THE ACCOUNTING TREATMENT OF EMPLOYEE STOCK OPTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE ACCOUNTING TREATMENT OF EMPLOYEE STOCK OPTIONS

Tuesday, June 3, 2003

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

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [Chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Shays, Gillmor, Oxley (ex officio), Castle, Lucas of Oklahoma, Manzullo, Ney, Kennedy of Minnesota, Brown-Waite, Renzi, Royce, Kelly, Shadegg, Green, Miller of California, Toomey, Capito, Hart, Tiberi, Harris, Kanjorski, Hooley, Sherman, Meeks, Inslee, Gonzalez, Hinojosa, Crowley, McCarthy, Matheson, Miller of North Carolina, Emanuel and Scott.

Chairman BAKER. Welcome all those who are in attendance today.

Because of the nature of the panels we have this morning, there being three in number and the distinguished participants in each of those panels, I am going to suggest—I have discussed with Mr. Kanjorski and his side minimizing opening statements to myself and Mr. Kanjorski, and we will enter into the record all of the members' statements for that purpose, simply to expedite our hearing and move forward to important testimony which we will receive.

Today, the Subcommittee on Capital Markets turns its attention to expensing employee stock options and, more specifically, H.R. 1372, the Broad-Based Stock Option Plan Transparency Act introduced by Representatives Dreier and Eshoo. This hearing is especially timely as we are moving towards issues of proposed standards on the mandatory expensing options later this year.

Stock options for executives, managers and employees have served as an important tool for cash-strapped companies in their efforts to attract and retain skilled management and employees. However, there are clearly two schools of thought on the methodology for proper accounting treatment.

Proponents of expensing include the big four accounting firms, institutional investors, as well as the current Chairman Greenspan and former Chairman Volcker. Their views and options are a form of compensation just like salary and bonuses. As compensation is an expense and as expenses eventually impact earnings, options should therefore be recorded and subtracted from income.

Opponents justifiably argue expensing has a different view. They believe that mandatory expensing would discourage the use of options and adversely have an affect on innovation, economic growth, job opportunity and national competitiveness. Furthermore, options for expenses to company valuation is a most difficult issue. For example, use of different option pricing models and different assumptions can lead to significantly different economic consequences.

H.R. 1372 would seek to have SEC issue regulatory requirements which would enhance disclosure of employee stock options while prohibiting the SEC to recognize new accounting standards related to stock options until a report is submitted to Congress and to this committee on the cost-effectiveness of such regulation. This report would follow a period of 3 years of study.

This is a very controversial but very important issue, and I look forward to hearing from each of our distinguished panelists this morning.

I will turn to Mr. Kanjorski for an opening statement.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, I, too, am interested in the stock option issue. We should look at its effect on corporate returns and disclosures.

I think we should move forward with our panel, however. In the nature of saving time and efficiency, I move that my opening remarks be entered into the record.

Chairman BAKER. Without objection. Thank you, Mr. Kanjorski.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 82 in the appendix.]

Chairman BAKER. If there be no further statements at this time, I would like to move forward quickly to our distinguished panel and recognize the Chairman of the Rules Committee, the distinguished David Dreier.

STATEMENT OF THE HON. DAVID DREIER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. DREIER. Thank you thank you very much, sir. This is the first time I have been in this room; and this room has changed a lot since I have been in here, Mr. Chairman.

Let me say I appreciate the fact that you and Mr. Kanjorski and the members of this subcommittee have agreed to hold what I think is a very important hearing, and I believe that what we have really done here is recognize that there is a problem. We all know that the problem of corporate corruption came to the forefront, and your full committee addressed that issue with passage of the Sarbanes-Oxley legislation. I know that there are many people out there who are still focused on a number of the concerns, and I believe that Ms. Eshoo and I are focused on those and really have tried to step up to the plate and responsibly address this issue with the legislation that we have introduced.

Now, some have alleged that our legislation is an interference in the accounting standards setting process. The fact is, Mr. Chairman, we can't divorce—as Members of Congress we can't divorce ourselves from our responsibility for dealing with accounting standards, but we also have to look at the very real impact that those standards will have on economic growth, investors in this country, shareholders and the economy as well.

Unlike the FASB board members, we are elected officials. And I am not an accountant, I am not an expert on this, Mr. Chairman, but I will tell you that I know that we have an obligation to the American worker and to the American investor to do everything that we can to preserve an environment that allows entrepreneurs to play a role in growing our economy.

Now, there is a disagreement between those who take a static view of the economy and see stock options as something that could theoretically impact shareholders today and those who understand the dynamics of an evolving, technology-based economy that views stock options as an important tool for increasing all share value in the future.

Now, if you try to cement the cost of those stock options and their grants up front, you will undermine the engine that will grow the company pie, because mandatory expensing—and I have no problem with voluntary expensing, but mandatory expensing will eliminate the use of broad-based employee stock option plans.

I am not concerned about executive compensation. We know there has been some abuse there, and obviously that needs to be addressed. What I am concerned about is the potential to jeopardize the stock option plans for employees. I mean, this is a public policy issue, Mr. Chairman. It is not an accounting issue.

Expensing—mandatory expensing will do little to curb the number of stock options granted to top executives, but it will directly harm, as I said, the ability of rank and file employees who enjoy corporate ownership.

Deborah Nightingale from Sun is going to be testifying in just a moment, and she is going to talk about—I read her testimony last night. She is going to talk about the innovation, creativity and the role that she plays as a partner in her company.

Mandatory stock option expensing not only threatens the high-growth sectors of our economy but will actually result in an investor receiving inaccurate information about a company's use of employee stock options.

Now, our bill will mandate—Mr. Chairman, our bill will mandate the uniform and standardized disclosure of employee stock options without resulting in the elimination of broad-based stock options.

Now you don't have to be an accountant to recognize that stock options are not actually an expense. If you look at the definition of an expense, that is anything that results in an outflow of a company's assets or an increase in the company's liabilities. Employee stock options meet neither test.

I mean, let's propose, for instance, that on the first of January of this year company A had hired a computer programmer at a salary of $50,000 a year plus 100 stock option grants that can be exercised at a price of $10 no earlier than 5 years from the date of hire. Only the cash salary and nothing for the options. There is no cash outflow for the options and no liability created at any time, not when they are granted, vested or exercised. Indeed, when the stock options are exercised, the company actually receives money, and obviously the only thing that ultimately happens is the potential dilution of that stock. So all shareholders need to do is be informed of exactly what that option package consists of, and that is what our legislation is designed to do.

Now, Mr. Chairman, the fact is employee stock options never actually impose an expense or cost on companies. Since that is the case, why is there this endless debate with FASB and others in the accounting community over expensing stock options or explaining exactly what the cost to companies is?

Well, that brings me to, actually, a visual aid that I have here, Mr. Chairman; and I would just like to share this with you.

This is a map of the universe from 2,000 years ago; and basically Claudius Ptolemy, as we all know, came up with this amazing theory that the earth was the center of the universe, and for 1,500 years—that is 15 centuries, Mr. Chairman—that view continued on and on and on by great minds who basically supported the Ptolemaic theory and Copernicus, Galileo, Brahe, the whole gang of these people ended up supporting it. The Mathematical Compilation, a 13-volume treatise, was put together, and guess what? We found, when all of a sudden Johann Kepler came forward, that while 15 centuries of stating that the earth was the center of the universe was out there, they were wrong.

It is true that you can take all kinds of facts and justify almost anything, but it doesn't necessarily make it right. That is why I don't believe that options are an expense, and I hope very much that we will be able to expeditiously move forward with this legislation to address the understandable concerns that FASB and all the rest of us raise.

Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Chairman Dreier. We have members requesting copies of that chart for further——

Mr. DREIER. And I will tell you that likely you might conclude that this is a meeting of Sherwood Boehlert's Science Committee.

Chairman BAKER. It could be helpful to a lot of us I think. Thank you.

[The prepared statement of Hon. David Dreier can be found on page 75 in the appendix.]

Chairman BAKER. Our next witness this morning is the Honorable Anna Eshoo, distinguished Member, and glad to have you here as a cosponsor of this important legislation.

STATEMENT OF THE HON. ANNA G. ESHOO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. ESHOO. Good morning, Mr. Chairman. Thank you for having me here today to testify on the issue of expensing of stock options to the distinguished ranking member Mr. Kanjorski and to the Chairman of the full committee Mr. Oxley, who has worked with us to have this hearing. We very, very much appreciate it.

I want to divide my comments up into what the expensing of stock options will not do and then the plus side of what stock options represent to the rank and file employees in so many companies in our companies today.

I think, first of all, that the term stock options is something that people instantly think of when the term is stated that it has—it is a term that has become sullied; and that, of course, is the result of the misuse and the abuse of stock options that produced the scandals and the excessive executive compensation. I believe really that these events have led to a renewed call, because this is a call

that took place many years ago in my first term when I came to the Congress in 1993, and I think that these events have led to the call for expensing, leading many to believe that this is the ultimate prescription for what might ail us.

Congress, as you know, and this committee of course knows, responded by the Sarbanes-Oxley bill that passed in the last Congress.

So what will the expensing of stock options not accomplish? What will it not do?

First of all, in my view, the expensing of stock options will not rein in any excessive executive compensation in corporate America. If in fact stock options are not available, anyone that is at the top of a company, a corporation, that board of directors is going to find some way to compensate people that are at the top. There may be some things that we haven't heard of, but certainly top executives in this country will be compensated, compensated well, and it is their board of directors and their respective committees that will take care of that.

I think it is relatively easy for companies like GE and Coca-Cola to expense stock options. Keep in mind that they provide stock options to only a few, a very small number of their rank and file, and provide those stock options on a smaller basis to their executives.

Companies in my district and many other companies across the country today—in my district, it is mostly biotechnology and high-technology sectors. They use stock options very differently than the companies that became the poster children for corporate fraud.

If in fact the expensing of stock options had been on the books, the debacle at Enron would have still taken place. So it should not be thought of as the prescriptive that some have described.

Rather than handing out options only to senior executives, new economy companies offer them broadly, and when I say broadly, it is very broad. They turned their entire employee base into corporate partners who have a stake in the future success of their company.

Recent research indicates that at the top 800 technology companies in our country, 80 percent of the stock options are granted to the rank and file employees, not senior executives, and in the last decade over 10 million employees have received stock options.

So who loses if stock options are required to be expensed? Not senior executives who will be compensated, as I said, in one way or another. But it is the rank and file employees. They are the ones that would lose out on this benefit. Why? Because, faced with the prospect of taking a huge charge against their bottom line in accounting statements, most companies would simply drop the broad-based option plans and eliminate this benefit to all but senior executives.

Broad-based—I think it is very important for the committee members to take this out of the hearing, that broad-based stock option plans have turned employees into corporate partners by tying the interest of the employee together with the company and its shareholders.

Small entrepreneurial companies start up with very little capital, and so they have used stock options as the magnet to attract and to retain bright and talented employees that are critical to that

company's success. And seated to my left is one of those employees, Debbie Nightingale of Sun Microsystems. She obviously is going to testify and speak to you in her personal story, but what you should also know is that she serves part time as a lieutenant colonel in the Army Reserves.

I just returned from Iraq with Chairman Hunter, and were it not for the role that our Reserves are playing, we would have had a much, much tougher time in the engagement there.

I also have brought, Mr. Chairman, a very thick compilation of statements from employees that I ask be placed in the record as well.

Chairman BAKER. Without objection.

Ms. ESHOO. Thank you.

[The following information can be found on page 173 in the appendix.]

Ms. ESHOO. These employees have used their options to purchase their first homes, to send their kids to college, to finance their retirements, to donate and sometimes begin foundations and charities; and they have contributed to our economy every step of the way.

Now, the FASB has indicated it will only focus on accounting standards and not economic standards when it rules whether to require stock option expensing. I agree that accounting standards are best left to FASB, but promoting job growth and economic viability is a responsibility of the Congress. It is something that we all have the responsibility for. So while FASB says it won't look at the economic impact its decision will have, again, we have the responsibility to examine these factors and ensure that our national policies foster economic growth.

Investors and shareholders access to information on how companies use stock options can and should be bolstered without throwing the baby out with the bath water, as expensing really would do.

The legislation that Chairman Dreier and I have introduced we believe strikes an appropriate balance by requiring companies who offer stock options to disclose additional information to every shareholder and potential investor. Our bill, H.R. 1372, requires and includes plain English descriptions of share value dilution. That is something that investors and potential investors should be able to see and understand.

The bill expands and builds a more prominent disclosure of stock option-related information, and it includes a summary of stock options granted to the five most highly compensated officers in a company or corporation.

The bill also directs the SEC to monitor the effectiveness for investors of the enhanced disclosure requirements and report its findings back to this committee, and during that time frame the SEC would be prohibited from recognizing as a generally accepted accounting principal any new accounting standard on stock options.

What our legislation does not set is accounting standards. Some have criticized this provision as a mandate on FASB, and nothing in our bill requires Congress to get into the standard-setting business. Congress can and should do many things. I don't think it

should do that. We have problems keeping up with our own books, much less do otherwise.

The legislation directs the SEC to exert its appropriate role in maintaining the integrity of our markets and to ensure that our economic policies foster growth. Forcing companies to expense stock options at some arbitrary value as the FASB decision is likely to require I think would be both misleading to investors and to shareholders alike. Our legislation provides greater transparency about the use of stock options without unfairly penalizing the innovative employees that are really building America's economic future.

So I thank you, Mr. Chairman, to the ranking member, and to the Chairman of the full committee for inviting us here today to speak to a story of success in our country and that we can move on in terms of transparency and other reforms without damaging what has become one of the most important recruiting and maintenance tools for small companies and others in our country. Thank you very, very much.

Chairman BAKER. Thank you, Ms. Eshoo.

[The prepared statement of Hon. Anna G. Eshoo can be found on page 78 in the appendix.]

Chairman BAKER. Which leads us to our final participant in this panel, a Project Manager for Sun Microsystems, Ms. Deborah Nightingale. Welcome, Ma'am.

STATEMENT OF DEBORAH NIGHTINGALE, PROJECT MANAGER, SUN MICROSYSTEMS

Ms. NIGHTINGALE. Thank you, Mr. Chairman.

Thank you, Mr. Chairman and committee members, for the opportunity to speak to you today about the importance of broad-based stock options to rank and file employees nationwide. I would also like to thank Representatives Dreier and Eshoo for their leadership on this important issue.

I am here today speaking as one individual, but I know that I represent the view of thousands of my colleagues at Sun Microsystems and hundreds of thousands of employees nationwide.

Today, I have a dual career, working full time for Sun Microsystems, and I serve part time as a lieutenant colonel in the Army Reserves. I started my career on active duty, and after 5 years I did make the decision to pursue some civilian opportunities. However, I have always remained in the Reserves, because I enjoy the military.

Within several weeks after 9/11, I was mobilized for over 6 months to help lead the airport security mission at San Francisco and other northern California airports. In the 15 years since I have left active duty, I have worked for four companies, both high-tech and non-high-tech.

Having worked in both high-tech and non-high-tech, one big differentiator, in my opinion, is employees in high-tech do tend to be more innovative and entrepreneurial. Granted, high-tech often pays more, but the question is, once you have a well-paid, secure employee, how do you keep him or her motivated to keep innovating and taking risks? One simple and very effective answer—solution is stock options.

I think and work differently as a result of stock options. I have always been a dedicated employee, but due to stock options I am incented to do much more than simply work hard and please the boss. I am motivated to drive results for Sun Microsystems so that I can participate in some sizable profit sharing, not just a better-than-average pay raise.

Working in operations, I am constantly looking for innovative ways to cut costs so that Sun Microsystems can continue to invest in their R&D. I have a strong sense of ownership and a real stake in Sun. Simply put, Sun does well, I do well.

As a member of the Armed Forces, I know that the technologies developed by U.S. high-tech are key elements of our military strength and our national security. A unit under my command as a battalion commander deployed to Iraq about 4 weeks ago. As a result of a recent fire fight in Iraq, one soldier has been evacuated to Spain and will be coming back to the U.S. for major surgery before he will be returning home. These soldiers are in harm's way every day. I will never forget what one senior officer said to me: We need to do whatever we can to make sure it is a very unfair fight in our favor.

I worry every day about those soldiers over there, but I do feel just a little bit better knowing that we have given them the best technology and equipment in the world. We need to ensure that U.S. high-tech companies maintain their competitive edge. I definitely worry about the possibility that other foreign competitors could begin using broad-based stock options just when the U.S. is taking measures to curtail the feasibility for our U.S. companies.

In summary, broad-based stock options are really good for both companies and employees. Stock options are a key reason that I came to work for a high-tech company and a key reason that I stay at Sun. Broad-based stock options create employee commitment and loyalty. They attract and encourage innovators and entrepreneurs. They give U.S. companies a competitive advantage, and stock options really do matter to rank and file employees like myself.

In summary, H.R. 1372 makes a lot of sense to me. It increases disclosure requirements right now without discouraging any broad-based stock options. It also provides for more time to study the issue and look for win-win solutions. This issue is an important issue to me and my fellow employees. We do not want to see broad-based stock options eliminated.

Thank you very much.

Chairman BAKER. Thank you very much, Ms. Nightingale.

[The prepared statement of Deborah Nightingale can be found on page 166 in the appendix.]

Chairman BAKER. Ms. Eshoo, you raised a point in your comments with regard to FASB's focus on accounting principles as opposed to economic policy. Is it your judgment that the current availability and reporting methodology for options enhances capital formation, business creation? It is a tool of principal value to the smaller not necessarily technology based but innovative companies that are out there that otherwise might have difficulty in attracting capital that a larger brick and mortar institution with a track record might not have.

Ms. ESHOO. There isn't any question in my mind that it has served as a very, very effective tool. I am looking across both sides of the committee, and I think most of the members have come to—at one time or another travelled to my Congressional district, and so—and because members wanted to learn how these small companies, these incubators were—you know, what the ingredients were that was spawning the companies, the ideas, but also the tools that help attract employees and to hold them.

Now, I think it is really a great American story. Now, why we would want to take an accounting standard to rejigger this and destroy it is still a real question to me. There is not—there isn't any question in my mind that this has served very, very well. I mean, Debbie's story is one of—an eloquent story of tens of thousands. So I think that we really shouldn't be throwing the baby out with the bath water.

Are there more reforms that can take place? Absolutely. But this accounting standard that wipes out what the rank and file are going to get, keeping in mind that executives will always be recompensed in some way I think is wrong-headed. But has it attracted employees? Absolutely, and it is a retention tool as well. And keep in mind, again, that small companies don't start up with a great deal of capital. This is one of the magnets that has drawn some of the best and the brightest to the companies that then go on and build, and the average person has really won under this—you know, what has taken place. I don't have any question in my mind, and I think that members that have travelled to my district and the region that I am from have seen this firsthand.

Chairman BAKER. Chairman Dreier, do you see it as a start-up issue, or do you see it in a broader perspective with regard to expensing of options?

Mr. DREIER. Well, I mean, it is a broad issue. But I will tell you that if you take, Mr. Chairman—look, up until recently, 45 percent of the gross domestic product growth in this country has emanated from the tech sector of our economy. We are hurting—and I represent the Los Angeles area. I am not from the Silicon Valley, but we know that this has been broadening all across the country.

This morning I was listening to National Public Radio, and they were talking about a program that is going on today on the technology sector right here in the District of Columbia. We know we have the corridor going out to Dulles Airport. It has grown all over. There are start-up companies that need to have an incentive to continue to pursue their work, and we all recognize that there has been a problem of corporate abuse. I mean, there is no secret about that whatsoever.

That is why I believe empowering shareholders and investors with more information as to what the policy is rather than putting into place a policy which frankly not FASB—I don't believe FASB—but there are some forces out there, Mr. Chairman, that have as a goal the complete elimination of stock options, and to me that would do more to undermine the entrepreneurial spirit for existing companies as well as those start-ups than almost anything else.

Chairman BAKER. I thank the gentleman.

I think much of the comment is based on the presumption that when an option is granted the only way that thing is going to go

is up. There hasn't been a lot of discussion about the consequences of when things go in reverse, and I think that is an area where we need to do a lot of examination.

Mr. DREIER. We have certainly seen that.

Chairman BAKER. I have no further questions but just want to thank both of you for your testimony and participating in this hearing this morning.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

An interesting history lesson Mr. Dreier gave us, 1,500 years of perhaps incorrect analysis of where we were. I wonder if that applies to the——

Mr. DREIER. I wouldn't say perhaps. I don't think that—we still think that the earth is the center of the universe.

Mr. KANJORSKI. I know there are some members of this committee, Mr. Dreier, that may be flat-earthers that don't overargue that point.

Mr. DREIER. They didn't believe there was a flat earth, actually, about—that is another misnomer, if you want to continue the history lesson.

Mr. KANJORSKI. But it just raises the question that there is a large, compelling thought that tax cuts will stimulate the economy by a large element. So that theory may also be tested sometime in the future.

Mr. DREIER. Well, it worked under President Kennedy and it worked under President Reagan and it worked under President Harding and I think that it will work under President Bush.

Mr. KANJORSKI. Well, if we assume that that is what—the compelling reasons for the successes of those economies, but we will argue that another day.

There has to be a middle ground here. Certainly I don't think we should take it upon ourselves to make a judgment as to what the proper tools to stimulate the economy, encourage entrepreneurial activity is, but, on the other hand, we have seen that in some instances stock options have led to abuses which have caused problems which have put investors at risk, just as off-shore deals in Enron caused a great deal of problem.

I just looked at a paraphrase that I was going to ask two congressional witnesses, particularly Mr. Barrett of Intel, who will be on the next panel. He suggests certain conditions under which we could establish a rhyme or reason how you look upon—if you have had an opportunity to know what his position is and how you look upon his thoughts of—maybe I should relate it to all employee stock option plans should be approved by shareholders. No more than 5 percent of the options should go to the top executives, while permitting substantial majorities of employees to participate. Companies should provide more frequent and understandable disclosures. Options should vest over longer periods, like 4 years, and compensation committees should be comprised of outside directors. Finally, he argues that expensing options under the Black-Scholes technique is inherently inaccurate.

Do you have any thoughts on his proposals?

Mr. DREIER. Well, I don't know that he is proposing actually mandating all of those provisions. I believe that the policies that

a company moves ahead with are policies which clearly should be disclosed to shareholders. That is the goal that Ms. Eshoo and I have with our legislation here.

I know that there are—and I am not going to speak for any of the other witnesses who are going to be coming forward, but I know that there are some of the panelists who are proponents of expensing who actually believe that Black-Scholes should not be the guide here, just as Mr. Barrett points out in his statement. But I think that, again, empowering investors, shareholders with as much information as possible as to what that company's policies are, if they choose to expense, they clearly should be able to do that. We just want with our legislation to have as much information made available as possible so that they understand the impact that it will have on the value of their investment.

Ms. ESHOO. To the distinguished ranking member, I think that Mr. Dreier has covered that well. I would just put out on the table a couple of other thoughts, and that is that, again, the term stock options having become sullied, and I think that the way perhaps you look at this legislation should be that we are establishing a firewall so that the broad-based is not wiped out.

When you think of the companies—and we—there was a lot of debate and reference to the companies that were involved in the scandals. You didn't read or hear about those that did broad-based stock options as being part of that mess, most frankly; and I don't think you can point to an employee stock option anywhere in the country that has been abused or is the source of some kind of scandal. So it is something that I think Republicans and Democrats alike should be looking to protect. This is for extraordinary, ordinary people. We are not talking about the top. We are talking about what goes across a company, whether it is small, medium or large. So I think the appreciation of what they are should be what is kept in the forefront and what it does for our overall economy.

This one-size-fits-all accounting standard that is being proposed by FASB is what is going to wipe it out. We are saying don't let that take place, and I think the ideas that—and I think it is important that the scandal that ripped through this country that lessened the confidence of the American people to invest, that those that head up companies and corporations certainly should be coming forward with ideas about how to create greater transparency and such, and we have some of those things built into the bill.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Let me first welcome our witnesses, particularly our good friend, the Chairman of the Rules Committee, the distinguished Chairman of the Rules Committee.

Mr. DREIER. Nice to be on this side of the table.

Mr. OXLEY. Yes.

And to my former colleague from the committee across the hall, we are glad to have you with us as well; and we are glad to have an opportunity to provide a forum for this most interesting issue. It has been my experience that after passage of Sarbanes-Oxley that the perception out there, right or wrong, is that somehow by expensing stock options you have got a silver bullet that would

somehow end all of the problems that we have had in corporate America, and obviously you have been around long enough to know that it is not that easy, and it is a far more complicated than that.

Let me ask both of our congressional witnesses to respond. Greg Barrett, the Intel Chief Executive Officer, is going to be on our third panel; and reviewing his statement, he says that mandatory expensing of stock options means that stock options ultimately will only be offered to the most senior managers, if at all.

From your perspective, is it good public policy to go in that direction? And what does that say about rank and file workers and the potential for growth in the economy and particularly attracting those kinds of workers?

Mr. DREIER. Well, thank you very much for that question, Mr. Chairman.

I think that we have tried to make it very clear here. I am not going to worry about the compensation of executives. I mean, these men and women are very smart, shrewd, capable people. They are going to figure out how to get compensated.

But if we move towards expensing, which jeopardizes the potential for growth in so many of these companies, my fear is that what will happen is that the Deborah Nightingales of the world will be the ones who will not have the incentive that is necessary to continue with this creativity.

Remember, Mr. Chairman, I mean, our quality of life and the number of jobs that have been created have been tremendous. Our quality of life has been improved because of technological advances that we have seen.

Deborah was just talking about the very important national security, the armed services aspect of this in dealing with the war in Iraq. We know that so many of the things that we enjoy have come from this, and the idea of squelching this creativity among rank and file employees I think would have a devastating impact on both job creation and our quality of life.

Ms. ESHOO. Mr. Chairman, first, let me thank you again for your leadership and your working with us to create this forum and examine this issue, which is really so important to the economic life of our country, healthy economic life of our country.

I think that any suggestions that corporate leaders have, both Mr. Barrett—that the committee should pay close attention to it. I mean, this is all about ideas on how to create better transparency and to continually rebuild the confidence that the American people have ultimately in our markets and the system that we have. I mean, that is the coin of the realm. That is why we have the broadest, deepest markets in the world. If there is anything that we have worried about is what the scandals did to affect the average investor, and we know that we have many average investors in our country today.

