed very promising new medicines and we have investors with a high risk-tolerance who have provided us more than $300 million in capital to advance these new drugs toward the market. Without the ability to attract and retain highly skilled employees and the ability to attract investment capital we would simply go out of business.

I am here today because I believe the proposed expensing of stock options, however well intentioned and consistent with accounting theory it may be, is a direct threat to our ability to attract and retain talented employees and our ability to attract investment capital. I urge you to consider the following points in deciding whether or not to support Senator Enzi's Bill:

1. Our ability to grant stock options without adding expense to our Statement of Operations (Profit & Loss statement) has helped us recruit and, at times, retain talented employees.

   We have attracted a large number of key employees from much larger pharmaceutical and biotechnology companies. We have offered competitive salaries, challenging jobs and stock options as a means to convince people to join our company. The final stage of recruitment often hinges on the question of how many options are going to be granted. We recognize that professionals who come to work for our company may be taking substantial incremental risk because we are not yet a profitable company. Our use of options is a means to offset this risk and align the long-term interests of our employees with the interests of our shareholders. If granting stock options becomes very expensive, we will simply have to reduce the number of options we grant. The fewer options we grant, the less competitive we will be for the talent in our industry. It's that simple.

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