So on what any of the ideas are, certainly pay close attention to them for more transparency and increasing the confidence of potential investors and the investors that are there, but also I think that, again, we can't—I think at a time—I have almost 10 percent unemployment in my congressional district today, close to 10 percent unemployment, and this is the place more than any other place in the country that fuels our national economy. Why would

we choose to take something that has been an overwhelming success with employees, broad-based stock options, and cast it aside today, I really don't know.

I think the Congress can accomplish two things: higher transparency, better transparency and the protection of these broad-based stock options. I think we can do both. I think we can accomplish both.

Mr. OXLEY. Thank you.

Mr. Chairman, let me commend you for putting together an all-star group of witnesses today, and we look forward to the testimony of the other panels as well. But we appreciate our colleagues, particularly Ms. Nightingale, to have you with us today, and I yield back.

Chairman BAKER. Thank you, Mr. Chairman. We appreciate the courtesy of your attendance as well.

We will go regular order. I just have—note that we have a number of members who have expressed an interest in questions, and we do have a couple of more panels of prominence this morning. So I will go down the order by time of arrival and certainly want to be recognized, but the courtesy of brevity will be most appreciated and noted.

Mr. Gonzalez.

Mr. GONZALEZ. The simple question is, who will determine the method—or the manner of methodology? Is it going to be FASB? Is it going to be the SEC? Is it the new accounting board? Because the final analysis, whether we wait 3 years or not, if we disagree with the findings or the determination of FASB, what are the options?

Mr. DREIER. Well, let me just say that our goal with the legislation is very clearly just to have each company provide whatever structure they have in place for their handling of options, have that information become—be made available to the investors who are out there, to the shareholders. That is our goal with this legislation. That is why it is called the Broad-Based Transparency Act.

Ms. ESHOO. Well, what the bill calls for is for the SEC to examine how the higher transparency that is called for in the bill actually works, and that is very important. I think for those of you that may not be absorbing the message that Chairman Dreier and Debbie and myself are here to talk about today, I think it is very important that the SEC examine this. We really should have a definitive statement based on a good, solid period of time to understand what this means to our economy and also what the greater transparency would bring about, and the bill provides for that.

Mr. GONZALEZ. And at the end of 3 years if FASB remains in their position today?

Ms. ESHOO. Pardon me?

Mr. GONZALEZ. What happens is they come out with the same methodology whether you wait 1 year, 2 years or 3 years. Are we going to have someone trumping basically FASB?

Ms. ESHOO. Well, I think that it is very important to build into this something that FASB does not do, and they have stated that, and it is fair enough for them to state that they do not include economic considerations in their considerations for accounting standards. They stop at accounting standards. They do not take into con-

sideration economic impacts. That is where we come in, and that is why we have built what we have built into in the bill.

Mr. DREIER. Obviously, Mr. Gonzalez, this is something that will continue to be addressed as we go down the road. We just believe that right now it is important for us, recognizing, having put into place the Oxley-Sarbanes legislation, we need to ensure that we don't throw the baby out with the bath water. We want to do everything that we can to make sure that the Deborah Nightingales of the world still have opportunity. That is our goal.

Mr. GONZALEZ. Thank you very much.

Chairman BAKER. Thank you, Mr. Gonzalez.

Mr. Shays.

Mr. SHAYS. Mr. Chairman, in the sake of moving forward, I happen to agree with my colleagues and understand where they are coming from. I thank you for being here, thank you and would defer questions.

Chairman BAKER. Thank you for your insight, Mr. Shays.

Ms. McCarthy.

Mrs. MCCARTHY. I thank my colleagues. Again, my question was actually already answered the second time around, so I will pass on to the next speaker.

Chairman BAKER. Thank you very much.

Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Chairman, I am interested in hearing from the next panel, so in the interest of time I will pass as well.

Chairman BAKER. Thank you, sir.

Mr. Emanuel.

Mr. EMANUEL. This is a question for both Members. Have you found any difference between a start-up company and its use of options to recruit talent versus an established company that is already a NASDAQ-listed company and its use of options where they permeate throughout the company from top management down and how—because I have heard in your presentation, obviously, the importance of options in the sense of recruiting talent, but where does that exist for a company in the early studies today versus a start-up, versus an established company listed on NASDAQ, et cetera?

Mr. DREIER. Well, it is a very good question, Mr. Emanuel; and I will tell you that I believe that both are equally important. Obviously, when we think about the technology sector of our economy, we think about the amazing success stories, created from absolutely nothing over a relatively short period of time, ultimately being job creators and then, as I was saying to Mr. Oxley, improving our quality of life, our standard of living. So the real attention is focused on those new start-ups, but this is obviously something that you are going to be hearing from Mr. Barrett in his testimony about the impact that mandatory expensing could have on a large company which is out there, still very creative, but obviously it would have a greater impact on a larger number of people, a detrimental impact on a larger number of people than the potential that exists with the start-up companies.

Ms. ESHOO. I agree with Chairman Dreier. I think it is important—and you already know this—that just as your children are

small and they grow, these small companies have grown in relatively short periods of time.

Mr. EMANUEL. You are not suggesting I give options to my kids.

Ms. ESHOO. Well, you have a real investment in them. That is for sure.

I would suggest to members that they get a copy of this book, In the Company of Owners, and it says why every employee should have them. I think it is the most definitive look at stock options. It is by Joseph Blasi, Douglas Kruse and Aaron Bernstein; and if any of you have questions on where to get it or wherever, I can tell you about it.

Mr. DREIER. You can get it online, is where you can get it.

Ms. ESHOO. Well, it may have been sent to Members as well. If it is sitting in your office, take it home, because this will be highly instructive to you and goes to the heart of many of the questions that have been asked, both in terms of small companies, large, how they would be affected. They all have employees, and I think that the story over the last decade of what broad-based stock options have done, both in the offering of them and the growth of companies, is pretty clear.

I think that Debbie wanted to add something to this.

Ms. NIGHTINGALE. Thank you very much.

I just want to add that, living and working in Silicon Valley, I definitely have seen and had a perspective of friends and peers of mine that have taken that big leap and gone off to work for a small company that has offered them a bunch of stock options. They leave a larger-paying job to go to a smaller-paying job to go off and be entrepreneurs and take that chance.

In addition, though, I would say, as an employee of Sun Microsystems, Sun at one point not too long ago was one of those little start-ups. It is now a very big company. But working within a big company, I think the stock options absolutely have a role as well. Because big high-tech companies that don't keep innovating go out of business. The history books show lots of examples.

So while I might have a little bit more security working for Sun Microsystems, if myself and my peers and everybody else does not keep innovating and keep taking chances then Sun is in trouble. And it is really because of those stock options, as I mentioned in my testimony that we go the extra mile. You know, I could just sit by, easily doing my job, keeping the boss happy, not really taking that risk, but instead myself and my peers absolutely will go the extra mile, work those 60, 70, 80-hour weeks that we are not being paid for because we stand to benefit a lot if these stock options become of great value.

Thank you.

Chairman BAKER. Thank you, Mr. Emanuel.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

I want to welcome our witnesses here. I am ordinarily on the other side of this discussion from the Chairman, so it is good to see you. Ms. Eshoo, nice to see you. Ms. Nightingale, Lieutenant Colonel, welcome.

I think at the heart of this legislative proposal is the issue of mandating a certain treatment for these stock options, and at the

heart of that question is how do you go about valuing them. One of the things that I struggle with, which I would appreciate your input on, is whatever system you use for valuating these stock options, whether they be narrowly or broadly distributed, there are assumptions underlying the valuations. Is it your concern that the assumptions, say, under a Black-Scholes method or some iteration of that, is it your concern that the assumptions will be as inaccurate, perhaps, as the current levels of disclosure might be?

Mr. DREIER. Absolutely. I mean, that is—I think that it is virtually impossible to make a determination as to exactly what that value is; and, as I say, the only impact that really is going to come here upon exercise of those options is ultimately diluting the value of that stock. That is why our goal here is to focus on the shareholders, the investors to provide them with as much information as possible.

Ms. ESHOO. I think it is important to note that in the Sarbanes-Oxley legislation that executives are now required in a very clear and—a clear and strict manner to report under penalty of law what—you know, their statement of financial health of the company, and they are held responsible for that.

Now, if in fact you add to this the mandatory expensing of options and you cannot predict what the value of those options are going to be, what does that do to Sarbanes-Oxley? What does it do to people that have to report as that law requires? So it points to the weakness I think of the FASB proposal in that it is next to impossible to state what the value that—the value of those options are going to be, and I think it is an intrinsic weakness of what the proposal presents. In real life, I don't know how these executives are going to be able to, as I said, stay true to and remain whole and legal, so to speak, under Sarbanes-Oxley in the obligations that they have as a result of that law.

Mr. OSE. If I might recast Ms. Eshoo's remarks, I think this exactly pinpoints the problem here. We are potentially criminalizing by mandate assumptions having to do with future interest rates, future discount rates, future earnings, future inflation, future changes to market conditions and the like that no one from Mr. Greenspan to Mr. Buffett to Mr. Baker or Mr. Ose can accurately predict, and this is a horrendously questionable approach, notwithstanding our desire to disclose to the investing public what it is they need to understand in these financial statements. I just want to be clear. We are potentially criminalizing mistakes on assumptions made in valuing these options that no one can predict with certainty out into the future.

Thank you, Mr. Chairman.

Mr. DREIER. Thank you, Mr. Ose, for being a cosponsor of our legislation.

Chairman BAKER. Thank you, Mr. Ose. I don't know about Mr. Greenspan or Mr. Buffett, but you certainly were right with regard to forecasting my abilities.

Mr. Scott.

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

I would just like to ask a question of my distinguished colleagues, Ms. Eshoo and Congressman Dreier. On the stock options, do you believe that stock options provide appropriate incentives to

executive employees, number one? And, secondly, do you believe that stock options should be spread out among employees other than executives or that executives should have only a certain percentage of their compensation in stock options?

Mr. DREIER. Well, those are good questions, Mr. Scott. Thank you for them.

I will say that, as Mr. Kanjorski pointed out in outlining Mr. Barrett's testimony that you will be hearing in a few minutes, he talks about a level of compensation that executives should receive as far as options are concerned; and, as I have said, I am not concerned about the compensation that executives get. I mean, they are going to figure out how to be compensated. My concern is that this proposal could jeopardize the opportunity for the Deborah Nightingales of the world, the rank and file employees who are coming up with these innovative, creative proposals to succeed, and that is really what I think we are getting at here.

So the answer to your question, sir, yes, I want to make sure that we have these options made available to those who are working on the front line in these companies. I think that is a very, very important thing, and that is part of the incentive, as Deborah just said. People who are actually in reasonably high-paying jobs, they will take a lower level of compensation to go to a start-up company with options being made available so that they can be part of that engine for growth.

Mr. SCOTT. Thank you.

Ms. ESHOO. I think, to my colleague and friend, that it is important to note that in H.R. 1372 that we call for a summary of stock options granted to the five most highly compensated officers. I think that that is very important not only for investors and potential investors but for everyone in a company, in an organization to know who has what and how much of it. I don't think that information was readily available in many of the companies that brought about and participated in the ruination, really, of many people's lives in the country and the companies that they worked for. So I think that is a very important consideration.

There may very well be coming from this committee and from outside the Congress some even better ideas for transparency, and I think that we should—I know that Mr. Dreier and I are open to that, and also the members of the committee as well, because this is all about a delicate balance. And I have respect for FASB. I don't think that they are in the business of writing accounting standards, and I respect that, and I have in the past with legislation where I didn't direct them to do anything, but I thought it was the responsibility of the Congress on economic issues to step in.

So, yes, this is important and should be protected for rank and file for the broad-based organizations, those that are a part of it, but I also think that—and we know what we have built into the bill, and that is why I restated.

I think that—I hope we have, you know, answered your questions. They are very good ones, and we have to keep being sensitive to that. It is not just because we are in the aftermath of these scandals. I think what the scandals have taught us is that we better very well take care of the investing public. Otherwise, no matter

what is on the stock market, they are not going to want to go near it.

Ms. ESHOO. These options and what they represent to people are a very important part of that mix.

Mr. SCOTT. Thank you both very much.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Royce.

Mr. ROYCE. Thank you.

Chairman Dreier, I think your point is the question of whether we are really making financial statements more precise, if they are really going to be more accurate if we are forced to adjust the actual earnings by inputting noncash charges derived through a flawed model in there, into the income statement. And I guess your position is that because the supporters of this Black-Scholes model say at best it is kind of right, it is in the ballpark—and detractors, of course, say it is way off the mark—that instead you want publication of shared dilution in financial statements in plain English and that that is going to objectively reflect how stock options are going to impact shareholdings, is that your position?

Mr. DREIER. Exactly. You got it exactly right.

Mr. ROYCE. The thing I have a harder time understanding is, when you mandate charts and graphs on the part of the SEC in order to show the dilution effects, would you have any mock-up or would you have an example of what you have in mind with respect to how you are going to convey that?

Mr. DREIER. I don't know what it would consist of. I can't tell you what it would consist of.

Mr. ROYCE. The SEC is going to basically make that interpretation.

Mr. DREIER. Clearly will do that.

Mr. ROYCE. Well, thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Royce.

Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

I want to thank my colleagues. This is one of those occasions when you come to a hearing where you are completely undecided. I am completely undecided, and the information that you have provided is very valuable to me to come to a determination because I think it is absolutely important for the American public that we bring back some integrity into our system.

My question just went along the same lines of Representative Scott. You know, I understand the transparency issue, and I think that it is important. I understand that we don't need to throw the baby out with the bath water. The whole thing with executive pay as to maybe limiting it to something, I want to hear the rest of the testimony. Because it seems to me that those top executives, particularly the CEO, the CFO, would be the ones that would have the ability as well as the motivation, even though you may have transparency issues there, to try to manipulate the value of those stock options to their benefit because they have it; and that becomes the key, is to being sure that someone does not manipulate the value of it so that you have it falling through the bandwagon.

The question I have is, basically, within the bill, is there any way, any disincentive in the bill to prevent the top executives

from—you know, other than maybe eliminating them having the possibility of having stock options so they won't manipulate the value of it to their benefit?

Mr. DREIER. Well, I mean, I will just say to you that I believe that everyone who is involved in a company should have the opportunity to benefit. Again, I argue that the threat of mandatory expensing will not hurt in any way the plans for compensation for those executives, Mr. Meeks. The people who will be hurt by expensing and those who are moving down the road and some who, as I said earlier, support the actual elimination of stock options, it will be the rank and file employees will be hurt.

The reason I say it is that the executives of these companies will continue to find other ways to be compensated. And I don't think that we should stand in the way of their being compensated. I mean, I am not one who is a proponent of dictating exactly what the salary level should be for executives. I think that should be determined by the boards of directors and the shareholders. But I think that empowering people with as much information is as far as I happen to believe we should go.

I want to thank you for being a cosponsor of our legislation, too.

Ms. ESHOO. To my colleague, Mr. Meeks, you asked I think in many ways the $64,000 question. I think it is important to keep in mind that stock options in and of themselves did not cause the scandal. It was, as you pointed out or touched on, the manipulation of the statement of earnings and all that followed, which really goes to the heart of what Sarbanes-Oxley was all about. That is what that legislation sought to correct. There is now appropriate and enormous burdens, as it were, which need to be borne legitimately by those at the top of a company where they sign off in terms of the accounting and everything that goes with it and file those statements with the SEC. That is an enormous change and I think is a very important and healthy one to take.

But this accounting standard as expressed by FASB I think, and I don't know want to keep repeating it, is so detrimental to what stock options, the broad based for the employees, would do; and that is what we are seeking to protect.

I am just as outraged as you and all the members of the committee, the Congress and our constituents over the abuses. There is no way to defend the indefensible, and that is what that legislation directed itself toward. We want to build on some of the things that we think can and should be accomplished for more transparency. But I think it is a very clear case of what we really should protect and not cast overboard.

Mr. MEEKS. Yield back.

Chairman BAKER. Mr. Gary Miller.

Mr. MILLER OF CALIFORNIA. Thank you for being here. I am a cosponsor of the bill, so I do support it 100 percent.

I agree with you. Executives are going to be taken care of. It is the rank and file that generally get left behind, if anybody.

It is a great bill. I support it. I am looking forward to the next panel.

Mr. DREIER. Thank you for your support, Mr. Miller.

Chairman BAKER. Mr. Crowley.

Mr. CROWLEY. I thank you, Mr. Chairman. I will be very brief as well.

I want to thank my colleagues for testifying today, Ms. Nightingale for her testimony. Most impressed, especially you, Ms. Eshoo, in terms of impact on your district, what this means in terms of job loss, a district that is experiencing a great deal of job loss in this current crisis.

I had the opportunity of being in India last year talking about the need for the Indians to be more transparent, to encourage more investment by the United States investor and at the same time having to defend our own system here because of Enron, a company that had considerable trouble gaining a contract, putting a contract to rest in India. There is still a great deal of bad taste in the mouths of many Indians, especially the government. So I do think it was interesting to be talking today about the need for transparency.

I agree 100 percent that the more the investor knows about what the stock options are, especially of the top executives, but also the employees themselves of the company, the more they know about that as well, I think the broader and more light of day that is shown on this issue can have a major impact as to the actions of those who would try to manipulate the value of those stocks to defraud the company, to defraud the people who work there but, more importantly, to defraud the American investor, the mom and pop who are now engaged in the stock market like never before.

So I appreciate all of your testimony today, especially you, Chairman Dreier. I want to make sure I made the point that the Chairman—appreciate having you in front of us as well.

Mr. DREIER. You sound like a co-sponsor of our legislation.

Mr. CROWLEY. Well, not as of yet. But the option is always open, so we will talk about it.

Chairman BAKER. Mrs. Kelly.

Mrs. KELLY. Mr. Chairman, I have no questions for my colleagues. I appreciate their testimony today.

Chairman BAKER. Thank you very much.

Ms. Hooley.

Ms. HOOLEY. Hopefully, a quick question to my colleagues. Thank you for being here today, talking about this issue. I think it is an important issue for many of the companies.

The question is, if we are going to provide transparency information—and I absolutely believe we need to do that—are we going to treat companies differently if only the executives get stock options as opposed to a company with broad-based stock options?

Mr. DREIER. Well, I just say that that is information that would be made available to the shareholders; and, quite frankly, it is my view that I would rather be invested in a company that provides options to the Deborah Nightingales of the world who are going to come up with the creative proposals that will ensure the success of that company than I would simply to the executives of the company.

Ms. ESHOO. It is a good question. The legislation doesn't change what you describe. In fact, I think today we probably have more companies in the country that do not offer broad-based stock options, but it is growing, and that is why we want to protect it. It

is an important tool. But it doesn't—the legislation doesn't differentiate between the two.

Ms. HOOLEY. Thank you. I yield back.

Chairman BAKER. Thank you, Ms. Hooley.

Mr. Inslee.

Mr. INSLEE. Thank you.

I want to thank the sponsors for their work. Because we sat through scores of hearings in this room following the Enron collapse and the like. I can't think of a case where this really would have solved the problem that caused those collapses, and I think it is important not to let our justifiable concern about those defaults lead us to something that may not get where we want to go.

I want to thank you, particularly, Ms. Eshoo, your comment about there are better ways to go about this, particularly looking at shareholder approval, which is important to these issues. I hope we go in that direction. Thank you.

Chairman BAKER. Mr. Kanjorski.

Mr. KANJORSKI. I request a statement be made for the record by Congressman Pete Stark. It is included together with his statement, an analysis and letters and a bill.

Chairman BAKER. Without objection. Thank you, Mr. Kanjorski.

[The prepared statement of Hon. Pete Stark can be found on page 86 in the appendix.]

Chairman BAKER. There being no further questions of this panel, I want to express my appreciation to you for your time committed to this hearing. It has been very valuable to the committee.

Mr. DREIER. Thanks again for holding this hearing. I know you will get some very interesting input from the next two panels, and we look forward to the conclusion that you will draw on that.

Chairman BAKER. Look forward working with you.

Ms. ESHOO. Thank you very much to your legislative hospitality, to the ranking member and to all the members that came to this hearing today, I think speaks highly of the committee that there would have been the kind of participation that we saw here today. Thank you very much.

Chairman BAKER. We have a total of 47 members on the subcommittee. We had in excess of 30 here today, which speaks to, I think, the importance of the issue. Thank you for your courtesy.

Ms. ESHOO. Thank you.

Chairman BAKER. At this time, I would ask our next witness to come forward, Mr. Rob Herz. It is my pleasure to welcome as our next panelist Mr. Robert Herz, Chairman of the Financial Accounting Standards Board. Welcome, sir.

STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee.

As you said, I am Robert Herz, Chairman of the Financial Accounting Standards Board. I am very pleased to appear before you today on behalf of the FASB.

I have some brief prepared remarks. I would respectfully request that those remarks and the full next of my testimony and all supporting materials be entered into the public record.

Chairman BAKER. Without objection.

Mr. HERZ. The FASB is an independent private-sector organization subject to oversight by the U.S. Securities and Exchange Commission. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the U.S. economy because investors and other users of financial reports rely heavily on credible, transparent, comparable and unbiased information to make rational resource allocation decisions.

Our work is designed to provide investors and the capital markets with the most useful yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors, Congress and other policymakers also need an independent and objective FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information you need to properly assess and implement public policies. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run a crooked yardstick in the form of a biased accounting standard is harmful to investors, to capital markets, and the U.S. economy.

In March of this year, at a public meeting, our Board unanimously decided to add a project to its agenda to address issues relating to improving the financial accounting and reporting for stock-based compensation. That decision was based largely on three factors:

First, the high level of concern expressed by individual and institutional investors, pension funds, mutual funds, creditors, financial analysts and other users of financial statements, as well as America's trade unions, consumer groups, the conference board's Commission on Public Trust and Private Enterprise, and the major accounting firms about the need to improve the reporting for stock-based compensation, in particular the need to eliminate the narrow but often used exception for so-called fixed plan employee stock options, which are the only form of stock-based compensation that is not currently reported as an expense in the financial statements.

Secondly, the growing noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting stock-based compensation which has been magnified by the recent trend of hundreds of major U.S. companies—sometimes as a result of shareholder resolutions and votes—to adopt the voluntary expense recognition provisions of our 1995 standard.

And, third, the opportunity to achieve convergence to a common, high-quality global accounting standard for stock-based compensation. There is no subject on our current agenda on which we have received so many strong and heartfelt calls for action. They go beyond the abuses of executive pay to just plain wrong accounting.

In April, the Board began its initial public deliberations to consider improvements to the recognition, measurement and disclosure of stock-based compensation. To date, we have held four public meetings and have reached certain tentative conclusions.

In the coming weeks and months, at public meetings, the Board will continue its deliberations of the many issues relating to this project, including the measurement issues and special issues related to private companies, to start-ups, to venture-backed companies. The Board's public deliberations of the issues will be systematic, thorough and objective. The deliberations will benefit from a review and analysis of the vast amount of research and other literature in this area. The deliberations will also benefit from the ongoing input of our constituents, including the advice of leading valuation and compensation experts that we will consult with throughout the entire process.

We currently plan to be in a position to issue a proposal—we have not issued anything yet—for public comment in the fourth quarter of this year. Any proposal would have to be approved by an affirmative vote of the majority of the Board. The proposal would be exposed for an ample public comment period so that all interested constituents will have the opportunity to provide detailed responses. The Board will also consider whether to hold public roundtables or public hearings to solicit additional input on the proposal.

Prior to making any final decision on any changes to the accounting for stock-based compensation, the FASB would consider at public meetings all of the input received in response to the proposal. The Board would not issue any final standard until it has carefully considered at public meetings the views of all constituents. Like any proposal, any final standard would have to be approved by an affirmative vote of the majority of the Board.

We have reviewed H.R. 1372. We note that, if enacted, it would impose a more than 3-year moratorium on any FASB improvements to the financial accounting and reporting for stock-based compensation. We strongly oppose H.R. 1372 for a number of reasons.

First, the moratorium would unduly intervene in the Board's independent, objective and open process to make unbiased decisions on the substance and timing of improvements to the accounting for stock-based compensation. Such intervention would be in direct conflict with the express needs and demands of many investors and other users of financial reports. Such intervention would also appear to be inconsistent with the language and intent of the Sarbanes-Oxley Act and the related and recently issued SEC policy statement reaffirming the FASB as the Nation's accounting standard setter.

Second, the moratorium would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality global accounting standards on stock-based compensation. The FASB is actively working with the International Accounting Standards Board and other national standard setters in an effort to achieve convergence in this important area and in many other important areas. The moratorium would likely hamper those efforts and again appears inconsistent with the language and intent of the Act and the related SEC policy statement, both of which explicitly encourage international convergence.

Finally, and perhaps most importantly, the moratorium would establish a potentially dangerous precedent in that it would sent

a clear and unmistakable signal that Congress is willing to intervene in accounting standards based on factors other than the pursuit of appropriate accounting. That signal would likely prompt others to seek political intervention into future accounting standard activities.

We have all witnessed the devastating effects and loss of investor confidence in financial reporting that have resulted from companies intentionally violating or manipulating accounting requirements. What impact then on the system and on investors' trust in financial reports might there be if it were perceived that accounting standard setting was being deliberately biased toward the pursuit of particular objectives other than those relating to appropriate financial reporting or that the FASB was being blocked from pursuing timely improvements in financial reporting?

For all these reasons, again, we strongly oppose H.R. 1372 and any other legislation that would seek to undermine and impair the Board's independent, objective and open standard setting process.

Again, thank you, Mr. Chairman. I would be happy to respond to any questions.

Chairman BAKER. Thank you, Mr. Herz. I appreciate you being here this morning.

[The prepared statement of Robert H. Herz can be found on page 113 in the appendix.]

Chairman BAKER. I have a series of questions that go really to a broader issue. The question of valuation of stock options is a very fine point on a big platform of issues. It would be my view that if you go back over the past 24 months and look at the volatility of the NASDAQ and require an individual to value the options granted to employees and then look at the value of those options 89 days later, it would be a very difficult calculation to know which way the wind was blowing.

On the other hand, the underlying argument for additional transparency and the ability of the prospective shareholder to understand the current valuation of a corporation is something no one could possibly object to. It would seem the current retrospective rules-based system that is based on the reporting paper data on a 90-day trail gives a false impression of understanding corporate performance. Have you or has the agency explored extensible business reporting language as a platform on which to have a real-time market performance analysis where an empowered shareholder could at the close of business on a daily basis not only look at options but look at the loss of a particular customer, look at the loss of a supplier, the award of a big contract?

If we are trying to eliminate volatility, you have to do what large corporations do in this country on a daily basis: At the close of business, look at your risk, look at your assets and determine where you are. Arguing over whether we price options on a 90-day platform, given underlying market volatility, interest rate exposure, credit risk, if we adopted everything FASB proposes right now I wouldn't feel a bit better than I do this morning.

Can you respond?

Mr. HERZ. Yeah. Thank you. Very excellent set of questions. I think you had two main questions in there, one about the valuation

of stock options, although that kind of led to another broader question.

You know, the issue of the valuation first, we are going to have a hard look at it. We are consulting with lots of experts. Our predecessors 10 years ago concluded that it could be appropriately valued, reliably valued——

Chairman BAKER. Let me jump back in on that point on valuation. Whether we use binomials or Black-Scholes, if you had an extensible business recording platform, you could sit at your own PC Apple mainframe and say, the value today at the close of business Black-Scholes, value today binomial A, B, C. Then you could get all the variables because there isn't a single way to arrive at value, and the number of variables outside the formula assessment also vary. So you could plug in different valuables on different analyses and come up with a recommendation.

Now, the typical investor may not want to do that, but this is where you get back to turning to my local accountant and say, figure this out for me, as long as he has got the tools to do it. Shouldn't we be moving more in that direction?

Mr. HERZ. Well, let me continue. Thank you.

You know I am a big supporter of XBRL and expansion of business reporting. You know I was a co-author of a book called The Value Reporting Revolution: Moving Beyond the Earnings Game.

Chairman BAKER. I have read it many times.

Mr. HERZ. That is something that I think not only we but I think the whole private sector with I think some regulatory stimulus from the SEC needs to pursue. I agree with your point there.

The other point is—and that would provide additional information. But there is a basic accounting system which keeps a base score on earnings, cash flows, other things. And all transactions, whether they be cash, whether salary, profit sharing, and all stock compensation transactions other than a narrow form of stock options are accounted for at fair value in the financial statements. They are scored that way in determining earnings.

And the issue of, you know, can you calculate the value of this particular instrument at a point in time—and those calculations take into account current data. They don't project future data. Take into account the current prices of stock, current interest rates and the like, and they calculate values. That is what underlies trillions of dollars of options trading markets. People trade in options, and there is a value at a point in time.

I agree that you can get—like you say, you know, you can plug it in, and you could get values every day and deliver them over XBRL, and that would be very informative. But that doesn't mean that the basic accounting information itself at the date of grant, the value of the date of grant consistent with all other stock-based compensation gets scored then.

Chairman BAKER. But that is like taking a photograph of your child while you are overseas and snail mailing it. By the time it gets to you, that is what your child used to look like. But that is not what he looks like today. He has got a buzz cut and a ring in his ear. I mean, things have changed.

That is my point. In dealing with reporting in business accounting we are still using a system built in many years ago. We are in the slide-rule era and people are using PCs at home.

Arguing this specific point, although understandably important in the overall assessment of business performance, I understand, but it goes to the broader issue of FASB's policy mission of advising the policymakers on our end, does the current system provide a responsive measure of corporate performance, given the decade we have just endured? I don't think anyone can say it does, particularly when we are trying to move to an international accord where there are considerable differences between a rules- and principles-based system.

Mr. HERZ. Well, I agree with you. But I think financial reports are an integral part, a very vital part, because they are the ultimate score, the ultimate feedback. All the other information, including the kind of information that I advocated in the value reporting revolution, is both supplementary and very complementary. You get a better picture through all of that.

Chairman BAKER. My time has expired.

I find it very difficult to focus solely on this issue, make a judgment that this is going to satisfy the information that is really needed in order to make an informed judgment when the presumption for this modification is that people can't make an informed judgment using—without modifying the current rule. Although it is not the obligation of FASB to be concerned about economic models, many of us in the Congress are very concerned about economic models and how we can encourage business growth. This goes right at the heart of that.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Herz, I want to reiterate for the record you are an independent nonprofit organization. Is that correct?

Mr. HERZ. Yeah. We are independent, and under Sarbanes-Oxley we hope we have been made more independent through the mandated funding mechanism that now applies to both us and the public company accounting oversight board.

Mr. KANJORSKI. You are charged with establishing a single rule to apply for accounting purposes to public corporations. Is that it?

Mr. HERZ. Public corporations, private companies and not-for-profit entities.

Mr. KANJORSKI. It seems that our prior panel felt that this was above an accounting rule problem but goes to the essence of whether or not the economy survives and grows. Do you feel your organization is able to establish a rule for accounting purposes that will cause greater transparency for the investing public and not interfere with or in some way compromise the growth of the economy of start-up and high-tech companies?

Mr. HERZ. Yes.

A couple of points there. First, you know, we believe clearly that better accounting information adds to better decisions in the marketplace, better credibility in the marketplace; and that has its own huge economic benefits when you translate it over the whole overall economy.

Second, and, again, we are not looking per se at the macro issues, but I can't help but have noticed that the issue of stock options is, this particular instrument, according to the U.S. Bureau of Labor Statistics in the year 2000, which was apparently a banner year for the issuance of stock options by companies, was only granted to 1.7 percent of the total U.S. nonexecutive work force.

Thirdly, as I said, in terms of the private companies, start-ups, we are going to look at that separately, apart from the large public companies.

Mr. KANJORSKI. So that it is possible to take into consideration start-up companies and particular specialized high-tech companies, that they could get a different rule that applies to them as opposed to across the board?

Mr. HERZ. I can't speak for my fellow board members, but I think the distinction would be with companies that have an actively traded stock versus those that don't.

Mr. KANJORSKI. I am sort of amazed here today that after all these years it seems to me such a contested issue and the desire now to impose legislation to affect that. What is your general opinion as to what kind of a precedent this would set, that if the Congress adopts a particular piece of legislation to somewhat change the independence of FASB in establishing accounting rules?

Mr. HERZ. Well, I think—as I said in my opening remarks, I think it would be a dangerous precedent, because we are constantly faced with groups that want to basically—they have gotten comfortable with the existing rules and how they can then use those in their business transactions. Any time we want to move things forward by proposing change to get better accounting, closer to economic concepts, you know, we are often opposed by the people who would rather keep the status quo; and they will always argue economic consequences. I think the history of that would show that those usual dire predictions of major negative economic consequence were not borne out once the better standard was put in place.

Mr. KANJORSKI. Do you feel that we also have to take into consideration the international accounting standards that we are in competition with now in terms of the global economy and that, in effect, the rule that you are trying to put together and propose would take us closer to international accounting standards?

Mr. HERZ. Yeah. This issue, you know, was not only looked at by the FASB over the last 20 years, the last time 10 years ago, but it has been looked at by the International Accounting Standards Board and by accounting standard setters in many, many other counties; and everybody comes to a very similar conclusion about the accounting aspects of this. As I said, the IASB is ahead of us. They are intending to propose—issue their final standard later this year, probably around the time we just issue a proposal. The international accounting standards will apply starting 2005 for all of Europe. They are going to apply for Australia, New Zealand, Russia. They already apply for many other parts of the world that for years used international accounting standards. So to a certain extent we would be the odd man out.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. OSE. Mr. Shays.

Mr. SHAYS. Thank you very much, Mr. Chairman.

For the sake of honesty, I have to disclose that FASB is in my district. There are many things about FASB that I love and cherish. There is only one that I don't. That is it sometimes takes you all too long to act.

I am in a quandary because I believe we need to have better formation of capital, but I also believe that we need to have disclosure. I believe that that people need to know the facts. But what I am wrestling with is that this is an issue of valuation. In other words, by disclosing the stock option are we—you are only making money—you only take advantage of the option if the stock goes up.

I would also say to you I had a number of parents call me because their children had been given these glorious stock options which they never took advantage of but had to pay a significant tax on when the companies went out of business, which was a tragedy for these young kids who thought somehow they had a great future.

My question to you is, why are we acting now and why didn't we act 5 years ago?

Mr. HERZ. I think we are—first of all, let me—three issues, valuation issue, the issue of the stock price going down, and the option being worthless or deep out of the money, and then why are we acting now.

On the first issue, again, we are going to look at that very carefully. Again, the models—and we have got lots of suggestions as to how to improve the valuation. Things come into our door every day. You know, again, the models that support the public option trading markets, whether it be equity options, interest rate currency options, commodity options and lots of other options, those models all support this trillion—trillions of dollars of trading in markets. The question is then can you apply those models to employee stock options because they have certain other features, including the forfeitures prior to vesting, nontransferability and other kinds of adjustments?

The issue is really what is the cost to the company. Because we are preparing the financial statements for the company. The accounting standards deal with the company's financial report.

Mr. SHAYS. You say what is the cost of the company or the value of the company?

Mr. HERZ. It is viewed to be, from the company's perspective, what is the value of the instrument that it grants. And that is the real issue. What is the commitment and hence the value of that instrument that is granted by the company unilaterally at that date, and how do you value that most reliably?

The third issue of why are we taking action now, because we have gotten hundreds of letters, e-mails, input from people, recommendations of many, many groups who have studied this to say that action needs to be taken. I think it has been prompted in the wake of the—not only the scandals but the market meltdown of people believing that the financial information was incorrect.

Mr. SHAYS. Is it also an issue of political pressure and is it also a question of, frankly, not knowing what to do?

Mr. HERZ. Is it an issue of political pressure in what regard?

Mr. SHAYS. Well, did FASB feel that for the last so many years that had they acted there would have been a fire storm that would have been difficult to contend with.

Mr. HERZ. Of course, I only joined July 1st. So I can only relate what people have told me. But certainly, after the experience of 10 years ago, I think FASB was a little gun shy and virtually, other than academics and some people who understood options, no one supported the FASB at that point. Now there are many, many parties who are not only supporting this change but have demanded it.

Mr. SHAYS. The bottom line is that there was some—well, part of it was being a little gun shy, as you say, and from your standpoint that no longer exists.

Mr. HERZ. I am not gun shy. I am careful, and I study things, but I am not gun shy, and I don't think my colleagues are.

Mr. SHAYS. So that issue is resolved.

The second issue is a reluctance because—maybe not knowing what is the right thing to do. A lot of letters saying you need to act. Are you totally comfortable that your actions will be the right thing?

Mr. HERZ. Well, I have a lot of confidence in our process. As I said, we are early on. We haven't even gotten to a proposal yet, which is kind of what I always find amusing.

Mr. SHAYS. So your argument here is let us go through the process and let Congress evaluate what we have done.

Mr. HERZ. Exactly. We have a very rigorous, thorough and I believe objective process. We get input from everybody. We send out a proposal. We get wide comment.

Mr. SHAYS. How long is it going to take for that process to end?

Mr. HERZ. Our goal right now is to get a proposal out by year end. That would be out probably, my guess, for a 90-day comment period. We would probably hold some public roundtables. We then analyze what all the input is.

Mr. SHAYS. Thank you for your good work and the good work of your organization.

Thank you, Mr. Chairman.

Mr. OSE. [Presiding.] Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

Thank you, Mr. Herz.

I guess I need to frame the question a certain way. I love process. I love systems. I like predictability. I like to look at other certain boards or whatever that we look to for their expertise that set certain standards, that it is my understanding. At the present time, people are questioning whether—how relevant your standards are going to be, that they don't really reflect the real world. I tend to lean in that direction. I guess I am like Galileo, who really didn't believe that the Earth was the center of the universe until the Catholic church had a talk with him. So while I await some religious experience, I am leaning over there.

You heard Congressman Dreier, especially Congressman Dreier, who basically made that analogy with what you are doing today. Do you share any of their fears, though? Is that what you are going to do, that you have some sort of accounting certainty in that pure world of accountants, which is wonderful in many ways, but what

is the advantage, what is the benefit? Everything that we feared and that happened and we are trying to avoid, again the Enrons and the WorldComs, what you are going to do, according to a lot of people, and again I tend to agree with them, wouldn't have avoided any of those disasters or catastrophes. So what I am saying is, is there a real-world application with what you are about to do? And do you disagree with Congressman Dreier's opinion that this could be something that could be disastrous for many companies?

Mr. HERZ. Well, first of all, I also enjoyed Congressman Dreier's map of the world. I thought the conclusion was going to be that California was the center of the universe. But——

Mr. OSE. The Chairman would instruct the witness that that is accurate.

Mr. GONZALEZ. Only if Texas supplies you guys with enough energy.

Mr. HERZ. I am in trouble because I am from New Jersey.

Mr. OSE. You send it. We are still not going to pay for it.

Mr. HERZ. Nobody from New Jersey here, huh?

The issue on pure certainty, and we are never purely certain, but I think our process comes up with the right accounting. And I think accounting is very important. There is a whole discipline to it, and there is a whole way we measure incomes, show balance sheets, show cash flows and the like.

I read those articles—or editorials yesterday in the Wall Street Journal, as you may have; and I know the two gentlemen quite well, Bennett Stewart and Peter Wallison because I have worked with them. Some of what they say I agree with, and some of it I don't agree with. In fact, the parts that I and others agree with at the Board, we have been moving aggressively to try and build more economic concepts into the accounting, more reflection of cash flows and the like.

You know, there is—just wanted to—because I was struck by those works, and I particularly—I met with Bennett Stewart when he was developing his work last fall on Accounting is Broken—Here is How to Fix It—a Radical Manifesto. He suggests a number of adjustments to accounting, and one of the ones he suggests are stock option grants are an expense.

He says many corporate managers have found it difficult to understand that the cost of handing out options is an expense because they have collapsed two steps into one. An employee option grant is substantively the same as compensating the employee with cash, which is an obvious operating expense, and then compelling the employee to turn around and use the cash to purchase an option from the company for its fair market value. The true option expense is given by the option's fair market value of the date of grant. Once the option is outstanding, the employee becomes like any other equity holder and the gains and losses from exercising the option or letting it expire should not be recognized as a corporate expense or income item.

He goes on to expound as to why, you know, based on economics that is just the right answer. He has other adjustments. For example, he strongly argued about special purchase entities that they ought to be consolidated. Well, we took care of that earlier this year. He argues that there ought to be better delineation between

operating items in the income statement and financing. We totally agree. We are working towards that with the International Accounting Standards Board. So we are working on those kinds of things in order to improve the utility of the information.

As to the disastrous impacts, no, I don't believe there will be. I believe that certain companies have gotten used to using a particular form of stock option.

Let me be very clear on this: There are many forms of equity-based compensation. There are restricted stock grants. There are employee stock option plans, ESOPs. There are various forms of stock options, stock options that are tied to corporate performance or unit performance. There are stock options that are tied to an interest rate, that are tied to your performance relative to a competitor's performance. And all of those get expensed. There is just this one form which has been an accounting anomaly for 30 years now.

Mr. GONZALEZ. Thank you very much.

Mr. OSE. Mr. Herz, I just I believe you have set a new record here with your submitted testimony.

Mr. HERZ. We like to be complete.

Mr. OSE. I do want to compliment you on the thoroughness of your presentation.

In the attachments, attachment number 7, there is a submittal from the conference board I believe, and one of the footnotes—the Conference Board, Commission on Public Trust and Private Enterprise. One of the footnotes on page 5 indicated that a Merrill Lynch study shows that expensing stock options would result in a decline of approximately 70 percent in earnings per share in the high-tech industry compared with declines of 12 percent in telecom industry, 9 percent in the consumer materials industries, from 2 to 7 percent in other industries, and 10 percent in the overall S&P 500.

Now there may be some accountants within our membership here in the House of Representatives, but I can tell you that every one of us would hear about declines in valuation of 401(k)s and IRAs and individual portfolios. If expensing stock options were to cause a decline in the value of people's portfolios, why would any Member of Congress vote for it?

Mr. HERZ. Well, it is because I would hope that you would believe in the importance and value of the right information. The right information then leads to certain things happening, people understanding what the performance really is.

Mr. OSE. You are suggesting Sarbanes-Oxley does not accomplish the transparency that you are seeking.

Mr. HERZ. Well, I think on this issue, clearly this issue has been left unresolved. It was left to us to decide whether or not to try and address it, and based upon all the input we decided unanimously that it was something that needed to be addressed.

Mr. OSE. I do want to highlight one point. Within the financial statements of America's corporate industry, those that are publicly traded, are the impacts of dilution reflected in the statements themselves for granting of options?

Mr. HERZ. That is an excellent question. Earnings per share is a calculation. It is a metric. It is not part of an accounting system. All it says is that if you—everybody who basically, you know, could be a shareholder based on a calculation you then divide that into

the current earnings number. So it is not captured—economic dilution is not captured in the accounting numbers.

It is the same issue as, for example, you know, if you pay a lawyer with stock or stock options, it is absolutely clear that you would show that legal expense as an expense and you would reduce earnings. You would also show it in the numerator to the earnings per share calculation in addition to the denominator. The only instrument which escapes that treatment are these so-called fixed plan stock options. They get in the earnings per share calculation once the option is in the money, but they don't get an economic charge in the income statement.

Mr. OSE. Within the statements themselves, perhaps in the footnotes, are not the effects of dilution reflected?

Mr. HERZ. There is a pro forma disclosure that came about as a result of the FASB's action in 1995. Most of the commentators that we have had for a variety of reasons that, you know, users of financial statements have said that is not adequate. It needs to be factored into the accounting numbers themselves.

One of the reasons is that they cite—I guess there are a couple of reasons—is they use not just earnings per share numbers, but they also calculate all sorts of other numbers based on the accounting numbers, things like return on equity, return on assets; and unless you put it into the accounting numbers, it makes their life quite difficult. Further, they pick up numbers from databases, and unless you put it into the accounting numbers those things are not picked up.

Mr. OSE. But the information is in the statements.

Mr. HERZ. The information is in a footnote. By the way, it is in an audited footnote. It has been there for——

Mr. OSE. Sort of like this.

Mr. HERZ. Which, by the way, is covered by the Sarbanes-Oxley certification—has been. And it is there. But it is not—it is a pro forma number. It is kind of like saying on special purpose entities, why don't you just put the information relating to a special purpose entity in the footnotes and don't make them show the debt or the assets on their balance sheet.

Mr. OSE. We will come back to the special purpose entities, because that is not related to this issue at all. But my time has expired.

I would like to recognize Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman. I will follow up with a question I asked earlier.

We have got this either/or choice and a failed attempt to try to find if there is a middle ground here. Has anybody looked at or have you looked at the difference of how you would—whether you would expense stock options on a private—not private but a public company, recruiting—they are used differently for a big public company versus an early stage company.

I have this kind of aversion to Congress getting into the accounting business. I have an aversion of FASB getting into the—no. But how do you get towards maybe finding at a certain point whether it is a market capital company, you—maybe it is a stupid question.

Mr. HERZ. No, I think it is an excellent question. It is an excellent question. It is a question we intend to look at. Because cer-

tainly, if nothing else, the valuation issues when you don't have publicly traded stock become of another realm on valuing an option. Companies that have publicly traded stock they may themselves have traded options. So when you have a private company, a start-up, even if it is pre-IPO I think that is a real issue.

Plus you take a start-up, and you get six guys together in a garage, and you say we are going to divide, you know, divide it into six pieces, that to me is a formation issue, a founders issue, rather than a compensation arrangement. So we are going to look very carefully at those issues and where that dividing line might lie.

Mr. EMANUEL. Because I think this—you know, companies use options to attract talent early on, which is so important to the creation of that company and its ability to go public, that options may be used later on in later stage companies that one could argue it is—I think the panel before you, one of the members—one of our colleagues said it is like other forms of compensation package. Well, health care, retirement benefits therefore do get expensed at that level. Why options would be treated differently is something else.

On the other hand, I am sensitive to the fact that it has become so ingrained in the culture, in the economy and the everyday running of a business that you don't want to—you know this is going to have a negative effect. A decision that you guys made to expense options will have a negative impact. And maybe short-term companies and CEOs and management will adjust, but to disregard it at——

Mr. HERZ. Remember, across the whole capital market, as I said, according to the statistics only a small portion of nonexecutive workers receive stock options; and of course we have gotten fairly strong support from the trade unions that represent America's workers on the need to change the accounting. So, you know, I agree with your thinking, the thinking about different companies, different uses.

Mr. EMANUEL. Most importantly, different points in their maturity. That actually, rather than this being linear, options change over time as the company has developed into a different place, where it started and where in its midlife, so to say, and that therefore the options become something different over time, et cetera. I don't know, as you look at that, you think about it as you guys analyze this.

Mr. HERZ. Thank you.

Mr. EMANUEL. Thank you, Mr. Chairman.

Chairman BAKER. [Presiding.] Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman; and thank you, Mr. Herz.

I may be getting in a little over my head here because I am not an accountant, but I do understand something about the economic of options. I used to trade options professionally.

One of my concerns here, and I appreciate this is a tricky dilemma that we face here, but I guess my concern is whether or not the proposal that seems to be coming from the FASB here is going to best reflect the economic reality of these transactions. And specifically my concern is that if you go down the road of expensing, which I am not advocating, but as you seem to be heading down

that road, it occurs to me that you may be doing it in a way that by design almost necessarily misrepresents the economics of the transaction. Because you recognize an expense at one point in time sort of, you then spread it over the life of the option, but you never do anything to reflect the change in value.

As you know, if a company were to short a call option on another company, which is what this is, we are taking a short position and a call option on one's company, you would have that as a liability which would you then mark to market. You would capture that value on day one, but you would then recapture the change in value if it diminished in value or you would show greater expense if it became a greater liability. But that provides a convergence to economic reality.

And I understand that what you are doing instead seems to be more consistent with the way other forms of equity are treated, but it seems to end up misrepresenting the economic reality. And now I am further concerned—and one of the reasons I am not comfortable with expensing is if you go down this other road of showing it as a liability and marking it to market, you create this bizarre anomaly of showing earnings or losses that are a function solely of fluctuations of the stock price and have nothing to do with the operating forms of the company, which one suspects this is not necessarily very useful to investors, which is why I sort of end up thinking that really the best reflection of the economic reality here is to show the impact of the dilution in the event that the options are in fact issued.

So could you comment on this? It seems to me—and I don't mean to be harshly critical here, but it seems to be almost a half measure in terms of capturing expense, because it never captures the change that would better reflect economic reality.

Mr. HERZ. Yeah. I don't know if I can do justice to this discussion in this hearing or make my points succinctly enough, because this is an issue that we and accountants and economists have debated for a long, long time, the issue of when to measure. We call it the measurement date issue. Do you measure it solely at grant date? Do you measure it from grant date through to the vesting date when the person has performed the services, or do you measure it right to the exercise date, kind of like the way the tax method does it? And there can be arguments for all three, but I think the argument—the last argument that you argued about—maybe it was the next to the last one about the idea of marking it to market right through exercise date, there are some proponents that would say not only employee stock options but all call options issued by a company ought to be accounted for that way, including a call option that is embedded in convertible debt or warrants that a company issues for financing or to obtain goods and services. That is an issue we are looking at also internationally in terms of the distinction between liability and equity. Where is that line?

Accounting traditionally has drawn the line at things that are equity, a stock option is an equity, just like a share of stock. And when you use that to acquire goods and services, that becomes the measure of that transaction.

Now, I would posit that that is the accurate measure of that transaction at that point.

Mr. TOOMEY. Is or is not?

Mr. HERZ. Is. The question then is, is something else going on after that, which is more of a financing item, and I think you would have to look at it not only for just employee stock options but all call options that a company may issue related to its stock. We are going to look at that, but I think the measure of the compensation or if you use options to buy goods, that is what they are recorded at at that date. That is a pretty clear issue in accounting right now.

Mr. TOOMEY. It just seems worrisome to me that we would go down a road that says we will knowingly and intentionally refuse to recognize that an expense that we put on an income statement on day one and that we subsequently learn is never going to occur in any economic reality but we are never going to do anything about correcting that, and that is where you end up if you don't do the—again, I am not advocating that we use that model, but that is—given that inherent set of difficult choices, it seems the dilution model is rather appealing.

Mr. HERZ. Yeah. I understand the accounting conclusion is different. The conclusion of many economists, including Chairman Greenspan, including three Nobel prize winners, is not that. But it is a good debate to have.

Mr. TOOMEY. Thank you.

Chairman BAKER. Thank you, Mr. Toomey.

Mr. Gonzalez.

Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman. Thank you, Mr. Herz, for being here today and for your comments. I think that many of us could look back in the 1990s and see both the positive and the negative effects of the market and what took place during then, especially in the high-tech industry, but I think we can all agree that for overall what took place during the 1990s was highly beneficial towards the economy of our country, and especially the growth of the high-tech industry and the impact that that had. Many would argue because of the ability to not have to necessarily expense these items that that actually encouraged growth in development within high-tech, and it has been touched upon by a number of my colleagues.

What I would be interested in knowing is do you think, one, that it is appropriate for Congress to be inquiring into this issue? Because I think it goes beyond just technical accounting standards. It goes towards the larger macro economic policy issues, job creation, job loss potential because of these new standards that you are suggesting. Are you factoring in the macroeffect that this would have on our economy? And can you tell us—I mean, I know who is supporting the standards change. Can you tell us about what comments you received in opposition to it? And just lastly, in terms of your time line, I believe you expect to have these standards in place by the spring, April of 2004. Do you think that that is realistic given I think all of our experience with government how slow we are to move, whether or not you as quasi will do it any faster than we in government can?

Mr. HERZ. Thank you. On the macroeffects again, you know, we study the economic effects of the transactions, and our clear belief

is and our mandate is that we then come up with an accounting that we think under our concepts, under looking at characteristics like relevance or reliability or what is the better accounting, and we test that out with users, financial information to see how they use it, how they make decisions, things like that. And then we weigh that against the costs, the costs of the company to provide that information and the like. You know, our clear mandate is to produce accounting information that is more useful for people who need to have independent neutral information to make decisions.

On the opposition, we got opposition from a number of companies, particularly in the high-tech industry, you know, who wrote us a lot, a lot of letters. There was opposition earlier from other people in industry, but I think most of industry has now said let's focus on the measurement issues, you know, can it be done reliably, how, you know, what is the best way to measure it.

The April 2004, we would like to stick to that, but we are going to do this thoroughly and objectively and systematically and consult with lots and lots of people and get lots and lots of input. You know, I am committed to try and move the FASB more quickly than it has in the past, and I think we have demonstrated that on some of the things we have done over the last year, but I don't want to sacrifice the appropriate due process to make sure that we are getting to the appropriate result.

Mr. CROWLEY. I would just in closing say that it has been suggested to me that FASB in this case is acting more like Congress and this committee acting more like FASB in terms of our approach, possibly in terms of looking at this and examining it before we throw the baby out with the bath water. But I appreciate the gentleman, his testimony and his time this afternoon.

Chairman BAKER. Thank you, Mr. Crowley. Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman. Following up a bit on Mr. Toomey's questioning with respect to the cost issue of expensing stock options, do you believe there is a cost to the companies?

Mr. HERZ. Oh, absolutely.

Mr. TIBERI. Explain how.

Mr. HERZ. It is the economic cost of issuing that option at that date. I don't know if you were here when I read the piece by——

Mr. TIBERI. I wasn't. I apologize.

Mr. HERZ. By Bennett Stewart, but basically to paraphrase it, there are lots of different ways of looking at it. I mean, you are issuing an economic instrument that you could have issued a similar instrument to the market, got the cash and paid the employee in cash. Another way that economists look at it is that you are basically forcing the employee to buy the instrument. So I think most economists say that, yes, there is a cost at that date to the company. It is an opportunity type cost, but it is relevant in terms of comparing the company's actions versus other actions.

Mr. TIBERI. And you believe that there is a cost to the shareholder as well then?

Mr. HERZ. Well, any cost that is a cost to the company is a cost to the shareholder.

Mr. TIBERI. And not just a cost to the shareholder as opposed to the company?

Mr. HERZ. Again, let me explain that there is an accounting system that measures revenues, costs to the company. There is also a metric called earnings per share. That is a metric. It is just a calculation. It is a calculation that says instead of looking at the existing number of outstanding shares let's take this period's earnings and pretend that there were more shares outstanding based upon things like options, and it spreads that—then says instead of, you know, there being a dollar earnings based upon the outstanding issues shared, you factor in the options, maybe it is 80 cents and the like. But that is outside of the accounting system.

Mr. TIBERI. Were you here for Ms. Nightingale's testimony?

Mr. HERZ. Yes.

Mr. TIBERI. Referring to her testimony, she talked about this issue of options being a benefit to her as an employee, a benefit to her as an employee, a tool that her company can use to attract not only employees but also potentially capital. What is your response to that?

Mr. HERZ. Well, first of all, we don't set the laws, and we are not telling anybody that they can't issue options. And, again, this form of option is one of many forms of options, and the other forms of options already get expensed. It is one of many forms of equity-based compensation, some of which are very broad-based that get expensed and the like. So I don't know whether her particular employer might decide to consider that form, another form or the like. I would think they might consider continuing it. I don't know. One of the great things about stock options is they have very favorable tax treatment. You get a tax deduction for the full-spreaded at exercise, and many, many companies have gotten lots and lots of tax benefits in a form of reduced tax payments from this device.

Mr. TIBERI. Would you agree that there are many, many people who have been the beneficiary of stock options, who have done quite well and otherwise wouldn't have if there were the ability to have stock options given them?

Mr. HERZ. Well, again, across the economy the best statistic I have available is that only 1.7 percent of the nonexecutive workforce has received any options. So I am sure there are many people that have benefited from other forms of equity compensation. I am sure there are many people that have benefited from profit sharing plans that a company has or stock appreciation rights or lots of other ways that companies can innovatively compensate people.

Mr. TIBERI. Do you think—where did this information come from, the 1——

Mr. HERZ. The U.S. Bureau of Labor Statistics, their figure for year 2000.

Mr. TIBERI. And you believe that your proposal at FASB won't prohibit this from——

Mr. HERZ. No.

Mr. TIBERI. Explain why.

Mr. HERZ. We can't prohibit any transaction. We just say if you do something, here is how to account for it.

Mr. TIBERI. Obviously there are some who believe that your role is—some up here believe that your role is—you are overstepping your role in what you are doing.

Mr. HERZ. We set accounting standards for transactions and economic events that occur to business enterprises. So if you choose to issue stock options or if you choose to issue other forms of compensation, all we would say is here is how to account for them.

Mr. TIBERI. You don't believe that your role will stop that?

Mr. HERZ. No.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Tiberi.

Mr. Inslee.

Mr. INSLEE. Thank you. I have yet to win a Nobel prize in economics, so I approach this issue with some humility. But there are a couple of things that I want to—that I have sort of concluded and I want to ask you a question. If you reach my conclusions, what do we do then?

First, I sat through a score of hearings about all the Enron-related debacles, and I was struck during those hearings of repeated rapacious behavior by these what I believe to be criminals. It didn't involve this issue. I mean, we went through months of testimony, and I just can't remember seeing that the lack of expensing was really the critical thing that occurred to these corporations. That is just an observation that I had throughout these hearings.

Secondly, this concerns me a little bit, because I understand the desire for a number, but it bothers me to say that a bad number is better than no number at all, and I think that is where we are headed a little bit because of the difficulty of assessing this vehicle. And to me the real issue really is dilution, diminution of value to the shareholders, and if you reach that conclusion that that is really what we ought to be aiming here for is a fair assessment of the potential dilution of stockholder value when an option is issued, if you sort of reach that conclusion as I have, what advice would you give us on how to form a vehicle to really give investors that type of information?

Mr. HERZ. Okay. Thank you. Let me make sure I got your questions—your points. On the rapacious behavior, we are not trying to cure that. We are just trying to provide an accounting standard that deals with an anomaly, a 30-year anomaly that most people recognize is an anomaly among forms of stock-based compensation and how to account for it.

The issue on the bad number, again, we are going to look at that. We have been told by a lot of experts that you can get a pretty reliable number that is more reliable than a lot of other things in the financial statements. That doesn't mean that those numbers are bad either. There is a required disclosure now that the SEC has. It is called critical accounting policies and estimates, and you will find that companies disclose those in 10 or 12 areas. And what they are, they are a fulsome disclosure of the way the company went about making estimates in the area of inherent uncertainty. Most of those deal with other types of things. They deal with things like impairment of long-lived assets. They deal with reserves like loan loss reserves and the like. They deal with things like that, and I think you will find that, you know, we are going to look at this. And we have been told by other people who have looked at it that the relative precision on these kinds of things is much higher than

on those kinds of numbers that have been for years and years in the financial statements.

Again, on the dilution, you know, we will agree to disagree that dilution is not the only effect here, is not the complete effect. There is an economic cost. It is an economic cost that is associated with all other equity transactions, and by the way, these instruments are used not only to compensate employees. They are used to acquire goods and services from outsiders. They are used in M&A transactions. They are used to make investments and the like, and all of those get accounted for at the value of the option at that date.

Mr. INSLEE. Let me—just one closing comment. I think one of the things you said that is important in the context of how the public perceives this, that this really is not a response to the Enron wave. It is coincidental in time, and I think that is an important point, because I think the public has sort of washed those two together. And I appreciate your comment that these are separate issues.

Mr. HERZ. I think that is an excellent point, because I sometimes give it in speeches. I say, you know, on the one hand we have people saying that if you do this accounting you are going to destroy America. On the other hand, if you do—people saying if you don't do this accounting, we are not going to rein in all this corporate abuse and all that. And I say, gee, we are just trying to prescribe what we think is the right accounting.

Mr. INSLEE. Thank you.

Chairman BAKER. Thank you, Mr. Inslee.

Ms. Hart.

Ms. HART. Mr. Chairman, I am going to pass to Mr. Shadegg. I think he has a question.

Chairman BAKER. Mr. Shadegg.

Mr. SHADEGG. Thank you. Mr. Herz, let me first of all start with a disclaimer. This is not my field, not my topic. I also apologize for being here late. I have been bouncing back and forth between two hearings.

Let me start with a first question. Sophisticated investors from current disclosures are aware of the existence of stock options; and to the extent that they dilute the stock that is out there, they are cognizant of that, are they not?

Mr. HERZ. I guess there is some mixed evidence on that. Before you got here I explained that the fact that it is in the footnotes most people don't think is enough.

Mr. SHADEGG. But it is not footnotes.

Mr. HERZ. Yes.

Mr. SHADEGG. You propose to go all the way to the solution of expensing stock options. Pardon me, but have you already proposed a different method for valuing those stock options than the—I guess it is Black-Scholes value estimate that is currently being used?

Mr. HERZ. No. We haven't proposed anything yet. We are at the beginning of a process to assess all these issues.

Mr. SHADEGG. If you were to require that stock options be currently valued, would you use that method, or would you come forward with another method?

Mr. HERZ. We have received numerous suggestions from all sorts of academics, people who are experts in valuation compensation,

experts on ways to—that they believe would provide better valuations. Our staff is at the beginning of looking at all of those kinds of suggestions.

Mr. SHADEGG. I think Congress is confronted with an issue here, and they are trying to resolve it and do what they think ought to be done. I read a portion of your testimony, and it pretty much says you don't think the legislation that has been proposed by those that were on the prior panel is a good idea, and I have read your specifics on that. And quite frankly, most of your specifics legitimately go to protecting FASB's turf and say this is FASB's job. The Congress shouldn't intervene. It could have an adverse impact on FASB's efforts and it could set a dangerous precedent. Those are words you used. Well, I understand that, I understand the role of your agency. Do me a favor then. Respond for me to those who are going to appear on the panel after you to the criticism that says, number one, there is no way to accurately value these stocks now, that the Black-Scholes process does not provide an accurate valuation because these are not traded options, and second, address the issue that those people also raise about how do you set forth a value for a stock option that will never be used?

I spent the week last week with a good friend. He had some options issued by the company he used to work for. He was let go from that company, and he could never exercise the option. It is not a value. And address the concern of those who say anything you do will be inaccurate and therefore requiring CEOs to certify to what is inaccurate puts them in an untenable position.

Mr. HERZ. Yeah. Okay. The issue of valuation—and, again, I will go over it. You weren't here. Again, we are looking at all of that. You know, the question is can it be valued with sufficient reliability. We are going to look at that hard. People who have looked at that before us, our predecessors at the FASB 10 years ago, the International Accounting Standards Board, many experts in the field all say that it can be done.

Chairman Greenspan a few weeks ago in response to a specific question on this said that is just flat wrong. I was on the International Accounting Standards Board at the time they started looking at this issue. Unfortunately or fortunately, I left for the FASB before they got to this particular issue of measurement reliability. So I am looking forward to getting into that and making my own hard judgments on whether or not these can be sufficiently reliably valued at the date of grant or any other date after that.

The issue of the certification, the SEC tells me that the companies that already are certified with the figures in their footnotes have implicitly already said that, because the information certified already includes all the information in the footnotes of which this is in the footnote.

The second thing I would tell you is that 280 companies or so, major U.S. corporations, have voluntarily switched to the expensing method. Well, these are among America's biggest, most respected companies with highly respected CEOs and the like, and they must believe they can do it.

Mr. SHADEGG. I guess I could respond by simply saying if current disclosure is inadequate, some argue, you say it is in the footnotes and they are already certifying it, but the new method is also ad-

mittedly inaccurate, maybe we are best to leave those companies to decide which of the two voluntarily most accurately tells the public about the condition of their stock?

Mr. HERZ. Yeah. The argument that—well, first of all, we believe that excluding it from the financial statements makes the financial statements wrong. You know, obviously if we conclude that this is a valid expense, then it ought to be in the income statement just like any other expense.

Mr. SHADEGG. So you have already concluded the footnote is inadequate?

Mr. HERZ. Well, we have generally concluded historically that footnote disclosure is very useful, but it is not a complete substitute. And I went through this before on this particular issue. People have said to us that, for example, the reason it is not enough is that people pick up information, analysts and the like, from databases. And unless it is in the accounting information, they don't pick it up.

Mr. SHADEGG. I appreciate it. My time is expired. I appreciate your input.

Chairman BAKER. Thank you, Mr. Shadegg.

Ms. Hart, did you have a question at this time?

Ms. HART. I will just be brief, Mr. Chairman. Thank you. You had just mentioned in your answer to Mr. Shadegg that, oh, these corporations have made the decision to expense their stock options, and, gee, would they do that if they couldn't figure out a value, and I think my answer to that question, having been on this committee through the entire storm of the last session, would be they thought they had to and they will figure out a way to value them. I don't know that there is anything that is clear about where they can go with that. And I am interested in actually seeing your process through to the end.

Can you give us just a little window about how you would actually go about valuing an option in light of the fact that it isn't necessarily worth anything until it is exercised?

Mr. HERZ. Well, again, an option is worth something, maybe not to the employee, but there is a cost to the company. Options, I mean, there are trillions of dollars of traded options in the market. There are options embedded in convertible debt and you get a lower interest cost, and there are calculations that very precisely do all those things. So I understand from an employee's point of view that is the case, but our accounting standards deal with the accounting by a company and what are its costs, what are its revenues.

Ms. HART. I follow that, but taking that one step further, it is the value to a company which they could actually sell out of market. I understand that, but as far as the date—when you talk about the date of the valuation, are you looking toward that date that is actually given to the employee?

Mr. HERZ. Yeah. Date of grant to the employee.

Ms. HART. So that is the actual date that you would use?

Mr. HERZ. When the company officially commits itself.

Ms. HART. So that is your actual date. And from there you are going to go ahead more based on what that option could be worth on an open market?

Mr. HERZ. Well, what you would do is you would value an option through whatever technique we would come to, and we are going to look at this hard, as I say, at the date that the company commits to the employee to grant the certain number of options. And then you establish a value. If the terms of the options say that—to the employee you can't exercise this for, say, 3 years, a vesting period, the way it is looked at is that that is the service period over which the company benefits from that cost. So you spread that cost over the 3 years that the employee gets it. If the employee never gets it because he leaves the company, we would reverse everything because a deal was not consummated.

Ms. HART. So things can get pretty complicated. Have you been conferring at all with these companies that have decided to use the expensing method within the last year or so?

Mr. HERZ. We have talked to a lot of them, and, again, calculations that they think they will be doing are under the same calculations that they have been doing for 7 years that are in the footnotes.

Ms. HART. Okay. Thank you. I have no further questions. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Hart.

Mr. Sherman.

Mr. SHERMAN. I have arrived just at the right time. First, I don't think you can defend the present system that you have got or the present rule on stock options. I remember while I was studying accounting I learned two things. First, comparability, the ability to compare two like companies and tell which one is producing more net income or has a higher book value, is one of the essential elements of any good series of accounting principles.

The second thing I learned while I was studying accounting is that you could turn on the TV and see the taste test, Pepsi versus Coke. There was a big commercial back then. And the people being tested were often blindfolded. Well, today you are blindfolded if you are trying to compare earnings per share of Pepsi and Coke, because of course they use different systems for comparing the cost of compensating their executives.

But as I understand it, what you are saying is the professionals dealing with securities can by looking at the footnotes turn Pepsi into Coke by making some calculations and determining what Pepsi's earnings per share would be if they used the same method. Is that true?

Mr. HERZ. They can from the footnote data—first of all, let me go back. Thank you for that comment on comparability, because that is an absolutely essential ingredient to good accounting information and to the information that is used in the marketplace and investment decisions and capital allocation.

They can make those adjustments, but one of the issues apparently is that they can't make them everywhere, because the databases that they use don't pick up—if it is not in the accounting information, the accounting—you know, they pick up the straight information from the income statement, not from footnotes.

Mr. SHERMAN. Well, you are saying that those who don't bother to read the footnotes cannot compare Pepsi and Coke, but if you are getting your advice from a team of professionals in a few hours,

they can do the calculations to put Pepsi's earnings per share calculated exactly what it would be if they used——

Mr. HERZ. They can do the bottom line but they can't do other things like gross margin and other aspects that they might want to calculate, because it is not broken out that way.

Mr. SHERMAN. Well, once you have determined what the expense item would have been on Pepsi's financial statements, can't you then calculate everything else? What is missing?

Mr. HERZ. Well, for example, let's say people not only in production but in sales and marketing and other parts of the enterprise——

Mr. SHERMAN. So a portion of the compensation cost should not be charged to this year's expenses, but instead could be part of inventory——

Mr. HERZ. Inventory or other things below the gross margin and the like and things that are needed in financial—proper financial analysis.

Mr. SHERMAN. So without much controversy, you believed at least require beefier footnotes so as to provide in effect a complete restatement of what those financials would look like——

Mr. HERZ. Yeah.

Mr. SHERMAN. ——if the expensing method was used?

Mr. HERZ. We could. I mean, I think the concern is that you do it on one item, then we are going to have pro forma disclosures on everything. Why have financial statements?

Mr. SHERMAN. Well, the problem you have here is this is the only item I am aware of where the FASB has announced there is a right way to do it, but we don't have the fortitude, I think is the term, to tell everybody to do it that way.

Mr. HERZ. Oh, we have the fortitude.

Mr. SHERMAN. Well, you haven't—I mean, your current release on this is the right way, and 98 percent of the companies are doing it a different way.

Mr. HERZ. Right.

Mr. SHERMAN. I don't know of any other issue that is this hot. I don't know of any other issue where you can't just say, this is the right way. Do it this way. So at a very minimum, if you can't impose that same standard on this issue, which is too high, you could provide the same pro formas. Then the world out there could decide which of the two numbers to use. The analysts could all decide that they like the pro forma number better, or they could like the main number better, but——

Mr. HERZ. They could. I mean, we—there was a survey of—that the AIMR did a couple of years ago of their membership. The AIMR is the Association for Investment Management Research, and they surveyed thousands of people. They got about 2,000 responses from financial analysts and portfolio managers, and one of the questions they asked was is footnote disclosure enough, and the answer was no.

Mr. SHERMAN. It is obviously a lot easier for them if you are able to come up with one number and they don't have to read the footnote. What you are basically saying in the survey is they don't want to read the footnotes and they certainly don't want to do the additional work of——

Mr. HERZ. That may be so or there may be others——

Mr. SHERMAN. Trust me. No one wants to read those footnotes. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Sherman.

Mr. Ney, did you have a question?

Mr. NEY. Thank you. Thank you, Mr. Chairman. Welcome. Some people have argued that requiring expensing of the stock options will undermine clarity of the financial statements and provide greater opportunity really for fraud, because the valuation methodology would not be exact, and I just wonder what your view on that would be.

Mr. HERZ. Well, our view is that—again, once we have gone through our whole process and we have concluded that not only conceptually it is an expense but it can be measured with reliability, that that is the right thing to do, to put that number in. To leave it out is to make the financial statements distortive.

You can provide lots of other information in the footnotes, continue to do that, provide lots of other information. We are looking at that as well, because there are other aspects related to these. For example, the ongoing mark to market might be instructive right through their exercise date, lots of other things that could be useful and informative, as well as trying to make the financial statements correct.

Mr. NEY. On a note about the component stock options which people have pretty well agreed they are difficult to value, and one of the people testifying—I think it was Mr. Craig Barrett—he will be on the third panel—points out that the CEOs are now required to certify the accuracy of their company's financial results and that the problems inherent in valuing stock options will make that extremely difficult.

So my question again is the first part I said. How can we require the CEOs to do that when everybody has kind of agreed that that is a difficult thing to do?

Mr. HERZ. As I said earlier, having talked with the SEC, their belief is that under section 302, the CEO has already been certifying the information that is in the footnotes on this.

Mr. NEY. Thank you.

Chairman BAKER. Thank you, Mr. Ney.

Mr. Herz, we appreciate your courtesy in being with us for such a length of time. This of course is an important issue, but the broader question of financial reporting generally is of interest to me, and we look forward to working with you over the months to come. Thank you, sir.

If I may invite our third panel, participants to come forward.

I want to welcome each of our panelists here this morning and for your patience. This has been a much lengthier hearing than some would have expected, and I know of time constraints on our first witnesses. I certainly want to express appreciation for your participation but understand the necessity for your departure after the conclusion of your remarks.

Our first to be heard this morning is the Honorable Paul Volcker, former Chair of the Federal Reserve, and in his capacity as Chairman of the International Accounting Standards Committee Foundation Trustees. Welcome, sir.

STATEMENT OF THE HON. PAUL A. VOLCKER, CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION TRUSTEES

Mr. VOLCKER. Thank you, Mr. Chairman. I appreciate your courtesy in letting me go first, and I will steal out with an appointment with some of your colleagues, and I will come back if I can dispose of that and you are still talking. But let me just be quick with a couple of points.

I am, as you indicated, the Chairman of the Trustees of the International Accounting Standards Foundation. We appoint the Board that makes the decisions. I am not the one who makes the decisions. I am not to interfere with those technical decisions.

Having said all that, let me make a few comments. I think the basic issue you are all grappling with here is what should the role of the determining boards with, whether you are talking about FASB nationally. You haven't got any jurisdiction over the international, but we are aiming for consistency internationally, and those boards, both the domestic and the international, have been set up to provide insulation from extraneous influences. They are set up as professional boards to make professional judgments of integrity, and that decision making is to be protected by a rather elaborate arrangement, including my board of trustees, including the trustees of the domestic FASB.

We have people who are not accountants on the Board. Some of them are drawn from business. Some of them are accountants. Some of them are drawn from analysts. They have large and elaborate advisory procedures. So these decisions are not reached in a vacuum, but in the end they are reached on the basis of professional judgments directed to assure what the best accounting judgment is and hopefully, from my viewpoint, to achieve international consistency over time.

Now, I recognize it is amply apparent here that how you value stock options is exceedingly controversial. I might say to those that argue that it is not an expense, we better stop the practice of permitting the expense on tax returns. I don't think we can argue that they are a tax deduction and not an expense. That is why they are a tax deduction. And we are a little inconsistent the way they are accounting for now. I don't think we can argue that they have no cost. It is very difficult to know what that cost is, certainly on the grant date.

There is one date where we know the cost, and that is when they are exercised. You can look it up in the Wall Street Journal. There is no doubt about it. That is the date that is used as an expense for tax purposes.

I want to emphasize, when you consider what viewpoint you might want to take in the area, that while stock options are controversial, they are not the most controversial issue, in my judgment, that the standard setters are going to face. There are a number of extremely basic and controversial issues that will arise in accounting over the next months and years, and I think some of those will have a more profound effect on the financial world than will any decision that is made on whether there is to be expressing of options.

There is a rather furious debate going on in Europe right now about the application of a proposed ruling by the International Board which will become law in Europe unless the European Commission says no, unless the European Commission vetoes it, about the handling of financial instruments. This is a ruling which has already been in effect in the United States under GAAP for some years. The International Board said they think they made an improvement, that it should be applied internationally. There is very great opposition in Europe. There are very strong political pressures being brought on the European Commission.

Now, all my point in making this is if Congress wants to intervene in this particular decision, is a great precedent for everybody intervening in every decision that they don't like. The professional standard-making boards have been set up deliberately to provide a degree of insulation away from the professional judgment.

So I want you to understand what you do here is not limited to the particular question of stock options. I think it would be obviously from my point of view a bad precedent for a political body to begin overriding the professional judgments of the independent standard makers, whether they are international or domestic. It will certainly lead to a lot of inconsistency internationally and all of that would be damaging I think to the basic international framework—the financial framework.

Now, I happen to think, in looking at stock options as a matter of substance, that they are deeply flawed, and I know of no other word for it, as an incentive for business management. I think it is clear after experience, and they are largely a phenomenon of the last 15 years or so, that in the middle of a bull market there are enormous rewards that really weren't intended. They rise to grotesque—and I use that word advisedly—rewards for some business managers because you were in the midst of a bull market. People who performed well got richly rewarded. People that performed mediocrelly when the stock market was going up so fast got rewarded. People that performed relatively poorly or the stock performed relatively poorly got richly rewarded because of the popularity of stock options.

Not only that, that there are clearly, I think it has been demonstrated, temptations for abuse in terms of incentives, that the incentive is given to the manager to attempt to affect the price of the stock, sometimes in ways that are inconsistent with the long-term health of the company. And I think we unfortunately have seen examples of that.

Now, I understand that for start-up companies or venture capital companies, you have some discussion of that, you are under somewhat a basically different situation, where you have the owners of the companies, the founders of the company making a decision basically about how they want to distribute some stock, and they are not at that stage publicly owned companies at all. When I say I think they are basically flawed as a compensation instrument, I am talking typically about the big public companies that are tempted to abuse stock options. They may not abuse it. You have got one company here that feels very strongly about the use of stock options. They distribute them very widely, and don't concentrate them so heavily on a limited group of people. But unfortunately

that is not uniform practice by a long shot. We have seen these egregious examples where people have gotten very large payoffs for stock options the very year that company goes bankrupt or has a decline in stock price of very large amounts. And when you get in a bear market, nobody gets rewarded, good, bad or indifferent economic performance.

So I would say there are better ways of motivating people, better ways of aligning incentives than the use of—I will use the words carefully—a fixed price stock option by large publicly owned companies without concentrated ownership, where the ownership itself is basically not making the decision but the managers that are affected are making the decision.

I think that is a certain background for this whole discussion when we talk about the overall impact of stock options. I am not arguing they should be outlawed. I am just arguing that as a matter of corporate practice that a company that wants to use them should do a certain amount of explaining as to why in their particular circumstances and the manner in which they use their stock options is justified. I think in the end of the day, the pricing of the stock option one way or another will encourage more conservative behavior and more prudent behavior with respect to fixed price stock options.

The point was made earlier ironically when you have a performance-based stock option, it is already expensed and it is an interesting phenomenon. Not many companies use it. So you have to ask why not. The temptation is because they are not expensed to abuse them in some cases. You can't avoid the uncertainty I think of expensing them, which is very real, because one thing you know is zero expense is not true. I think the overwhelming professional economic opinion says if there isn't expense to stock options and there wasn't expense, we shouldn't be deducting it for tax purposes.

[The prepared statement of Hon. Paul A. Volcker can be found on page 169 in the appendix.]

Chairman BAKER. Thank you, Chairman Volcker. We appreciate your participation today. We are here. We welcome you back if it works out for your schedule.

Our next witness would be introduced by Congressman Shadegg. Congressman.

Mr. SHADEGG. Thank you, Chairman Baker. It is my privilege to introduce today Dr. Craig Barrett, the CEO of Intel. Dr. Barrett is a constituent of mine from Arizona and one of the distinguished witnesses we have today. As you know, Intel is one of the largest, if not the largest supplier of microprocessors and has played a significant role in shaping computer and information technologies.

Since joining Intel in 1974, Dr. Barrett helped perfect the process for manufacturing Intel's powerful microprocessors. He became CEO of Intel in 1998. Prior to that he had an impressive record of academic achievement at Stanford University, where he served on their faculty.

He also has a demonstrated commitment to public service. He has been a passionate advocate of higher education and of placing higher education within the reach of a wider range of students. He has testified before Congress about strengthening math, science and technology education requirements and has advised the Presi-

dent on education issues. He has also been an outspoken advocate for higher standards in education.

It is a privilege to have Dr. Barrett with us today.

STATEMENT OF CRAIG R. BARRETT, CHIEF EXECUTIVE OFFICER, INTEL CORPORATION

Mr. BARRETT. Thank you, Mr. Shadegg. Mr. Chairman, it is a pleasure to be here. Sometimes after listening to some of the prior testimony, I wish I was here talking about education and math and science. It is perhaps a simpler problem to solve.

What I would like to do is perhaps represent the high-tech community at this table this morning. I have submitted some prepared remarks. I will try to summarize those briefly. I want to talk primarily about three subjects. One is the importance of stock options to America's economic health going forward, why expensing stock options is not a solution to corporate corruption, a topic that has been discussed some today, and why expensing of stock options will confuse corporate financial statements and confuse investors. We have heard statements to the contrary this morning, and I would like to give you my perspective on that.

I also want to compliment Representatives Dreier and Eshoo for putting H.R. 1372 in play. I enjoyed their comments this morning. I am going to look forward to working with them on this bill going forward.

If you look at the United States economy today and increasingly going forward, it is a knowledge-based economy. You can determine that either by looking at the number of knowledgeable workers in the United States over time. You can look at that, at the assets of companies as they move. If you look at the nonfinancial assets of the company, they increasingly move from property and equipment and raw material to in fact intangibles such as patents, copyrights and knowledge based on their workers.

Those two trends are absolutely going forward. It is in fact the only way the United States supports the standard of living it has today. It has to add more value to its goods and services than other countries or our standard of living goes down and our employees can't afford to get paid.

If you look at the company that I am proud to represent, Intel Corporation, it was founded in 1968 by Bob Noyce and Gordon Moore. They founded that company out of Fairchild. At Fairchild they learned the important lesson that employees as partial owners of companies can contribute more to that company, will contribute more to that company, will do more to make that company successful. When Intel started, approximately 30 percent of its employees were given stock options. Today essentially all of our 80,000 employees receive stock options.

Speaking at this table as a CEO today with experience in running a major corporation, with 30 years of experience in the industrial field, I can testify that stock options are a great incentive to employees to be owners of companies, to work harder for companies and to make those companies successful. In my opinion, this is why we give stock options. The owners of the company recognize that. The owners are the shareholders. They agree to a dilution of their

holdings in the company on the basis that the employees will work harder and make the pie bigger.

Intel is not alone in this area. If you look at Intel, which I think is a company of substantial success over the last 35 years, Microsoft, Dell, Cisco, you can go right down the list, all of these companies were founded in the same fashion, founded off of knowledge-based workers, and this incentive ownership in the company has been a prime motivating factor for those employees to work hard.

We could look at it slightly differently. Those are all large companies that I mentioned. If you look at small companies, start-up companies and start-up companies do create the basic fuel to create jobs and wealth in the United States, stock options are an excellent tool for start-up companies. Those companies cannot afford to pay often the salaries that major companies can, and therefore they must compete with the stock options to attract knowledgeable workers into their base.

I think if you were to expense stock options as some of our previous speakers have mentioned—subjected to and in fact had the harsh reality of the profit and loss statement, the profit to earnings ratio, the stock price associated with that expensing, you would see a dramatic move away from granting stock options in the United States. You would have to do that. This would be at the same time when we are competing increasingly not with Europe, which Mr. Volcker mentioned IASB represents primarily, but we are increasingly competing with Asia, and the Asians have no intentions of expensing stock options. That is where the competition is in the future.

One of the other areas that was mentioned this morning was this book, which I would suggest that everyone read. Representative Eshoo mentioned this. If you are interested in the data in terms of return on investment productivity, return on capital growth for companies with a wide holding of stock by their employees, that is, companies with broad-based stock options, I think this book is the bible on that topic. Occasionally it is useful to interject data when discussing this topic. This book is full of data.

There has been a lot of talk about one of the reasons for expensing options is to curb corporate corruption. I totally disagree with this topic. The companies such as Enron, WorldCom and others that have crashed and burned did not crash and burn because they were not expensing stock options or because they had broad-based option programs. They crashed and burned because the executives in those companies broke the law. They deserve to be punished. They deserve to be prosecuted for what they did. They betrayed the public trust.

I think what this discussion is all about, though, is the impact that broad-based options can have on companies and their success. I would like to make just a few simple suggestions which would help introduce the topic of broad-based option programs and the impact they can have on companies and the value they add. And it is really a five-step program.

First is that option programs should be approved by shareholders. The shareholders are the owners of the company. They are the ones that are agreeing to the dilution of their proportion of the company. Broad-based option plans should be exactly that, broad-

based option programs, and you ought to limit the amount of options that go to the top executives at companies. At Intel our compensation committee is taking the move to limit it to 5 percent or less of the options go to the proxy five.

A key element of the Dreier-Eshoo bill is that companies should provide investors with sufficient information, whether it is a footnote or not, and by golly, if you read any of our financial statements today, they are filled with footnotes on all sorts of topics and any seasoned investor who doesn't bother to read the footnotes is certainly not a seasoned investor.

But the footnotes should be written in plain English. Options ought to vest over an extended period of time, 4 years or so, and compensation committees who are the committees that dispense options to the executives and companies should be made up entirely of outside directors. That is the job of the compensation committee. That is the job of the directors. They can't shirk that.

If you do those five things, I think you will do more to solve any potential abuse of option programs, and you will create jobs. You will create growth. You will create economic strength and innovation and entrepreneurship in the United States.

I do want to end my comments with just a brief vignette about the accuracy of Black-Scholes, which has had some discussion this morning, the accuracy and transparency of financial statements and what you would project to the casual investor if you followed something like the Black-Scholes technique, which I believe to be inherently inaccurate in valuing options.

I wrote an op ed piece for the Wall Street Journal a few weeks ago. I pointed out in the last few years Intel would have expensed via Black-Sholes over $3 billion worth of expense for options which are currently underwater. That is, their strike price is less than the current market price. That $3 billion, had it been on our expense, would have decreased earnings. Those options may never be exercised. Stock price may rebound, they may be exercisable, but unlikely. That $3 billion of expense would never come back to Intel had it been charged. So it is a one-way street if you expense on the date of grant.

I can't imagine how any investor would have the situation clarified by having over $3 billion of expense on RP&L which may never occur. It may be obvious from my comments that I disagree with Mr. Herz. I disagree with the direction that FASB is going. I don't think there is an expense in the form he suggests to the company.

There is an expense to the shareholders. That expense is dilution. They approved that dilution when they approved the shareholder plan.

So I think the shortcomings in the expensing methodology are profound, but I think perhaps more important would be the shortcomings to economic development and economic well-being in the United States if you were to do away with broad-based stock option programs, which is what I entirely believe expensing would do.

Thank you.

Chairman BAKER. Thank you, Mr. Barrett. We appreciate your time here today.

[The prepared statement of Craig R. Barrett can be found on page 88 in the appendix.]

Chairman BAKER. Our next witness is the Honorable Roderick M. Hills, Partner, Hills & Stern. Welcome, sir.

STATEMENT OF THE HON. RODERICK M. HILLS, PARTNER, HILLS & STERN

Mr. HILLS. Thank you, Mr. Chairman. I ask that my remarks that I sent in to you be accepted.

Chairman BAKER. Without objection, as will all witnesses' testimony.

Mr. HILLS. I see that an article from The Economist April 24th that was to be with my remarks is not here. If I may submit that later.

Chairman BAKER. Absolutely.

Mr. HILLS. I appreciate the opportunity to offer my views as to H.R. 1372, legislation which I think is fair to say is a reaction to the problems—I would say the crisis that faces the accounting profession.

The problems which I list in some detail in my prepared remarks are, among other things, causing a fundamental change in accounting to the increasing use of market values, rather than historic costs, engaging profits and losses, and in the use of general principles, rather than a myriad of rules to evaluate financial statements.

Whether options should be accounted for or not I suggest is part of this process of change. It seems to me there are lots of reasons why options should be accounted for. They are a material factor in how companies compensate employees. They can significantly affect stock prices. And I am sad to say they have, because they are not accounted for, distorted the compensation policies of some companies.

Why then is there a problem? Well, it is, of course, the opinion of many CEOs who believe with justification that their strong prices may be severely hurt by costing. They believe that analysts and investors will punish their stock prices if management, using information that is largely in their financial papers, public papers today, applies a Black-Sholes type formula and uses the resulting number to reduce reported earnings per share.

You might ask why in the world would analysts have any different view of the value of the company because the management does the math that he or she could do as an analyst. The fact is and the problem is that over the years the accounting profession and the analyst community have not been making the kinds of judgments about earnings and the kind of judgments about the assets of corporations that would long ago have given us an understanding of what the true cost—because it is a cost—of stock options. It would give us a better understanding of many other things about our assets and the costs of running a corporation.

Yet I don't see how you cannot sympathize with CEOs who do not wish to shoot themselves, if you will, who argue that a Black-Sholes number will not be a precise gauge of cost. So we ask why our FASB and the ISAB persist and, in short, why isn't H.R. 1372 a perfect answer?

It is attractive in one way. It puts the fight off again. It has been a long fight. It is not going to go away. It is an understandable ap-

proach. But I suggest to you that the studies contemplated are simply another way to delay something that is inexorable.

It is only going to be when accountants, companies and analysts begin to wrestle with the various approaches to valuation in the context of a profit and loss valuation that we are going to get the discipline we need to make the world understand option costs as well as so many other things. The fight against pricing of options is the lack of precision, the fear that it will cause so much uncertainty that it becomes a worthless process and somehow will destroy the use of stock options.

I have served on boards over 34 years, 18 different boards. My own view is that this, too, will pass. We will find a way to value stock options; and stock options used intelligently by companies, as they have been by Intel, will continue to be used; and analysts will figure out that the value of the company has not been affected.

The real point of my remarks is to say that the costing of options is not the most serious accounting problem facing corporate America today. This Economist article which I have asked to be submitted identifies so many other areas that have even more pressing reasons for reform, and the article warns again of the confusion that may arise or will arise again and again as reform continues in these other areas as well as when the profession moves to the use of general principles in evaluating companies' presumptions rather than specific rules, and as we move to market values rather than fixing costs on historical basis.

Profits, says the article, may come to be stated as a range of figures, each of them arrived at by using different accounting assumptions. This, continues The Economist, may sound worryingly uncertain, but it may be better than trying to rely on a brittle illusion of accounting exactitude, which is liable to collapse during times of economic strain.

I suggest to you that the changes of accounting that are coming is because of a growing realization that we have for too long relied upon this brittle illusion of accounting exactitude. I suggest to you that the accounting difficulties of the past few years are in some significant part caused because of our reliance upon precision in accounting.

I believe Congress should suffer the transformation to continue. The role of self-regulation is intact. It has a far stronger oversight with a new public company, accounting oversight board, with a newly staffed SEC that has far more resources to do its job. I suggest to you an effort now by Congress to stop this fledgling effort will be a serious interference with the development of the accounting profession that we so badly need.

I have no love at all for the Black-Sholes formula. I sincerely hope that it is not adopted as a requirement for a corporate America.

More important, I very much hope that FASB and the SEC will allow flexibility in the costing of options, let different companies use different formulas. The fact that there will be no precise formula or no precise number should be a vivid illustration of the fact that much of the information in the profit and loss statements today, much of that information is equally imprecise.

If I may close by saying that Robert Frost—and this is as early as 1905, when he wrote a poem called The Hardship of Accounting: Never ask of money spent where the spender thinks it went, for no one was ever meant to remember or invent what he did with every cent. What Robert Frost knew almost a hundred years ago is beginning to be understood by us. I fear that H.R. 1372 will impede the development of that understanding.

Thank you very much.

Chairman BAKER. Thank you, sir. We appreciate your contribution this morning.

[The prepared statement of Roderick M. Hills can be found on page 158 in the appendix.]

Chairman BAKER. Our last witness is Mr. James K. Glassman, Resident Fellow, American Enterprise Institute. Welcome back, sir.

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Kanjorski, members of the subcommittee, I am concerned that the FASB is rushing to a decision that is not in the public interest and that it is ignoring serious critics of expensing stock options, among them not only successful business leaders such as Mr. Barrett but respected economists and a large number of financial and accounting professionals.

By the way, despite Mr. Herz' earlier response to a question, at last count opposition to expensing is running three to one ahead of approval in comment letters.

I strongly favor the approach in H.R. 1372. In my view, requiring the expensing of stock options would be a serious and disastrous mistake for three reasons:

One, by severely discouraging the use of a powerful incentive for employees at all levels, all levels, mandatory expensing is likely to have a dangerously adverse impact on innovation, economic growth, and national competitiveness. Options work. They align the interests of managers and shareholders, and they provide a powerful incentive to innovation and hard work.

Two, mandatory expensing is likely to confuse and mislead rather than further enlighten investors. You heard quite simply there is no way to value stock options accurately at the time they are granted.

Three, as a long-term strategy, mandatory expensing leads accounting policy in precisely the wrong direction. The expensing of stock options has become a prime example of an accounting fetish, a kind of obsession to reduce contingent liabilities and other forms of information about a company to a single number that can be included in earnings statements under GAAP, Generally Accepted Accounting Principles. GAAP earning statements in truth comprise only one view of a company's health and prospects, as my friend Mr. Hills just stated, and often a distorted one. Investors need many views, and they are poorly served when policymakers elevate GAAP to a kind of holy status.

These three points are discussed at great length in my testimony. But in my remaining time let me just address a couple of issues that relate directly to the role of Congress.

The FASB has a single mission which it states this way. This is a quote: "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."

Federal policymakers have a far broader mission. For example, they are responsible for encouraging economic growth, for preserving and increasing jobs, innovation and U.S. competitiveness. Even if the FASB is not—even if the FASB expensing proposal were cogent from an accounting viewpoint, and it is not, it would be the duty of Congress and the executive branch to consider its economic impact. I do not have to remind you. That is your job. You can't abdicate it, you can't farm it out to a group of accountants, however well-meaning.

In fact, Mr. Herz said earlier, he said that the moratorium "unduly intervenes." That is a quote. I disagree. I assume that you disagree, too.

Second, do not be intimidated by all this technical talk about accounting. Understand that accounting is not a science. It is not biology or astronomy. Accounting attempts to render in words and number the history and current status of businesses. The best way to do that is a matter of opinion. There is no single right way to do things. And often accounting rules allow choices and flexibility. And that is a good thing.

The current rule allows companies either to expense options at the time grants are made or to explain their possible effects in footnotes and then dilute earnings.

I discussed in my testimony a typical firm, Gilead Sciences, a biotech company. I just pulled the 10-K off a pile that I have in my office whose footnote extends to four pages. Now, understand that footnotes, if you never read a 10-K, and I am sure every member up there has, footnotes are printed in the same type as everything else in a statement. They are tremendously important. No serious investor would ever ignore footnotes. These footnotes show far more information, quite frankly, about options than they do about other more important aspects of the business such as intellectual property assets or cash compensation and leases.

The current regime is perfectly valid. The accounting profession and top academics are not united in their support of the change that the FASB proposes. As a result of expensing options, many firms, among them America's most successful and innovative, will be forced to take massive charges against earnings. These charges are likely to lead to lower stock prices and higher cost of capital for the firms. Companies, in addition, will be discouraged from issuing options in the future; and firms will be less likely to list on the public markets. The likely effect will be to reduce economic growth, U.S. competitiveness and job creation.

It is the responsibility, in short, and in conclusion, of elected public officials to weigh the economic costs and to act. I do not question the sincere desire of the FASB and its supporters to restore investor confidence through a mandatory expensing. But I have written a column for several large newspapers about investing for many years. I think I know small investors. It is my judgment that investor confidence will probably be affected negatively, if at all, and the economy will be placed at risk. This subcommittee under those cir-

cumstances cannot sit idly by and watch new accounting rules imperil what is today a tender and tentative recovery.

Thank you.

Chairman BAKER. Thank you, Mr. Glassman.

[The prepared statement of James K. Glassman can be found on page 102 in the appendix.]

Chairman BAKER. I will start out by talking about the current environment we find ourselves in, especially in light of distinguished Chairman Volcker's comments advising the committee to be careful in moving forward on any of these subject matters.

I can go back in financial services in this decade with regard to proposals relative to the treatment of derivatives, the adequacy of loan loss reserves. There have been any number of occasions when there have been public expressions concerning the manner in which disclosure should be made. I suspect that will continue. In fact, the FASB approach today is not to act precipitously but to engage potentially in public roundtables or public hearings to further assess the feelings of those in the enterprise in the stake-holding business as to their view of the proposed rule modification.

To that end, I think it is also important to confirm what you characterize, Mr. Hills, as the brittle illusion of exactitude, that in fact in this effort we should move quickly beyond the issue of the expensing of options and look at the adequacy of the current reporting methodology in the broad sense in light of the significant changes in the way our economy performs today versus two decades ago, much less the last 50 years.

In an earlier exchange, I was asking the FASB representative concerning the appropriateness of XBRL and having a much more rapid reporting of material fact that is principles based instead of rules based. Just in editorial comment, our system is defective; and the fact that we find, as a policy perspective, deficiencies, for example, Sarbanes-Oxley, requires us to act.

I guess what I am suggesting is that we don't really have to run very fast to stay ahead of the historic pace of FASB in promulgating regulations. This ought to be a complementary approach where we can have a public discussion, allow professionals to reach their conclusions but, at the same time, evaluate whether those conclusions fit in the context of our current economic condition.

I am worried unless we get to real-time material fact disclosures that everything else is throwing very small life jackets overboard to people in very deep seas when they really need a whole new vessel. I don't know how we get there, but I suggest that, rather than this being an inappropriate exploratory activity, it is highly appropriate to fully understand how this expensing of options and the reform associated with it fits into the broader picture of reform of our whole financial reporting system.

I don't really have a question, but I just sense that we are also all so focused on the expensing aspect the bigger picture is passing us by and that is far more important because of the inevitable changes that are likely to come.

Mr. Hills, would you want to respond, given your concerns?

Mr. HILLS. I appreciate that.

I also want to pay a compliment to my friend, Mr. Glassman, who has made a wonderful argument for eliminating the profit and

loss statement. But, unfortunately, we have one; and it is going to change.

This Economist article which I recommend strongly says we may be looking at ranges of values. We will not have an earnings per share that we can look at with precision. We may look at a place where different companies will make different assumptions as to what they did—the assumptions they used in coming to the concludes they came. It will be ambiguous. It will be of concern. But I think it is better the people understand the ambiguity rather than think it is not ambiguous.

As I said before, there is no reason why an analyst today, a good one, can't look at the information in the financial papers and figure out in some fashion what he thinks the cost is of a company. Because, believe me, some companies abuse options enormously.

Chairman BAKER. Let me jump in. At this point, as opposed to taking the current methodology of a snapshot of a current corporation of a date certain with given facts that are in effect on that specific date, we really ought to have a motion picture analysis where you can take in variables of your choosing that you plug into a system that then quantifies your predictions about corporate performance in light of the conditions as you view them, interest rate risk, credit rate risk, customer satisfaction surveys. There is a whole array of things that tell you where the company is going as opposed to where it has been. That is the problem, is that the current system looks back and gives you an old snapshot. It doesn't tell where the corporate leadership is taking the company over the next few months.

Mr. HILLS. I think that is right, but you need a freeze frame once a year.

Chairman BAKER. But the issue is, on what do you base the freeze frame? Is it mark to market in current time? I think we have the technology today to get us to a mark to market on a daily basis.

Mr. HILLS. We are moving, as I said before, like it or not, inexorably toward market values rather than historic costs and trying to understand the values of corporations; and that is going to be a rocky road to get from one place to another.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, I find myself in a peculiar situation here on this side of the aisle. We are supposed to be the pragmatists and the liberals, and I find myself arguing for Edmund Burke's theory that you don't change it if it is not broken and you maintain something until it gives value.

Here we have a long-term attempt to take professionals, create FASB, empower them to establish these rules and principles. We now have a process we are going to a global market looking for standardization and transparency so that securities can be traded world wide and we can have a view. And yet we are sitting here as the Congress second guessing and much inferior to the experts I may say at FASB or in the corporate world. We are imposing on a single basis whether or not we are going to expense one part of stock options or not expense it and worried a little bit about the impacts.

Mr. Barrett, I have a great deal of respect for you and your company, but do you really believe that that $3 billion that doesn't show up, that the analyst and the people that are making that evaluation, if we change this rule and you had to expense that $3 billion in stock options that would appear on your sheet, suddenly wouldn't be explainable and understandable and that it would just have a tremendous effect at driving your stock value down on the market?

The reason I pose that question to you, if that is the case, then Mr. Glassman and others that have testified aren't correct that people are paying any attention to the profit and loss statements. You already show that information in one place. Now it is going to move to another place in the profit and loss to be reflected, and yet you seem not to have very much faith in the analytical community or the investor community if that is going to so impact on your individual stock.

Mr. BARRETT. As the CEO of a company, I can't say I have no faith in the investor community. The analyst community is a different topic.

Mr. KANJORSKI. Touche.

Mr. BARRETT. My comment was merely that Mr. Sarbanes was here earlier. I do get to certify my results every quarter, transparent to the investor community, et cetera, et cetera. I would suggest that $3 billion is big enough to be noticeable in a certification process. It is big enough to be noticeable by an investor. It is big enough to swing the tide. If that is an error, then everything I do for Sarbanes-Oxley is trivial. I worry about $1 million and $10 million issues on the financial statement.

Mr. KANJORSKI. Mr. Barrett, I understand that. But I think Mr. Hills' point is that we are getting so raptured in absoluteness in accounting when, in fact, it is just another way of getting a snapshot. The problem I am worried about is now corporate America that has been using these stock options are coming for a release or a protection to the Congress of the United States, and we are going to start establishing this precedent that every element of our corporate structures that get impacted in some negative way by accounting rules proposed by FASB in the future, they don't have to worry about that. They just turn it into a political issue. Come on up here to the Congress, probably no greater informed than the average investor in America.

And I don't have a great deal of respect for that standard of—in spite of your feeling, Jim, that they are so well informed, do you really want us up here to turn this into periodic political issues as to what we do with expensing? It isn't very sexy. It isn't very attractive. And you are going to be dealing with people making these decisions on an ad hoc basis that could be very dangerous for corporate America, for the accounting profession and what it represents to get any insight on reliability. You know, we are just going to be where the numbers are, where the administration feels we should come down.

In this instance, so many of the respected people in our society seem to come out on the favor of doing the expensing. I mean, Paul Volcker is certainly equal in stature to Mr. Greenspan; and they are both in favor of expensing. And I think they make an adequate

point. If corporate America can take a tax deduction based on the expense, why in the world can't it show it on its balance sheet? If I had my way, the statement would have to be identical to the tax statement so that we have reality there instead of these special provisions.

Mr. BARRETT. But you know that the tax laws are substantively different from the accounting laws across the board.

Mr. KANJORSKI. But why, Mr. Barrett? Because every time we have a tax bill on the Hill corporate America fills these halls with lobbyists who get their special provisions and their special ways. Now there is no rhyme or reason between what is good tax policy and what is reality in what should be taxed because everybody and their mother's uncle have a special provision up there.

Mr. BARRETT. Thirty years ago, Congress decided that it would be a tax-neutral event to tax stock options; and, therefore, they gave companies that depreciate a deduction associated with that.

If I could give you one thought, though, with regard to your earlier comments.

Chairman BAKER. Let me interject, if I might, with a little bad news. Not to cut Mr. Kanjorski off, we are down to 5 minutes on three votes. There are members who have expressed significant interest in coming back after the break for the votes. I don't know that each of you—of your schedules, but Mr. Volcker possibly could come back. If you are available, we would like to recess at this moment and return, and that way we can give adequate time for members to follow up on their questions. Is that appropriate?

Mr. KANJORSKI. Very high-priced talent here, but if they will remain.

Chairman BAKER. We leave it at their scheduled availability. We certainly understand if you cannot. But we will be gone about 20 minutes.

We stand in recess.

[recess.]

Chairman BAKER. If I may, I will call our subcommittee meeting back to order.

To continue, Mr. Kanjorski was into his questioning; and we will put 2 minutes on the clock to pick up where you left off, if you would like to pick up.

Mr. KANJORSKI. I know it was a great question. I just can't remember it. It was the issue on—Mr. Volcker pointed out if the corporation can take the tax deduction, obviously that requires a calculation of what the value is. Why can't we just disclose it on the form? Why shouldn't we have parity in those two things? I will throw it out to the committee as a whole.

Mr. BARRETT. Well, are we trying to align accounting principles with Tax Code? I mean, it is my understanding that 30 years ago when Congress decided that options were taxable income they assigned some value to them, they did a tax-neutral assessment and allowed the corporations to take a deduction.

Mr. KANJORSKI. Right. The point I guess I want to make is, if you asked, in my opinion, 100 common people walking the street, most people would assume that, whatever your report is, a profit as a corporation is also taxed as a profit. They don't understand the double or triple accounting of tax difference.

I have to tell you something. We went over to vote—I am not going to name the Members, but several Members were relatively shocked when they found out—you mean they are not paying taxes on these options? Or they are not—or they have given a tax deduction on these options when in fact they are not reported on the sheet?

So don't overestimate the knowledge of the Congress or the American people. Most of us would like to think simplistically of how things are going, and every day we spend here in Congress we get more confused.

Mr. BARRETT. I get more confused every day I read the Tax Code.

Mr. KANJORSKI. Do you have any suggestion on Mr. Volcker's idea that if we are going to use it for tax deduction it should be able to be reported?

Mr. HILLS. Well, I have to say, in fairness, the Tax Code is a different bargain than the accounting rules. So I don't think you can insist upon consistency since there is a hobgoblin of inconsistency. So it is a good argument, but I would rather rely upon the fact that we do have GAAP with all of its weakness.

We do have a profit and loss statement, whether we should or should not. We do have a requirement of an audited statement. People can argue about all of those things, but we do have them, and so we should make them as good as we can make them. I say soldier on.

I must say I think this hearing and the airing of this subject is terribly important, and I do think that Congress should not be unaware of it. I can imagine that there are times when Congress needs to step in. I think it is premature now. I don't think the hearing is premature. But it is going to be another year, perhaps, or more before it moves.

We will know a lot more about this subject when FASB sends out its pronouncements, and I think we will all be comforted by the period that this is happening. I truly believe that Intel will be able to have the same option program it had today, even if FASB finds a way to require that options be valued in some fashion for purposes of earnings per share.

Mr. GLASSMAN. Mr. Kanjorski, I associate myself with Mr. Hills' remarks. Not the last one about the option program. I think Mr. Barrett is the best expert on that.

But can I comment on something you said earlier about Edmond Burke and not kind of changing things just to change them? If we accept your argument, which is that there is enough information out now or that the information today if it is sufficient is not going to change the value of the company if expenses—if options are mandatorily expensed, that seems to me just as good an argument for keeping the current regime. So I think Edmond Burke would probably say, well, we have had it for 30 years. Why not continue it? Why make the change if the information is currently on the table?

Mr. KANJORSKI. I guess the argument to that is, then why have FASB and why have an attempt to go to international accounting? And then basically what—I just think, Mr. Glassman, what you are doing is you are telling the Congress that we are the final arbiters of all these individual rules and regulations on how we do things.

And we like to think that of ourselves, but then you are talking about the whim and fancy of Congress as it changes every 2 years. I am not sure we are going to get the standardization. I am not sure we are going to get to some certainty, not numbers certainty but at least form and process certainty.

Mr. GLASSMAN. One last comment. I absolutely respect that position, Mr. Kanjorski, but I think that this is clearly an issue that for good reason has disturbed a very important sector of the U.S. economy. I mean, I think we need—I have I think—just as you respect the idea that you don't intervene in every last little accounting issue, I also respect the fact that the engine behind this economy over the last 10 or 20 years really has been high technology; and high technology firms are very strongly opposed to this. And I think that they—among others. And I think we need to—you need to examine it for that reason. And you are examining it today, and I congratulate you.

Chairman BAKER. Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

I am amused by the thought when Chairman Volcker was here—when Chairman Greenspan comes, the traders all hinge on everyone's remarks. I am amused by some poor trader in the options pit trying to follow this discussion today, pro or con, and what their reaction is.

One of the reasons I am a capitalist is that I enjoy immensely the dynamic nature of the economy. I think the issue that I would like to explore is, when we talk about American standards of corporate transparency relative to reporting this or that on the financial statements of American corporations, relative to perhaps the standards in the International Accounting Standards Board which, correct me if I am wrong, is largely focused more towards the European-type of corporation, we end up missing where most of the growth seems to be occurring now in the world economy and that is around the Pacific Rim.

One of the tools that our corporate leaders use to attract talent, obviously, is compensation in one form or another. I would be curious particularly of Mr. Barrett's input as to, as America's leading-edge corporate entities compete for talent in the world economy, what is the value or use of options? And if we depreciate that value by whim or fancy of Congress what the impact of that will be.

Mr. BARRETT. I think you can get the right vector, the right direction if you look at just what has happened in the last 10 years.

First, if you look at Taiwan, with the growth of the high-tech community in Taiwan which basically grew at the expense of U.S. firms because it was basically hiring U.S. workers back to Taiwan with options and start-up companies, you then just follow that point in time to what has happened in mainland China, what is happening in India. Mainland China, it is more in the manufacturing side; and in India it is more in the software side.

If you look at both of those countries or all three of those geographic areas building up, you look at the fact that the U.S. educational institution is still the best in the world at creating highly educated technical personnel. Roughly half of the Ph.D.s that graduate in the physical sciences in the U.S. are foreign nationals. They are increasingly going home. They are not staying here. And if you

put U.S. corporations at a structural disadvantage I think you will just accelerate that.

That is where the action is in the future. The action is not in western Europe. The action is in Asia. You take Intel as the proxy. Asia Pacific, excluding Japan, is our biggest marketplace today, bigger than western Europe, bigger than the United States and growing much faster than either.

Mr. OSE. Are you suggesting that, to use Mr. Kanjorski's phrase, the whim and fancy of Congress may lead to unintended consequences of exporting of these high-tech jobs to an even greater degree than perhaps might be occurring today?

Mr. BARRETT. I think that is the potential danger, yes.

Mr. OSE. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Sherman.

Mr. SHERMAN. I have so many comments I would be asking folks to respond in writing to some of the questions that I raise here.

The first point some of you have talked about, principles based rather than rules based accounting, please don't do it. Don't move in that direction. Investors need solid information they can rely upon.

Imagine if we had rules for determining, okay, how much will an appropriations bill cost. We could possibly agree on something that narrow. But if instead we wanted to apply the big principle of is it a fiscally responsible appropriations bill, I suggest you and I might disagree.

Imagine if the Chair of the Appropriations Committee could hire me to opine on the fiscal responsibility of his appropriations bill. I do think, though, that you could ask for three or four different pro formas, each prepared with strict standards.

Keep in mind that these auditors are selected by and paid by the company, just as we wouldn't have the Chair of the Appropriations Subcommittee selecting who is going to opine on the fiscal responsibility of his or her bill.

Chairman Volcker raises an interesting issue, and that is that the present system wildly distorts our executive compensation system.

Imagine if you had a cash-strapped company that was trying to provide incentives for its workers and managers. That company might set aside a million shares to be given as bonus shares. Top management might get the shares not based on whether the stock price goes up but whether it goes up compared to an index of companies in the same industry.

Because good management doesn't just ride the wave, good management outperforms the wave. You might give the division head bonus shares based upon the success of his or her division. You might give employee shares based on that employee's department. But if you did any of those things you would be using shares to compensate employees in a logical way. You get penalized by GAAP because, as I understand it, correct me if I am wrong, all of those methods would be expensed because you are giving shares to employees based on something other than the plain vanilla stock option plan.

Another company in the staple industry decides, oh, we are just going to have stock options for everybody. So some division head

realizes that the success of his or her division slightly influences the company, provides some incentive.

Now I don't know which of these two systems is the better way to compensate executives or employees, but you do know that companies should decide that, without GAAP telling them, that they are going to be tremendously penalized if they choose anything other than stock options.

On the other hand, the Black-Sholes formula charging income when the options are granted seems pretty distortive. If you bring in an executive and say, Jack, you are doing a good job, here is a 3-year contract, and we are going to give you a raise, the cost of that compensation is charged over the 3 future years in which that executive works. But if you call him in and say, you are doing a great job, here's a 3-year contract, we are not going to give you a raise, we are going to give you options, then under Black-Sholes you charge income the year you give the person the raise rather than the 3 years that that person is going to work presumably for the company's benefit. Do I have that right?

Mr. VOLCKER. I should not pose as an expert in this area, but my understanding is that what the international body suggested in their exposure draft—they haven't decided yet—is that you would amortize.

Mr. SHERMAN. That you amortize it over a length of time.

Mr. VOLCKER. Right.

Mr. SHERMAN. I have been told something else. But clearly if you have a stock option designed to provide an incentive over the period of time when the employee holds that option, that the cost is amortized over the period of time and that would eliminate that concern.

I agree with several panelists that nothing we do on this stock option would have solved the Enron or the corruption thing. Managers are always going to have it in their interest to overreport earnings, and the corrupt ones will do that unless the auditors prevent them from doing it. The idea if they didn't have stock options they wouldn't want to overreport earnings—there are so many reasons to want to overreport earnings.

I will ask, starting with Chairman Volcker, if you have any comments to the——

Mr. VOLCKER. I don't fully agree with you on your last point. I fully agree that there are the lot of reasons that go into corruption or fraud or pressing the envelope too far, but I am afraid that we do see some evidence that the nature of fixed price stock options creates a temptation that adds to other incentives they might have.

Let me quote, if I may——

Mr. SHERMAN. If we didn't pay our managers so much, then maybe they wouldn't have as much incentive. But can you think of any way of rewarding managers for success of a company that wouldn't cause them to seek to distort any measure of the success of the company?

Mr. VOLCKER. You, I think, have a problem. I think some methods are more vulnerable than other methods. There is tremendous leverage in a stock option.

So let me just read, if I may, a comment which I found interesting. It was by a dean of a business school who formerly was a

strong advocate of stock options. He said, "mea culpa. You know, it was a simple idea. We compensate managers with company stock or options so they will do the best for the shareholders. It doesn't always work that way. Motivating managers with company stock can damage on a grand scale, encouraging them to pursue strategies to fatten their wallets at the shareholders' expense. Consider the trajectories of Enron and its ilk as well as a host of dot coms, companies devastated by managers motivated by powerful stock-based incentives."

Mr. SHERMAN. I understand you can find people wailing and bemoaning stock options and doing it in good prose. But is there any way to provide large incentive payments to managers based on a measure of their performance that would not be subject to—would not provide an incentive to managers?

Chairman BAKER. That will be the gentleman's last question.

Mr. VOLCKER. Are there any that are perfectly——

Mr. SHERMAN. Or even less likely than stock options.

Mr. VOLCKER. Restricted stock which you have to hold for some time, taking the ups and down of the stock and hold it for a considerable period of time beyond the vesting period. That has a quite different incentive. Even stock options, if you were required to hold them for, let's say, your whole period of employment, would reduce the incentive you have to do short-range manipulation.

So it is the matter of degree. It is not——

Chairman BAKER. The gentleman's time has expired.

Mr. Chairman.

Mr. OXLEY. Thank you, Mr. Chairman; and let me welcome this outstanding, all-star panel. I made a special effort to get back because I did want to, first of all, welcome you and, many of you, welcome back. We have some veterans here who have testified before this committee more than once. But we are delighted to have all of you here and to have your knowledge and participation.

Mr. Volcker, fixed-price options are an exceedingly popular way of providing compensation. Why haven't more companies used performance-based options in that respect?

Mr. VOLCKER. Well, I think one reason—I will give you two reasons. One reason is that the performance based options, I think it is an anomaly, are expensed. So if you are worried about how your immediate impact is going to be on the earnings statement, you are biased towards fixed-price options.

I once was the director of a company that had performance-based options, and I think it was an appropriate way to do it, but it does get into a lot of arguments about exactly how you measure performance. Do you do better than your competitor's stock price? Do you set some hurdle rate for return on capital?

Mr. VOLCKER. Do you have a price-earnings ratio?

There are a lot of different measures you can take, but I know we spent a lot of time arguing about it. So it is more complicated, but it makes I think, by and large, on the face of it more sense than a fixed-price option, which demonstrably has capricious results, because it is so affected by the total change in the stock market rather than the performance of an individual company.

You know, American managers suddenly didn't become geniuses in the 1990s compared to where they were in the 1980s. At least,

they weren't six times more genius, but that is when the stock market went up. Then it goes down by 50 percent. I don't think they are all stupid. So you get very capricious results. It has got quite a lot of resemblance to giving a lottery ticket, because so much of the result is not dependent upon the performance of the particular company.

Mr. OXLEY. Mr. Barrett, do you have a comment on that?

Mr. BARRETT. I think I would echo some of Mr. Volcker's comments. It is complicated to decide exactly what metrics you would choose, and you get capricious results on either side. The market can go up or down without you, and should you be benefited by that or disciplined by that is always the question.

We have adopted a fixed-price option. It is relatively simple and straightforward. If the shareholders benefit, then they only benefit when the price goes up. Then presumably you are doing a good job for your shareholders, not perfect but very simple and straightforward.

Mr. OXLEY. Mr. Hills.

Mr. HILLS. Devising a compensation policy for any company is a marvelous task. Cash, stock options, deferred compensation, retirement benefits, health plan, it is a complicated transaction. A lot of it should be based upon performance.

Personally, in the various boards on which I have sat, we have always had performance-based stock and some performance-based options. We found performance-based stock is probably a little easier to work with, is less volatile, but, as Chairman Volcker said, the decision to use these things is controlled by GAAP policy more than it is by common sense.

Mr. OXLEY. Interesting.

Mr. Glassman.

Mr. GLASSMAN. The use of stock options, it seems to me, is the purest way to align the interests of management with those of shareholders. The price of a stock is the best manifestation of a company's value. It is better than any kind of performance-based measure because millions of people are voting on what the value is every day. It is not perfect. Absolutely. But it really is the best.

So if you want to align the interest of managers and shareholders, which is what companies want to do and should want to do and which was not done, by the way, to a great extent in the 1970s—we got into trouble for that—the best way to do it is through stock options. And frankly, obviously, there are some risks to be run there, the temptation to manipulate in some way the stock, but I don't think there is any way to avoid that unless you bar managers from owning stock period, and that wouldn't be a very good idea.

Mr. HILLS. Let me comment, Jim.

The best way to align the shareholders' interest of management is with stock, not stock options. You find yourself—I found myself more than once in a situation where you have to make a decision on a board or on a company, and if that decision means you have nothing, which is what happens if the stock goes along a certain point, that affects your decision, as distinguished from the stock goes down a buck. If the stock goes down a buck, you may have lost 50 bucks. If the stock goes down a buck, you may have lost all

your options. So I would say to you that the best way to align stockholders and managers is with stock.

Mr. OXLEY. What about that, Mr. Glassman?

Mr. GLASSMAN. I think stock is a good way to align the interests of stockholders and managers. There is a very interesting paper on the differences between the two which I cite in my testimony and I am happy to introduce as an exhibit.

I do think, however, that options in some ways because of their leverage, because the increases are so dramatic, that makes it a much more important incentive for managers. I think options are a very good way to do it, frankly, rather than awarding stock.

Mr. OXLEY. Mr. Volcker.

Mr. VOLCKER. It is—just an obvious problem with a fixed-price stock option is you gain when the leverage goes in your direction; you don't lose when it goes in the other direction. That is a silly kind of incentive, frankly, for any manager. You can get a fixed-price stock option, and compare to the performance of the stock of a company that did no better than the interest on a government bond in the 1990s, you make a lot of money. Now, is that a great incentive? I mean, you took no risk of loss, and you made a lot of money when the shareholder would have been better off buying a government bond.

Mr. GLASSMAN. I would say, Mr. Volcker, that if your compensation as a CEO is 50 percent or 30 percent or some large number tied up in stock options, that if those options become worthless that is a big hit to you.

Mr. BARRETT. Could I offer one comment?

Mr. OXLEY. Yes, Mr. Barrett.

Mr. BARRETT. I read an interesting summary by the proponent of expensing stock options who alluded that there would be immense innovation in the field of executive compensation associated with this whole movement. I was dismayed by that for the following reason. The way companies are successful is we have innovation in products and services and we compete in the world's marketplace. If all we get out of this is a discussion on innovation and compensation strategy, I think we will have collectively lost.

Mr. OXLEY. Mr. Chairman, my time is expired. Let me once again thank our distinguished panel. This has been a most interesting day—I think the Chair will agree—and one of our better hearings that we have had because of the quality of witnesses that we have had. I yield back.

Chairman BAKER. Absolutely. Thank you, Mr. Chairman.

Mr. Shadegg.

Mr. SHADEGG. Thank you, Mr. Chairman.

Let me start out with what I think are some points of agreement, and if I am incorrect, please let me know. Let me start out with a premise that I think all of you are agreed that stock options are not the cause—were not the cause of the Enron WorldCom scandals with which we were faced a year ago and that this committee dealt with. We all agree that they are not the cause?

Mr. VOLCKER. Sorry. I don't agree with that. I think they were probably a contributing factor.

Mr. SHADEGG. Okay.

Mr. HILLS. I would say that it is a contributing factor. Certainly not the dominant factor. In many of the scandals it was a contributing factor.

Mr. SHADEGG. Let me try one that I think you will agree with. I believe we all agreed, particularly, Mr. Volcker, you and Mr. Hills agreed that there were bigger problems facing us in terms of corporate accounting than in terms of the stock option issue. Is that correct?

Mr. BARRETT. Yes. I think all three of us—or four of us might agree on that topic.

Mr. SHADEGG. Yeah. I think we all agreed on that, but particularly the other two.

I think there was agreement that valuing is difficult and imprecise, and I think both Mr. Volcker and Mr. Hills would agree with that, even though Mr. Barrett and Mr. Glassman are stronger critics of the ability to value stock. Is that right?

I think we also have agreed that broad-based stock options—and here it is particularly Mr. Barrett and Mr. Glassman have said broad-based stock options are a good vehicle to give employees ownership in a corporation, to give them a sense of ownership, to tie them to the company, but I think there is all agreement across the board that broad-based stock options have a value in incenting employees and making them a part of the company.

Mr. VOLCKER. I agree with that, but I don't know if they can do it more effectively than giving them stock or a performance option.

Mr. HILLS. I must also say it is company specific. It is quite true of a wide range of companies that broad based is terrific, but there are a whole lot of questions that it doesn't make any sense at all.

Mr. SHADEGG. Mr. Glassman made the point and Mr. Barrett that they are very important in incentivizing particularly in the high-tech field but generally across the board, and I didn't find a disagreement with that amongst the other two witnesses.

I think there also is agreement across the board that narrow stock options limited just to top management can in fact distort corporate conduct and hurt the overall interest of the corporation. Are we pretty much agreed on that?

Go ahead, Mr. Barrett.

Mr. BARRETT. We continue to get into this corrupt actions by senior executives. It is not clear to me always that stock drives that one way or the other. There are certain rules of conduct we all ought to be obeying if we are CEOs. If we obey those rules of conduct, we don't trade on insider information, we don't do things untoward to the P/L, then I don't see an issue. But if people want to be criminals, they will be criminals.

Mr. SHADEGG. I agree with that.

The point I thought there was agreement on is that a narrow stock option could in fact distort the conduct of some corporate executives even when it is not illegal, causing them to highlight temporary profits for their personal gain. I guess I will concede to you that that leads me to the conclusion that expensing looks like a solution in search of a problem.

I guess I want to ask you, Mr. Hills, if we are agreed that any particular valuation method will in fact be somewhat accurate, a point more strongly held by two of your panelists than by you. Why

isn't it better off to simply rely on the current disclosure mechanism and allow competing mechanisms for valuating those stock options in the marketplace rather than prescribing a single one which will have whatever inherent defects that particular method for valuating them is?

Mr. HILLS. I would say two things. First, it is not that it is inaccurate. It is that it has a lack of—it has an area of imprecision, no greater, as Mr. Herz said, than other things in the P/L statement. There are imprecisions in many parts of the profit and loss statement. Imprecision in cost recognition, for example, dwarfs any imprecision you get in the cost of a stock option.

Mr. SHADEGG. So aren't we just shifting the imprecision created by the current footnote structure where you gather a certain amount of information and all of the observers of the market can look at that footnote information and make their valuation of what those options do to the corporation's actual profit and loss position versus a prescribed method where we say, okay, this is the way you will valuate these stock options. And now we have prescribed one error. All we have done is shift the imprecision, I would argue, from one place to the other. But the unsophisticated now believe, well, this is the right answer because government, FASB in this case, mandated it.

Mr. HILLS. This is a good argument for not having an earnings per share conclusion. But if you have an earnings per share conclusion, there are things that ought to be in it. Cost recognition ought to be in it. Cost earnings options should be in it. There may be, as I indicated from The Economist article, a range of assumptions that may be chosen differently by one company from the other, so there will be flexibility left hopefully in doing it, but imprecision has never been a reason for not putting something in earnings per share.

Mr. SHADEGG. I guess the second question I have is, doesn't your argument against precision accounting, which I thought was a fascinating argument, auger against expensing stock options and having the FASB prescribe the method in which they will be valued?

Chairman BAKER. If I may, let that be your last question so I can get in one more gentleman in before Mr. Volcker has to leave. And to whom was that addressed?

Mr. SHADEGG. Mr. Hills.

Mr. HILLS. My answer is that, first of all, I am not against precision. I just can't find it.

Mr. SHADEGG. But if we can't find it now, are we going to find it any better with FASB prescribing expensing and how?

Mr. HILLS. There is a degree of inexactitude in accounting and the trick here——

Mr. SHADEGG. I thought you made that point compellingly.

Mr. HILLS. And the trick here is to do as good a job as you can for only one measure of the value of the company. One of the problems here is our analysts aren't trained enough to look at other values. Earnings per share ought not to be the controlling factor it is in valuing stocks.

Chairman BAKER. Thank you, Mr. Shadegg.

I am understanding you to say that we have that snapshot once a year, but it may be kind of fuzzy when we look at it?

Mr. HILLS. Yes. You need glasses.

Chairman BAKER. Thank you.

Mr. Shays.

Mr. SHAYS. Thank you.

I am sorry you gentlemen had to wait so long and then we had to have the break. I have been here 16 years, but I feel like you all know more on this issue in your pinky than I know on my entire body, but maybe that is why we have witnesses. But I can react to what you are saying, and some of it to me is just on the face of it somewhat hard for me to come to grips with.

I mean, Mr. Glassman, when you talked about FASB rushing into a decision, I think they act slower than a turtle. You know, I don't feel there is a rush to a decision. I feel like this has been an issue that we have been debating for years, and they are finally doing what they should have done a while ago. So I am just reacting to that and would love to hear your comment of why it is a rush.

I feel—and I am looking for reaction. I am asking myself, is the question we don't want investors to know the truth or is it we want them to know the truth, we just don't know what the truth is? But somehow we know how to tell people when we expense it it has value, and somehow we think—and I am reacting again to you, Mr. Glassman—that we say, you know, investors are smart. They read the fine print.

Well, a lot of investors don't read the fine print. They don't read anything. They just invest. And maybe that is their problem, but it seems to me that if investors are smart enough to read the fine print, they are smart enough to recognize that the company may not have the same value on the marketplace for some dumb reason, because all of a sudden they have to expense it. And it would seem to me they would say, well, part of the reason why they are valued this way is they had to expense it. But to me it is—I mean, disclose that.

But to me as an investor, I would say, hey, this is undervalued stock. Now, maybe I am just all screwed up here, but I would like comments.

I would also like comments on the other issue. It used to be we took the lead and the ISAB followed. It seems to me because we have not seized the initiative the ISAB may be taking the initiative. If they then decide that this has to be an expensed item and we don't, what challenges are involved with that?

So I mentioned Mr. Glassman's name more than once. Why don't you start?

Mr. GLASSMAN. Thank you, Mr. Shays.

The reason I use the word "rush" is certainly FASB has taken a long time to get to this issue, but I think under new management it seems to be moving very, very quickly and I think too quickly, but that is a matter of judgment. Mr. Herz said that there are people—why is it moving quickly? Because people are not—groups are not only supporting but demanding some kind of action.

On this fine print—and I think that is a very important question. First of all, it is not fine print. The print is as big as it is for the P/L statement. So it is not fine, but it actually provides fine information, important information. About half of Americans own

shares through mutual funds and other institutions, and I would hope and I know that the managers of those institutions in fact do read the footnotes. And if they don't, they shouldn't be in their jobs, and they certainly do. So that information is there.

The point I was trying to make in my testimony—and it is not, as Rod Hills said, that I don't believe in P/L statements. It is just that——

Mr. SHAYS. It was a funny comment, and you didn't laugh.

Mr. GLASSMAN. You are right. I didn't laugh, because I think——

Mr. SHAYS. That was the high point of the whole damn hearing, frankly.

Mr. GLASSMAN. Well, now I am going to provide you with another high point. It is not that I don't believe in P/L statements. I think they are very, very important, but I think they are only one way of valuing a company.

Let me quote the sainted Warren Buffett, not on public policy but on something that he really knows a lot about, which is investing. He says, how do you value a company? You just want to estimate a company's cash flows—notice he says cash flows. He doesn't say earnings or P/L statement—cash flows over time, discount them back and buy for less than that.

Mr. SHAYS. See, I think he told you that so you would make bad investments and he could keep making good ones.

Mr. GLASSMAN. That is true, but I own his stock. So the point is cash flow is tremendously important.

I think we are headed for a revolution, and the Chairman recognizes it. He mentioned XBRL. Things are changing in accounting, and I think we are fighting the last war in talking about expensing. It is like this is a Crimean War, okay. What is happening more and more—and I wish FASB and the Congress and the SEC would start promoting this kind of thinking. We need more—there is tons of information out there that is okay. They use it every day. I think investors should have more access to it, and I actually believe that the current regime with the footnotes and all that stuff actually promotes that kind of thinking much more than trying to shoehorn a single number into a GAAP statement which doesn't tell you all that much about a company.

Mr. BARRETT. I think you have got a good representation of this just this last quarter. One of the 280 companies who have said or actually do expense options, Amazon.com, reported their quarterly earns. They did it precisely with a GAAP P/L and a pro forma P/L. Nobody paid attention to the GAAP P/L. They only paid attention to the pro forma P/L. What you are going to see is precisely that replicated across the board, and frankly I thought what we were trying to do was harmonize all this stuff so we would get away from pro forma P/L's.

But in this instance, which I think is representative of what is going to happen, people went back—you can shake your head, Paul, but this is what they did. They went back and looked precisely at the cash flow of that company. They didn't look at some arbitrary expense.

Mr. SHAYS. Home Depot and Wal-Mart now have spent——

Mr. VOLCKER. I am not shaking my head about what they do. I think you will find——

Mr. SHAYS. Well, let me just make this point before you start. Home Depot and Wal-Mart now expense, and has that proved to be a negative for them?

Mr. BARRETT. I think if you look at most of the companies that expense options, it is a de minimus impact on their P/L. They only give options to the top executives of the company. They don't have broad-based option programs. If Intel——

Mr. SHAYS. Yeah. It is broad based.

Let me just have Paul just respond if I could. You were going to say something, Paul, and I——

Mr. VOLCKER. I was going to say, on this pro forma thing, this has become a big problem, because companies do present pro forma earnings the way they like to present them, which means there is no consistency. I would be very disappointed if the accounting standards setters do not in the next few years promote a standard for a standard pro forma statement that they will make a judgment about what should be on the pro forma and what should not be on the pro forma, what should be on an operating earnings statement to get some consistency. Because if you just leave it in a jungle, so to speak, you do get below the lines the stuff they don't want to report, and the stuff above the lines is good stuff.

Mr. HILLS. Mr. Chairman, would you excuse me? I promised to give a lesson to 12 Russians on corporate governance at American University, and I really——

Chairman BAKER. I think this effort has been more challenging than your task. Let me express appreciation.

Mr. Sherman wanted to make a brief statement. Please leave at your leisure.

Mr. SHERMAN. Thank you, Mr. Chairman.

I want to agree with Mr. Volcker that we need standardized rules for the pro forma statements. If they are going to serve chocolate, vanilla and strawberry, there ought to be a fixed recipe for each one of those three ice creams.

I think the arguments against expensing options may go too far. You have said that we have to compete with Asia for capital and for talent, and anything that impairs that effort puts us at a disadvantage. I want to point out that maybe compensation for managers is a good thing, and we want to encourage it. And we want to make companies that compensate their managers look good compared to Asian investments, but if we are going to do that, wouldn't we do the same thing for employee education programs? Wouldn't we do the same thing for research and development programs?

If you buy that argument, then maybe it is critical that we as a Congress instruct FASB to say that employee education and research programs and maybe all management compensation of all types ought not be charged against income, since we want to encourage those things or some of them and we want to make our companies that do them look good compared to their Asian competitors.

There is this argument that option holders and stockholders have identical interests. I think those interests are wildly different when it comes to risk. If I am a stockholder and I see one policy gives me a chance at the stock going up 10 percent or maybe it will go down 10 percent, that might be a good plan. But if I am an option

holder, I would much prefer a company that has a chance to either double in value or go bankrupt, because whether it goes down 10 percent or goes down a hundred percent, I am in the same position.

Executives, however, are both salary earners, where they are going to want a low-risk approach so they keep getting their salary, and they are option holders, where they are going to want a high-risk approach. When an executive becomes primarily not a salary earner but an option holder, you have a strong incentive for a high-risk approach.

Chairman BAKER. Can the gentleman wind up? I have got somebody else that wants to make a statement before we leave.

Mr. SHERMAN. And that concludes my remarks.

Chairman BAKER. I thank the gentleman for wrapping up.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

I want to express my appreciation to one of our witnesses here. When I was a much younger man, I came out of college, went in the real estate business, and shortly thereafter was confronted with an inflationary environment that was, to say the least, challenging. Mr. Volcker played a central role in bringing that bear under control. If no one else ever says thank you, I intend to today. Thank you for doing that.

Chairman BAKER. If there are no further comments, I just want to express my appreciation to you for your time and your willingness to stay with us today. It has really been most informative. We look forward to FASB's conclusion of their work product, but I think this marks a beginning of our long-term review of the appropriateness of current accounting regimes and not to get into the professional aspects but to the goals of our accounting methodology, to assist in all shareholders and those who have interest in a transparent, free flow of information that benefits the growth of our economy. Thank you for your participation.

Our meeting is adjourned.

[Whereupon, at 2:37 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 3, 2003

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"The Accounting Treatment of Employee Stock Options"
June 3, 2003

Thank you, Chairman Baker, for holding this important and timely hearing.

The accounting treatment of employee stock options has once again become a widely discussed issue among policymakers and in the financial press. Reasonable people continue to differ on whether stock-based compensation awarded to executives and employees should be recorded as an expense in a company's financial statements. There is no consensus view on this issue in academia. The large accounting firms have recently reversed course, and now support mandatory expensing.

The pro-expensing camp argues that options are a form of compensation like salaries or bonuses or health benefits. As such, they are an expense that should be deducted from a company's income. Merely footnoting their cost, they contend, provides investors with an inaccurate view of a company's financial condition.

Those on the other side of this debate believe that options are never expenses to the company, and even if they were, there is no reliable or accurate formula to properly value them. Moreover, they argue, expensing would virtually eliminate broad-based option grants to rank-and-file workers, and would hinder innovation and economic growth.

In April, the FASB declared that options are indeed an expense that should be reflected, at fair value, in a company's profit and loss statement. This unanimous decision, although tentative, indicates the direction of the Board's approach to this issue.

The Board's public deliberations will continue over the next few months. Difficult issues yet to be resolved include a methodology for determining the value of option grants.

I am pleased to welcome my good friends, Chairman Dreier and Congresswoman Eshoo, here this morning. They have introduced the Broad-Based Stock Option Plan Transparency Act of 2003, which would require new disclosures regarding companies' stock option plans, followed by a comprehensive study to review the impact of this additional transparency. During this review period, no changes in the accounting treatment of stock options would be recognized. The legislation raises important questions that we will address today.

I commend Chairman Baker for inviting today's most impressive group of distinguished witnesses. I look forward to a thoughtful and provocative debate on the issue of stock option accounting.

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Congressman David Dreier
Testimony Before the House Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Tuesday, June 3, 2003

Hearing on "The Accounting Treatment of Stock Options"

Mr. Chairman and Members of the Committee, I want to thank you for holding this hearing today on the accounting treatment of stock options and for giving me the opportunity to talk about H.R. 1372, the Broad-Based Stock Option Plan Transparency Act.

There are some who have accused me and our colleague, Congresswoman Eshoo, of trying to politicize the issue of stock option expensing through the introduction of our legislation. For that reason, I want to begin by noting that unlike the Financial Accounting Standards Board (FASB), we as elected officials are the ones who have an obligation to American workers and investors to preserve an environment that allows entrepreneurs to grow our economy. The fact is that although the potential change in accounting treatment proposed by FASB may be arcane to some, it is in the real world that the negative impact of expensing will hurt the risk-takers who are creating jobs and wealth in this country.

For this reason, I want to commend you, Mr. Chairman, for holding this hearing and not being intimidated by those lobbing political attacks on many of us who have legitimate concerns about a mandatory expensing accounting standard. The reality is that when you examine FASB's proposed expensing rule, you will find that it is not a black and white issue. The discussion about whether to expense resides in a gray area, and the sole responsibility to consider the damage that expensing could have on American innovation, job-creation, and competitiveness rests in the hands of public officials.

How to achieve better transparency for investors should be the real goal of all sides of this debate. To submit that stock option expensing will provide better clarity to investors ignores the pronounced lack of consensus among accounting experts about how to value such options accurately. You will never arrive at a precise number when you attempt to value stock options that have not been exercised, may never be exercised, and are not tradeable in open capital markets. Existing pricing models, when applied to employee stock options, can produce widely differing results depending on subjective estimates that a company would have to make. As noted by Harvard Professor William Sahlman, "[i]f anything, expensing options may lead to an even more distorted picture of a company's economic position and cash flows than financial statements currently paint."

But valuation aside, you do not have to be an accountant to recognize that stock options granted to an employee do not cause the company to incur any costs. If one looks at the definition of an expense, *i.e.,* anything that results in an outflow of a company's assets or an increase in a company's liabilities, employee stock options meet neither test. Let us propose for instance, that on January 1st, 2003, Company A hires a computer programmer at a salary of $50,000 per year plus 100 stock option grants that can be exercised at a price of $10 no earlier than 5 years from date of hire. What is

Company A paying out on the date of hire and throughout the ensuing 5 years? Only the cash salary and nothing for the options. There is no cash outflow for the options and no liability created at any time; not when they are granted, vested, or are exercised. Indeed, when the stock options are exercised, the company actually receives money.

Congress cannot divorce responsibility for accounting standards from the very real impact that a particular standard will have on investors and on the economy. Mandatory stock option expensing not only threatens the high-growth sectors of our economy but it will actually result in investors receiving inaccurate information about a company's use of employee stock options.

We stand on the side of investors in recognizing that while stock options do not incur a cost on the company, they can clearly impact shareholder value. Revisiting my earlier example, if Company A's net income is $100,000, with 1000 outstanding shares, the additional 100 shares given to the newly-hired computer programmer potentially dilutes the earnings per share for existing shareholders to $90 per share or 10%, if those 100 shares were exercised on the date of hire. That is precisely the type of information that investors need to have: how stock option grants impact their shareholdings.

Our legislation seeks to give them that information in a uniform and standardized format. Its objective is to improve the transparency and disclosure requirements for all publicly-traded companies issuing employee stock options, whether they are given to high-level executives or lower-level workers.

The Broad-Based Stock Option Plan Transparency Act of 2003 directs the Securities and Exchange Commission to issue regulations that enhance reporting disclosures in their annual and quarterly reports that will include at a minimum:

(1) "plain English" discussion of share value dilution, including tables or graphic illustrations of the dilutive effects;
(2) expanded disclosure of the dilutive effect of employee stock options on the company's earnings per share number;
(3) the prominent placement and increased comparability of stock option-related information; and
(4) a summary of stock options granted to the 5 most highly compensated executive officers, including any outstanding stock options.

The SEC will not be permitted to recognize any new accounting standard related to stock options until they have submitted a report to Congress on the effectiveness of the new disclosures. That report would be submitted following a 3-year period after the rule was implemented. For 1 year, the Secretary of Commerce will study the role of broad-based plans in expanding corporate ownership, the recruitment and retention of skilled workers, stimulating research and innovation, the international competitiveness of U.S. companies, and in growing the U.S. economy.

The result of this bill is that investors will clearly understand the impact of employee stock options on share value, while the most innovative sectors of our economy will be able to use broad-based stock option plans-stock option plans given to the majority if not all of a company's employees- to

recruit and retain talented workers.

Let me finish by returning to the fact that employee stock options never actually impose an "expense" or "cost" on companies. Since that is the case, why this endless debate with FASB and others in the accounting community over "expensing stock options", or explaining exactly what the cost to companies is? Well, that brings me to my visual aid.

Mr. Chairman, this is a diagram of the movements of the sun, moon and planets as they revolve around the Earth. It was developed in the Middle Ages. It is based on extraordinarily complicated, even brilliant, mathematical work by Claudius Ptolemy. Ptolemy wrote a 13 volume treatise, entitled The Mathematical Compilation, that explained the movements of the sun, moon and five planets around the Earth. His work was the leading scientific explanation of that truth for almost 15 centuries.

The point is, even if you started with the "fact" that the Earth was at the center of the universe, you could develop very complicated and precise answers to all types of questions, including why the visible planets, in particular, take very unusual paths across the sky. Geniuses like Nicolaus Copernicus improved on the Ptolemaic work by proposing that the sun and earth revolved around a point near the sun, and Tycho Brahe explained how the planets revolved around the sun and the sun and planets revolved around the Earth. Even Galileo did not break completely from the intellectual view underpinning the 15 centuries of Ptolemy's astronomy.

What does that have to do with FASB? Mr. Chairman, the accountants at FASB, good people that they are, are required to fit the entire universe around a world view that in the end is flawed as much as Ptolemy's universe was. Their view is that everything must be able to be scored and placed on a corporate balance sheet. Well, the earth is not the center of the universe, and everything doesn't belong on a balance sheet.

That's not to say that given enough hard thinking a smart person could not figure out a way to put everything on a balance sheet. Utterly brilliant people figured out a way to explain, with incredible precision, how and why the sun and planets revolved around the Earth. You can explain just about anything with mathematical precision if you want to. But that doesn't mean it's true. FASB is not populated by Ptolemy, Copernicus, Brahe or Galileo, and you don't have to be Johannes Kepler to say they just have this thing wrong.

I believe that this committee should focus on two keys points: (1) employee stock options do not ever impose a cost or expense on companies, so proposals that try to explain how that is the case and scores that cost must be flawed from the get-go; and (2) employee stock options do have the potential of imposing a "cost" on shareholders, primarily through the effect of dilution. Therefore, if the committee wants to do something to benefit shareholders, which I certainly support, you should look at improving the process of informing shareholders with accurate information regarding stock options and their potential impact on share value, as H.R. 1372 seeks to accomplish.

ANNA G. ESHOO
14TH DISTRICT, CALIFORNIA

Congress of the United States
House of Representatives
Washington, DC 20515-0514

Testimony before the Financial Services Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
"The Accounting Treatment of Employee Stock Options"

June 3, 2003

Thank you Chairmen Baker and Oxley and Ranking Members Frank and Kanjorski for inviting me to testify before you and my colleagues on the issue of expensing stock options.

The term stock options and what people instantly think of when the term is stated has become sullied.

Stock options have become associated with corporate scandals and excessive executive compensation and I believe these events have led to a call for expensing, leading many to believe this is the ultimate prescription for what is ailing us.

Congress responded by closing loopholes that were used by the Enron's and their ilk and passed the Sarbanes/Oxley bill passed in the last Congress.

What expensing stock options will not do.

Expensing stock options will not reign in excessive executive compensation in corporate America.

It is relatively easy for companies like GE and Coca-Cola to expense stock options – they provide stock options only to a small number of senior executives and managers.

Companies in my district, mostly in the high technology and biotechnology sectors, use stock options very differently than the companies that became poster children for corporate fraud.

Rather than handing out options only to senior executives, New Economy companies offer them broadly, turning their entire employee base into corporate partners who have a stake in the future success of their company.

Recent research indicates that at the top 100 technology companies, 80% of the stock options granted were given to rank and file employees, not senior executives. In the last decade over 10 million employees have received stock options.

Yet, who loses if stock options are required to be expensed? Not senior executives, who will be compensated in one way or another. These rank and file employees would be the ones who lose out on this benefit.

Why? Because, faced with the prospect of taking a huge charge against their bottom line in accounting statements, most companies would drop broad-based option plans – eliminating this benefit to all but senior executives.

PRINTED ON RECYCLED PAPER

Protecting broad-based stock options does benefit rank-and-file workers.

Broad-based stock option plans have turned employees into corporate partners by tying the interest of the employee together with the company and its shareholders.

Small, entrepreneurial companies with little or no capital use stock options to attract and retain bright and talented employees critical to that company's success.

We have one of those bright and talented employees with us today...Debbie Nightingale of Sun Microsystems, who you will hear from in a moment, who in addition to working at Sun serves part-time as a Lieutenant Colonel in the Army Reserves.

Ms. Nightingale represents thousands of employees in Silicon Valley who join with her in calling for the preservation of broad-based stock option plans.

I've received hundreds of statements from Debbie's colleagues that describe how important stock options are to them. I've selected a few of those statements that, with your permission Mr. Chairman, I'd like to add to the record.

In each of these statements you'll find the eloquent story of an American rank-and-file employee who has been rewarded for their hard work and dedication to their company with stock options.

These employees used their options to purchase their first homes, send their kids to college, finance their retirements, donate to and sometimes begin charities – contributing to our economy every step of the way.

Congress' does have a critical role in protecting our economic vitality

Unfortunately FASB has indicated it will only focus on accounting standards and not economic factors when it rules whether to require stock option expensing.

While I agree that accounting standards are best left to FASB, promoting job growth and economic viability is a responsibility of the Congress.

And while FASB says it won't look at the economic impact its decision will have, we have the responsibility to look at these factors and ensure that our national policies foster economic growth.

Investors and shareholder access to information on how companies use stock options can and should be bolstered without throwing the baby out with the bathwater, as expensing would accomplish.

The legislation I've introduced with Chairman Dreier strikes an appropriate balance by requiring companies who offer stock options to disclose additional information to every shareholder and potential investor.

- Our bill requires includes plain-English descriptions of share value dilution,
- expanded and more prominent disclosure of stock option-related information,
- and a summary of stock options granted to the five most highly compensated officers.

The bill also directs the SEC to monitor the effectiveness for investors of the enhanced disclosure requirements and report its findings back to this Committee.

And during that time frame, the SEC would be prohibited from recognizing as a generally accepted accounting principle any new accounting standard on stock options.

Our legislation does not set accounting standards.

Some have criticized this provision as a mandate on FASB - nothing in our bill requires Congress to get into the standard-setting business.

The legislation directs the SEC to exert its appropriate role in maintaining the integrity of our markets and to ensure that our economic policies foster growth.

Forcing companies to expense options at some arbitrary value, as FASB's decision is likely to require, would be misleading to both investors and shareholders.

Our legislation provides greater transparency about the use of stock options without unfairly penalizing the innovative employees building America's high technology future.

Thank you once again for the opportunity to testify before you.

June 3, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled "The Accounting Treatment of Employee Stock Options"

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

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

However, I am interested to hear from our distinguished witnesses this morning on the merit of the two authorized disclosure alternatives, recognizing the value of employee stock options as an expense or providing relevant and detailed disclosure regarding those options in the footnotes to the financial statements. Also, I think this committee will benefit greatly from their discussion on valuation options still under debate.

I am supportive of FASB's recent decision that the fair value of stock option compensation should be reflected in a company's financial statements and am encouraged that another final rule is being considered that would eliminate the disclosure alternative.

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

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE ACCOUNTING TREATMENT OF EMPLOYEE STOCK OPTIONS

TUESDAY, JUNE 3, 2003

Mr. Chairman, we meet today to examine an issue of great interest to me: the accounting treatment of stock options. This issue has caused significant controversy for more than a decade, and the Financial Accounting Standards Board's recent decision to revisit this matter has rekindled a fiery debate.

Without question, stock options have played an important and crucial role in the ongoing success of many American businesses. Many entrepreneurial companies have used stock options not only to compensate their executives, but also to improve the performance of their employees. The issuance of these stock options has helped millions of average workers to share in the success of the companies for which they work. In addition, stock options have permitted start-up businesses with little capital to attract and retain first-rate employees.

Despite this success, we have not properly accounted for stock options on corporate financial statements. Employee stock options are a type of compensation, just like a salary or a bonus. Because compensation is an expense and because expenses influence earnings, employee stock options should be counted against earnings and subtracted from income.

My opinion is shared by many others, including such respected financial experts as Warren Buffett, Alan Greenspan, and Joseph Stiglitz. Additionally, all of the major accounting firms now support the expensing of stock options. Furthermore, the Investment Company Institute, the Council for Institutional Investors, and the Conference Board's Commission on Public Trust and Private Enterprise have each called for the expensing of stock options.

Support for the expensing of stock options is also growing in corporate America with 276 companies having adopted or in the process of adopting fair value expensing of stock options. Respected corporations like Coca-Cola, Home Depot, General Motors, General Electric, Dow Chemical, Wal-Mart, and Amazon.com are among the companies announcing in recent months that they would start to treat stock options as expenses.

As we consider this issue today, I would strongly encourage my colleagues to protect the independence of the Financial Accounting Standards Board. When the Board last studied this matter a decade ago, meddling by some on Capitol Hill resulted in a retreat from an original proposal to require stock option expensing. This retreat allowed companies to continue hiding the true cost of stock options and contributed to the recent tidal wave of accounting scandals.

To protect against similar incidents in the future and safeguard the public interest, we incorporated into the Sarbanes-Oxley Act a provision granting the Financial Accounting Standards Board an independent funding stream. The active consideration of the Broad-Based Stock Option Plan Transparency Act by the 108th Congress, however, would threaten this

enhanced independence, intervening in the Board's ability to make unbiased decisions and disrupting an objective process for reasons other than sound financial reporting.

In addition, such congressional action would completely undermine a recent decision by the Securities and Exchange Commission finding that the Board "must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues." In making this announcement, the Commission wanted to ensure that the Board develops its accounting standards free from bias in order to have the maximum credibility in the investing community. I wholeheartedly agree with this judicious decision.

As the Financial Accounting Standards Board proceeds with this matter, I also expect that its experts will pay special attention to the proper method for valuing stock options so that investors may evaluate apples against apples, and oranges against oranges. Valuation methodologies have advanced greatly in recent years. Although it remains a difficult task, these advances should help to ensure that the Board can identify a suitable model for valuing stock options across all companies. America's capital markets can remain the strongest in the world only when the rules are clear, corporate activity is transparent, and the data is comparable.

In closing, Mr. Chairman, stock options are expenses and we must fix this obvious problem as quickly as possible. The Financial Accounting Standards Board must therefore proceed systematically in this matter with diligence and without political interference.

Opening Statement
Congressman Ed Royce (CA-40)
3 June 2003
The Accounting Treatment of Employee Stock Options

Thank you -- Chairman Baker -- for the opportunity to share my views with the subcommittee today on the topic of accounting treatment of employee stock options. I would like to commend Chairman Oxley and Chairman Baker for bringing the important topic of stock options to light through this hearing, and I look forward to engaging in an in-depth and ongoing dialogue with my colleagues -- with the benefit of insight and testimony from our distinguished witnesses -- to ensure that Congress pursues a path that is most helpful to future growth of the U.S. economy.

As someone who believes in free markets, I think that transparency and risk-taking are pivotal to a healthy, vibrant economy. The U.S. economy has been the world's driving economic force over the last two decades because investors from around the world recognize the U.S. is a place with sound laws that encourage economic activity and a free people willing to take risks to create wealth. This is evidenced by the fact that the U.S. economy accounts for an astounding 32% of the world's GDP -- and that since 1995 the U.S. has accounted for about 60% of the cumulative growth in world GDP. Furthermore, about 75% of the world's total foreign exchange reserves are held in U.S. dollar-denominated assets.

I believe that stock options have been an integral part of the success in the American economic system. Millions of people have benefited from obtaining equity ownership in their employing firm through stock options. In my home state of California, there are many companies, large and small, that offer stock options to employees throughout the ranks.

Currently there is a great debate as to whether or not stock options should be expensed on a company's income statement. After studying this issue closely, I am concerned that expensing options through the Black-Scholes Model, or any other binomial model under

consideration, does more harm than good in the effort to achieve transparency in our capital markets. Even vocal proponents of expensing stock options acknowledge that Black-Scholes is flawed at best -- and instead of that approach -- publication of shareholder-value dilution in financial statements will more objectively reflect how stock option grants impact investors' shareholdings. Are we really making financial statements more precise and accurate if firms are forced to adjust their actual earnings by inputting non-cash charges derived through a flawed model in their income statement?

The Broad-Based Stock Option Plan Transparency Act of 2003, H.R. 1372, legislation sponsored by Chairman Drier and Rep. Eshoo, would increase and improve "plain English" disclosure of stock options on companies' financial statements and detail the stock options granted and outstanding to top executives. Additionally, the proposed legislation would prohibit the SEC from recognizing any FASB ruling requiring firms to expense stock options in their income statement for a period of three years. In that three-year period, the SEC would be required to study proposals to expense stock options.

I believe that this is the prudent step for Congress to take on this matter because it protects the entrepreneurial spirit behind stock options while increasing transparency of their use in financial statements. This committee has made tremendous efforts to increase transparency and confidence in our free market system over the last 18 months. We must act to ensure that the marketplace rests on solid fundamentals.

I thank the Chairman for his time, and for bringing this issue to the attention of this subcommittee. I would like to take this opportunity to thank our witnesses for taking the time to share their insights on the topic of expensing stock options. Finally, I look forward to working with my colleagues to reach the best solution for the future and health of the U.S. economy. I yield back the balance of my time.

Statement for the Record of Congressman Pete Stark
The House Financial Services Capital Markets Subcommittee
Hearing on Accounting Treatment of Employee Stock Options

June 3, 2003

Chairman Baker, Ranking Member Kanjorski, and Members of the Capital Markets Subcommittee, I appreciate the opportunity to present a different view to those you are hearing today who support passage of H.R. 1372, the Broad-Based Stock Option Plan Transparency Act. Contrary to what one might think from the makeup of the witnesses at today's hearing, there are those of us in Congress who believe that stock options should be expensed on companies' SEC filing reports if they are claiming those expenses on their IRS forms. The books should be the same. I want to thank Ranking Member Kanjorski for his willingness to submit my views on the accounting treatment of stock options.

While H.R. 1372, the Broad-Based Stock Option Plan Transparency Act of 2003 is the only bill that is being represented by its sponsors at today's hearing, I wanted to make the Subcommittee aware that I have a bill that supports expensing stock options. My bill, H.R. 626, Ending the Double Standard for Stock Options Act has 10 cosponsors in the House and is the companion bill to S. 182 which has bipartisan support in the Senate. My bill, Ending the Double Standard for Stock Options Act, would bring fairness to the issue of stock option expensing by requiring expensing of stock options on the SEC earnings report in order to take the IRS tax deduction for stock option compensation.

Under current law, companies can deduct stock option expenses from their income taxes as a cost of doing business, just like employee wages. However, companies are not required to similarly report these business expenses on their SEC financial statement to stockholders. This lack of clear stock option accounting gives executives incentive to give themselves exorbitant stock option compensation packages that mislead investors who do not see this compensation deducted from SEC earnings reports. This perverse incentive was highlighted by the scandals of Enron, WorldCom and others in the recent past.

Last year, U.S. workers and investors faced an onslaught of accounting scandals which led to bankrupt corporations, diminishing pension funds and mass lay-offs. While Congress addressed many of the accounting problems that led to the deluge of scandals, the treatment of stock option expensing has been ignored.

Prior to last year's scandals, nearly all companies relegated their stock option expenses to merely a footnote in their SEC report and did not reflect these expenses in their bottom line earnings reports to the SEC. But since last year's scandals, many more companies have responded to investors' demands that

stock options be expensed in the earnings reports. Over 120 companies, including Amazon.com, Coca-Cola, and General Motors, have announced that they will voluntarily expense stock options on their SEC earnings reports in 2003. Other companies, however, have claimed that they will not expense stock options until forced to do so.

Currently, the Financial Accounting Standards Board (FASB) is in the process of developing a fair method for stock option expensing. I urge my Congressional colleagues to refrain from placing special interest political pressure on FASB in order to prevent them from following through with a formal rule on stock option expensing. FASB has tried to take this step as long ago as 1994, but special interest lobbying got the best of them then. It is my hope that this time FASB will be able to come forth with a final rule requiring companies to treat stock options as an expense in order to provide an accurate account of each company's fiscal health. However, in the event that FASB succumbs to political pressures from certain Members of Congress and their special interest allies as they did in 1994, I would urge Congress to take a serious look at the need for legislating a requirement to treat stock options as an expense on earnings statements and to use our bill, Ending the Double Standard for Stock Options Act, as a template for moving forward.

In addition to this statement, I have enclosed for the hearing record H.R. 626, Ending the Double Standard for Stock Options Act, and a letter to FASB from 30 Members of Congress supporting the need for stock option expensing.

I thank my colleagues on the Capital Markets Subcommittee for allowing this statement and the supporting documents to be made part of the hearing record.

Testimony of Craig Barrett, CEO of Intel Corporation
House Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises
June 3, 2003

Thank you, Mr. Chairman and Members of the Committee, for holding this important hearing. I am pleased to be here today to offer my perspective on the important role that employee stock ownership plays in creating jobs and expanding economic opportunity in the United States. I would like to briefly address three topics:

- The importance of stock options to America's economic health
- Why expensing stock options is not a solution to corporate corruption
- Why expensing stock options will confuse corporate financial reporting

Let me begin by expressing my strong support for H.R. 1372, the Broad-Based Stock Option Transparency Act of 2003. As Representatives Dreier and Eshoo stated in their own testimony today, H.R. 1372 recognizes that stock options help companies attract and retain a highly skilled, dedicated, and productive workforce at every level. The bill's disclosure requirements are a much needed reform. I commend Representatives Dreier and Eshoo for their leadership and look forward to working with them.

America's economic greatness throughout history has been built on two elements of our national character. One is our love for ideas – our relentless drive to "build a better mousetrap." Our ideas lead to spectacular inventions, exciting innovations, and expanding productivity.

Second is our entrepreneurial spirit – our willingness to take economic and personal risks to create jobs, wealth, and opportunity for ourselves and for others.

These characteristics were on display in 1968 when Robert Noyce and Gordon Moore founded Intel, the company I am privileged to serve. Like most other new enterprises, Intel began without much financial capital, but with a huge amount of intellectual capital, and an entrepreneurial willingness to take risks. To succeed, Intel's founders needed to attract men and women to the company who had specialized knowledge and expertise, and keep them in the face of stiff competition for their services. They couldn't begin to match the salaries such workers could get from more established firms; but they offered something better: an opportunity to be equity stakeholders in the company's

future success. Intel began by granting stock options to nearly one-third of the workforce; today, all Intel employees participate in the stock option program.

I'm especially proud of Intel's story, but we aren't alone. Many companies, especially in the high-tech field, use stock options to attract and retain a highly specialized work force in a competitive economic environment. The technology sector has been at the forefront of a trend toward more knowledge workers. This trend has been developing in the economy for decades and is rapidly accelerating. In the early 1980s, tangible assets in the form of equipment and goods made up 70 percent of all nonfinancial corporate assets. By 2000, tangible assets made up about half of all assets, with the other half coming

from intangible assets – patents, copyrights, software – in short, ideas and knowledge.[1]

Research indicates that the number of knowledge jobs increased from 43 percent to 62 percent between 1982 and 2000.[2] Knowledge workers now outnumber factory workers by two to one. Even people who hold traditionally blue-collar jobs in manufacturing usually need specialized training to work with advanced robotics and computerized production lines.

What does all this talk about global competition and knowledge workers have to do with the issue of expensing stock options? In a word: *everything*.

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[1] Source: *In the Company of Owners: The Truth About Stock Options* by Joseph Blasi, Douglas Kruse and Aaron Bernstein, 2003, p. 225.
[2] Yankelovich, 1982; Gallup, 2002.

Some people would like you to think that what's at stake in this debate is an esoteric matter, with little impact beyond the green-eyeshade world of accountants and CFOs. In fact, what's at stake is the future strength and vitality of the American economy. Mandatory expensing of stock options means that stock options will only be offered to the most senior managers, if at all. The cost of doing anything else, in accounting terms, will be prohibitive. That means the movement toward broad-based employee ownership will come to a halt. It means start-up firms won't be able to offer employees a stake in the company's future success.

The economic harm of stock option expensing cannot be overstated. Three-quarters of the net new jobs created in the U.S. between 1999 and 2000 were created by small businesses with fewer than 500 employees.

A report by the Bureau of the Census[3] found that start-up companies in the first two years of operation created virtually all of the net new jobs in the economy. The incentive that many small and start-up businesses use to entice talented men and women to work for them, and motivate them to work long hours at low pay (much like the situation for associates in law firms), is the prospect of one day being a co-owner of the business and reaping ownership's rewards. Without the ability to offer stock options, many industry leaders today – including Intel – would never have gotten off the ground.

Without the ideas and entrepreneurial energy of small business start-ups, our Nation's ability to compete in the

[3] Source: US Bureau of the Census; *Endogenous Growth and Entrepreneurial Activity in Cities* by Zoltan J. Acs and Catherine Armington, Center for Economic Studies, Working Paper #CES-WP-03-2, January 2003

global economy will be dealt a serious blow. Right now, American business is at the forefront of innovation and new technology. Without incentives to attract and retain key workers in these fields, we will lose ground to fierce competitors in Asia and elsewhere where there is no intention to expense stock options. Productivity will suffer as well; research shows conclusively that companies with broad-based employee ownership have higher productivity, higher returns on equity, higher returns on assets, and higher levels of employee satisfaction.

Rank-and-file American workers will suffer the most from the mandatory expensing of stock options. Professors Joseph Blasi, Douglas Kruse, and Aaron Bernstein are co-authors of *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have*

Them, a book I would highly recommend to anyone interested in the issue of the growth in employee ownership – the phenomenon the authors call "partnership capitalism." The book details how broad-based employee stock ownership has benefited average workers by increasing their job satisfaction, stability, and economic security. They found that the average rank-and-file workers at the 100 largest Internet-based companies earned an average of $425,000 in stock option profits between 1994 and 2001. These earnings financed a lot of homes, college educations, and secure retirements.

At a recent Senate roundtable on the issue of expensing, Professor Kruse warned that expensing would "hurt the chance of employee ownership for the middle and working classes and the employees of technology companies."

His associate, Professor Blasi, added that stock option expensing would result in the "protection and enhancement" of stock options for top executives, while "rolling back partnership capitalism" in the United States.

A popular reason given for expensing stock options is that it will help solve the problem of corporate corruption. I disagree. The collapse of Enron, WorldCom and others had nothing to do with the issue of stock option expensing – it had to do with scandalous abuses, greed and criminality by top executives who betrayed the public trust. We need to take action to prevent such abuses in the future. Let me outline a plan for comprehensive stock option reform that I believe will help achieve that goal.

First, all employee stock option plans should be approved by shareholders.

Second, stock option plans should be broad based and permit the participation of a substantial majority of the employees. No more than 5% of options should go to top executives.

Third, and this is a key element of the Dreier-Eshoo bill, companies should provide investors with expanded, more frequent, and more understandable disclosures – in plain English.

Fourth, stock options should vest over long terms – at least four years.

Fifth, the compensation committees should be made up entirely of outside directors.

This plan for comprehensive stock option reform would expand employee ownership, provide shareholders with more transparent and understandable information, and give corporate leaders greater oversight and accountability. These reforms would be good for job creation, innovation, entrepreneurship, and economic growth.

Let me conclude by briefly addressing one of the unintended consequences of the proposal to expense options. With the recent corporate scandals and resultant congressional legislation, CEOs are required to certify their company's financial results as being accurate and transparent to the investor community.

Expensing options using the Black-Scholes technique is inherently inaccurate. In a recent, op ed piece in the Wall Street Journal, I pointed out that using Black-Scholes would have cost Intel over three billion dollars in expenses for options that were underwater, that is, their strike price was below the current market price, and might never be exercised. The proponents of option expensing did not challenge this fact; they merely stated that there were other features of the P/L statement that gave equally inaccurate results. In a sense, they were saying two wrongs make a right. I fail to see how our investors would benefit from reported financial results that would be in error by three billion dollars. With all due respect to those who would support option expensing, I suggest they focus their efforts on fixing the current shortcomings of our accounting

principles before they move to take away something that underpins our economic competitiveness.

Thank you very much for this opportunity to testify. I look forward to your questions.

Mandatory Expensing of Stock Options: A Bad Idea Whose Time Has Come

James K. Glassman

Resident Fellow, American Enterprise Institute

And

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Testimony before a hearing entitled,
"The Accounting Treatment of Employee Stock Options"

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

June 3, 2003

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Mandatory Expensing of Stock Options: A Bad Idea Whose Time Has Come

Mr. Chairman and members of the subcommittee:

At a time when roughly half of Americans own stocks – either in the form of individual shares or in mutual funds[1] – the Congress has become appropriately concerned about scandals that have shaken the faith of investors.

Today's hearing focuses on stock options, issued as incentive compensation to chief executives and other managers and employees of publicly traded companies. The hearing is especially timely because the Financial Accounting Standards Board (FASB) is moving quickly toward a new rule that will require that companies expense such options when they are granted. The corporate scandals, which began with massive restatements of earnings in the fall of 2001 by Enron Corp., have put new life into the FASB's long-term crusade to enact an options expensing rule.

There is concern, however, that FASB is acting in a precipitous fashion and that it is ignoring serious critics of expensing – among them, not only successful corporate leaders but also respected economists and a large number of financial and accounting professionals.[2] Today's hearing focuses on H.R. 1372, "The Broad-Based Stock Option Transparency Act of 2003," which would obviate the need for mandatory expensing of options by directing the Securities and Exchange Commission to set new rules for broader disclosure of the effects of options on shareholders and to study the effects of those rules over three years.

I strongly favor the approach in H.R. 1372. In my view, requiring the expensing of stock options would be a serious, even disastrous, mistake, for three reasons:

1. By severely discouraging the use of a powerful incentive for employees at all levels, mandatory expensing is likely to have a dangerously adverse impact on innovation, economic growth and national competitiveness. Options work. They align the interests of managers and shareholders, and they provide a powerful encouragement to innovation and hard work.

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[1] American Council for Capital Formation, "Equity Ownership in America," October 2002. The report synthesizes data from the Investment Company Institute, Securities Industry Association, New York Stock Exchange and Federal Reserve System. In 2002, some 52.7 million households, representing 49.5 percent of all U.S. households, owned stocks – up from 36.6 percent in 1992 and 19 percent in 1983.

[2] For example, in FASB Comment Letter No. 239, the Association of Financial Professionals, an organization of 14,000 individual members in the financial management profession, wrote: "AFP continues to oppose any requirement that companies record as an expense the fair value of stock options issued by employees. Employee stock options have value to employees and are a cost borne by shareholders, not the company. The cost of stock options is reflected in fully diluted earnings per share, under current accounting rules."

2. Mandatory expensing of options is likely to confuse and mislead, rather than further enlighten, investors. As Howard Gleckman of *Business Week* writes, instead of shining a light on a company's financial health, expensing "may leave hapless investors blinded by a fog of incomprehensible calculations."[3]

3. As a long-term strategy, mandatory expensing leads accounting policy in precisely the wrong direction. The expensing of stock options has become the prime example of an accounting fetish – a kind of obsession to reduce contingent liabilities and other information about a company to a single number that can be included in earnings statements under GAAP, Generally Accepted Accounting Principles. GAAP earnings statements, in truth, comprise only one view of a company's health and prospects – and often a distorted one. Investors need many views, and they are being poorly served when policymakers elevate GAAP to a kind of holy status.

I will address each of these issues shortly, but, first, some brief background.

Background

An option is literally a choice. The owner of a fixed stock option has the choice of purchasing shares at a fixed time in the future at a price that was fixed at the date it was granted. Often, that price is the market price at the date of the option grant. Therefore, if, by the time of the exercise date, the stock rises above the price at which it was granted, the owner of the option will exercise the option, purchase the stock, then either sell the stock at a profit or hold it for a longer period. It is easy to see how such options help align the interests of managers with those of shareholders, whose main concern is that the value of their stock increase.

Encouraging management to adopt a shareholder-orientation became a major concern in the 1970s when managers, who typically owned little stock, were criticized for using corporate assets for their own benefit and paying scant attention to the interests of institutions and individuals who were the actual owners of their companies. Today, roughly one-third of the compensation of CEOs comes in the form of stock options, up from one-fifth in the 1980s.[4] "Options, as two distinguished economists, William Baumol and Burton Malkiel, recently wrote, "are needed to ensure compatibility of the interests

[3] "The Imperfect Science of Valuing Options: There's no one who can figure how they affect earnings," by Howard Gleckman, *Business Week*, Oct. 28, 2002, p. 122.
[4] Bryan, S., Hwang, L., and Lilien, S., CEO Stock-Based Compensation: "An Empirical Analysis of Incentive-Intensity, Relative Mix, and Economic Determinants," *Journal of Business*, 2000, 73:4, p. 661. The authors also report, at p. 687, that "the percentage of firms with no CEO stock option awards steadily decreased from 46 percent in 1992 to 28 percent in 1997.

of stockholders and management, whose divergence has recently been so dramatically demonstrated."[5]

The controversy over the accounting treatment for stock options goes back more than 30 years. In 1972, the Accounting Principles Board issued Opinion No. 25, which stated that no compensation expense need be recognized for fixed stock options granted to employees "because of the concern that stock options could not be reliably valued at the exercise date."[6] As the use of such options increased, the FASB in 1984 began to reconsider the earlier ruling by its predecessor.[7]

As a result, companies today have two choices. They can adopt the "fair-value" method of treating options and record them as an expense against earnings in the year in the which the grant is made, or they can use the "intrinsic-value" method, which discloses the impact on net income in footnotes but not as a charge against reported earnings; if shares are issued to accommodate the exercise of options, then a dilution will occur on that date. Most public companies use the second method.

On March 12, however, the FASB announced it was opening a formal inquiry into requiring the expensing of stock options, making the fair-value method mandatory. The FASB favors such expensing, as does the International Accounting Standards Board (IASB). The FASB and the IASB are eager to bring their standards into convergence within a short time.

Expensing of Options Imperils Innovation, Growth and Competitiveness

The FASB has a single mission, which it states this way:

"... 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."[8]

Federal policymakers have a far broader mission.

For example, they are responsible for encouraging – or at least not *dis*couraging – economic growth, for preserving and increasing jobs, innovation and U.S. competitiveness. Even if the FASB expensing proposal were cogent from an accounting viewpoint (and it is not), it would be the duty of Congress and the executive branch to consider its economic impact. I do not have to remind you. That is your job. You can't abdicate it. You can't farm it out to a group of accountants, however well-meaning.

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[5] "A false cure for the ills of stock options," by William Baumol and Burton Malkiel, *Financial Times* (London), April 3, 2003.
[6] Dechow, P., Hutton, A., and Sloan, R., "Economic Consequences of Accounting for Stock-Based Compensation," *Journal of Accounting Research*, 1996, 1:2, p.2-3.
[7] Ibid, p. 3.
[8] On the home page of the FASB website: www.fasb.org.

As a result of expensing options, many firms – among them America's most successful and innovative -- will be forced to take massive charges against earnings. "Accounting for [options'] cost by the usual method (the Black-Scholes options-pricing model) would cut tech firms' reported profits by 70 percent, on some estimates."[9] Although they will not alter the firms' cash flow or actual business prospects from what they are today without mandatory expensing of options, the reduced reported earnings are almost certain to lead to lower stock prices and a higher cost of capital for the firms. Companies, in addition, will be discouraged from issuing options in the future and, in some cases, from listing their shares on the public market. The effect will be to reduce economic growth, U.S. competitiveness and job creation.

While some critics have made wild claims about the uselessness of stock options,[10] the truth is that firms issue options because they work. They represent an efficient method, especially for companies that have limited cash and depend on innovation to prosper, to spur employees at all levels to work harder and accomplish more – and thus to increase the value of the corporation and ultimately its stock price.

Are other incentives, such as cash or perks or the awarding of restricted stock, better incentives than options? Perhaps for some companies, and nearly all firms diversify their incentives beyond cash. But academic research shows that "incentive-intensive" firms favor the use of stock options.[11] No one knows more about incentives at an individual company than the shareholders, the board and the top managers of that firm. When they choose stock options, it is hubristic and foolish for outsiders to second-guess them. Discourage stock options and you discourage a management tool that works for vast numbers of the best American companies. And not just for the CEOs of those companies.

In their book, *In the Company of Owners* (Basic 2003), Joseph Blasi, Douglas Kruse and Aaron Bernstein construct an index of the 100 largest firms that focus on the Internet. They find that "employees and executives at these firms hold fully a third of their company's stock. Break that down, and the top five officers hold only 14 percentage points. The other 19 points belong to average employees, 17 of them through options."[12] The authors argue that "investors and employees alike would gain if companies turned employees into corporate partners by granting stock options to most of the workforce. Most U.S. corporations would be better run, and in the long run most profitable, if America pursued this approach."[13]

The power of stock options is undeniable. As one of America's best-known and most successful venture capitalists said recently in Congressional testimony:

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[9] "Now for plan B: expensing share options," *The Economist*, March 15, 2003.
[10] Typical is Charles Munger, vice chairman of Berkshire Hathaway, Inc., who has said, "In 90 percent of the cases, the handing out of options is excessive." Quoted in "Options Vigilantes," by Robert Lenzner, *Forbes*, Dec. 23, 2002, p. 67.
[11] Bryan, S., op. cit
[12] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them* (Basic, 2003), Joseph Biasi, Douglas Kruse and Aaron Bernstein, p. xii.
[13] Ibid. p. xi.

"This is a big competitiveness issue.... The innovation economy is where we're going to get the growth in jobs and the economic security for Americans.... The use of broad-based employee stock ownership, which I contend will disappear if expensing is mandated, ...delivers higher returns to the shareowners of the companies who use them, produces higher productivity, higher returns on equity, higher returns on assets, counting the effect of dilution."[14]

Very simply, if an expensing rule is enacted, it will damage the most dynamic companies in America. Many of them will end their stock-option plans or reduce them significantly. Typical is Advanced Fiber Communications, which stated in a letter to the FASB: "The expensing of options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees."[15]

It is the responsibility of elected public officials to weigh these economic costs – and to act.

Expensing of Options Will Confuse and Mislead Investors

Stocks options issued by companies to their employees cannot be accurately valued at the time they are issued. They do not comprise a cash cost, and they have no market price since they cannot be sold. The Black-Scholes method of valuation, the "gold standard" for determining the value today of options subject to future contingencies, applies to options that are tradable – not to options whose ownership is restricted to specific individuals. Consider just one contingency: Many employees will quit before they options can be exercised and lose all their rights to the value of the options. That can't happen with conventional options purchased in open markets.

"Mark Rubenstein, a finance professor at the University of California at Berkeley, found that some models used to value options require as many as 16 separate variables." Adjusting only a few of those variables, he found, could produce "huge differences in costs." For example, in one test, Rubenstein discovered that the value an option for a theoretical $100 stock could range from under $20 to over $300.[16] How valuable is such information to investors? Not very. Can such information be easily manipulated by firms to meet earnings targets? Of course.

Think about how an employee stock option works. If a company issues an option today, when the price of its stock is $50 per share, allowing an employee to buy stock at

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[14] Testimony of John Doerr at hearing of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003; transcript, at p. 55. Mr. Doerr has been a partner in the venture-capital firm Kleiner Perkins Caufield & Byers since 1980. The firm has sponsored investments in such companies as Compaq, Cypress, Intuit, Macromedia, Lotus, Netscape, Sun Microsystems, and Symantec, which have led to the creation of over 30,000 jobs.

[15] FASB Comment Letter No. 185. See also many others (Staples, Altera, Genentech, etc.), including, poignantly, FASB Comment Letter No. 29 from Vermont Teddy Bear Company: "If options are expensed, I can tell you that a small company like the Vermont Teddy Bear Company will no longer grant them."

[16] Quoted in "The Imperfect Science of Valuing Options," op. cit.

the same $50 in five years time, how can the firm accurately value the option today if it does not know the price five years from today? It can't, so it has to guess the value, using those multiple variables, including interest rates, volatility, earnings, likelihood of job retention and on and on.

For that guess to have any usefulness to investors, it needs to be updated frequently. Imagine that the firm originally estimates its stock price at $120 five years from now and that, after one year, the stock drops to $15. Is it reasonable to believe that in four years, the price will rise to $120? Probably not. So the company should then reduce its estimate for the value of the options issued the previous year. Such a reduction would create increased earnings! So as the firm's stock price drops, its earnings increase.

Such a perversion reminds us of the purpose of accounting conventions in the first place – to convey information about the health and prospects of a company for investors and potential investors. But some information cannot be reduced to a single number. Nor should it be. The expensing proposal, nevertheless, "serves to satisfy an unquenchable fetish to see a contingent liability converted, however clumsily and unconvincingly, into a dollar amount that can be charged against earnings – without (and here's the fetish element) caring in the slightest whether it's helpful or meaningful to do so."[17]

In this case, it is not helpful or meaningful to reduce all the information about options to one number. It is confusing and misleading – and utterly unnecessary.

The current regime gives firms a choice: expense options at the time they are granted or provide information about the options in the footnotes and record a dilution when the options are exercised. The information provided today by companies is highly detailed. Consider, for example, the Form 10-K of Gilead Sciences, Inc., a biopharmaceutical company based in Foster City, California. The footnote on stock options extends for four pages. It shows the number of options outstanding, forfeited, exercised and outstanding for the preceding three years, the weighted average exercise price of those options and the weighted average fair value of options granted. It then breaks down, by four price categories, the number of options and their average price and contractual life. And it presents a table that shows what net income would be if the company had chosen the alternative method, "fair value" accounting, under FAS 123. There is more information as well.[18] In fact, for typical companies, the information provided on stock options exceeds information provided for far more important aspects of the business, including intellectual-property assets, cash compensation expenses, leases, and investments.

Under the current regime, investors who require information on stock options can get it – and get it in spades. They can use it – not as a single number – but as a mass of detail more important than a single number – to make their decisions. Perhaps there could be even more transparency. Perhaps the disclosures could be made in a more uniform way. H.R. 1372 addresses such improvements.

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[17] "Much Ado About Stock Options: The Epilogue," editorial, *Wall Street Journal*, April 23, 2003.
[18] Gilead Sciences, Inc., Form 10-K, submitted to the Securities and Exchange Commission, March 11, 2003.

Since 1993, I have written a regular financial column for the *Washington Post*, which is syndicated into many other newspapers, including the *International Herald Tribune* and the *New York Daily News*. I have written about investing for many other publications as well, including the *Wall Street Journal*, *Los Angeles Times*, *The New Republic*, *The Weekly Standard*, *Forbes* and *Worth* magazine. I have devoted much of my professional life to educating small investors, so I have a keen interest in ensuring that investors get all the information they need to make good decisions.

Do current accounting rules give them such information? Absolutely. Will expensing help them make better choices? Not at all. Will it confuse them and actually increase the fog surrounding investment decisions? That is highly likely.

Let's go back to first principles. William A. Sahlman writes, "What an investor cares about most is her percentage claim on the after-tax free cash flow generating capacity of a company. Accounting machinations often affect reported income but not cash flow."[19] Stock options "affect the percentage claim someone has on a company's cash flows – the more options outstanding, the lower the potential ownership percentage of the outside investor."[20] And that effect, of course, is duly noted under the current regime, which both discloses the potential shares that would have to be issued to satisfy the exercise of options and, when the exercise occurs, the actual shares and their dilutive results. In other words, stock options are a cost, not to the company, but to its shareholders.[21]

But wherever the cost is assigned, there is another side to options that is missing in the accounting debate. "Granting stock options," writes Mr. Sahlman, "will also affect the level of...prospective cash flows."[22] And *this* is what investors should care about. "The CEO will have strong incentives to increase value per share because of the stock option grant."[23]

In other words, whatever cost is assigned to options, it should – in the case of well-run companies – at least be balanced by the likelihood of higher cash flow. "A number of academic studies," write Baumol and Malkiel, "support the observation that employee stock options have an incentive effect sufficient, or more than sufficient to cover their market value."[24]

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[19] William A. Sahlman, "Some Thoughts on the Accounting for Stock Options," July 24, 2002, p. 2. Prof. Sahlman is the Dimitri V. d'Arbeloff - Class of 1955 Professor of Business Administration at Harvard Business School. See also his article "Expensing Options Solves Nothing." Harvard Business Review 80, no. 12 (December 2002): 90-96

[20] Ibid.

[21] This point was made forcefully by Dennis Powell, chief financial officer of Cisco Systems, at a recent hearing: "In the last six months, I have surveyed in face-to-face meetings over 50 of our largest investors, and I've asked them that specific question: Who bears the cost of the options that are outstanding? Is it the company or is it the shareholders? One hundred percent of them recognized that this is a cost that is borne by the shareholders. It's not an expense of the company. No assets of the company are being used. And that cost comes in the form of dilution." Committee on Banking, U.S. Senate, May 8, 2003, op. cit., p. 25.

[22] Sahlman, op. cit., p. 3.

[23] Ibid.

[24] Baumol and Malkiel, op. cit.

In short, to force all companies to take an immediate hit against earnings when they grant options would be to misrepresent the firm's potential for generating future cash flow – and that potential is what investors should care about.

Imagine an expensing requirement going into effect in 2004. As a result, Company A's reported earnings drop from $2 a share to $1 a share. Is the investor being provided with appropriate information about the health and prospects of this company? But the firm's profit-generating power has not really been cut in half. Certainly, there will be explanations ensuing from the company and from regulators to assure investors that this earnings reduction shouldn't be construed as dire. But such assurances will only add to the confusion. Mandatory expensing will have another unintended consequence: it will reduce the opportunities of investors by discouraging firms from risking their shares on the public markets. A major reason companies go public is to create a market for options issued as incentives for employees. If mandatory expensing is enacted, companies that had planned to list will not do so and many companies will stay private, issuing options but using non-market means to value them.

Expensing Options Is Bad Strategic Accounting Policy

The worst of the corporate scandals of 2001-02 involved WorldCom, the telecommunications company. At this point, it appears that the firm exaggerated its earnings by about $11 billion, mainly by recording current expenses as capital investments (which are depreciated over time). The WorldCom scandal was disclosed in June 25, 2002, when the firm announced a $3.9 billion restatement of earnings.[25] In January 1999, WorldCom stock traded at $75 per share. But, on the day *before* the restatement, the stock was trading at 83 cents. In other words, the stock had already dropped by nearly 99 percent before the revelations. "While [the] announcement dramatically altered WorldCom's reported earnings and EBITDA, the accounting restatement did not change its cash flows by a single dollar. Investors had been anticipating and reacting to the value destruction in WorldCom's operating strategy for years before the accounting restatement."[26]

The WorldCom experience is a vivid illustration of how reported earnings – that is, the earnings which would be affected by the change that the FASB proposes – do not comprise the only, or even necessarily the best, set of data used by investors in pricing corporations. The financial definition of the value of a business or investment is "the present value of a stream of future cash flows discounted at an appropriate rate."[27] Again, cash flows, not earnings. At the 2002 annual meeting of his company, Warren Buffett, chairman of Berkshire Hathaway, Inc., and probably the most successful investor of the

[25] See WorldCom website. (The company has since been renamed MCI.) http://global.mci.com/news/infodesk/restatement/

[26] Richard Bassett and Mark Storrie, "The Sarbanes-Oxley Act and the New Financial Accounting Oversight Board: Investor Saviour or Chimera?" Delivered at a conference on Jan. 23, 2003, at the American Enterprise Institute, Washington, D.C. See http://www.aei.org/events/eventID.117/event_detail.asp

[27] Ibid.

20th Century, explained the way to value a company: "You just want to estimate a company's cash flows over time, discount them back, and buy for less than that."[28]

As we have seen above, options policy can affect cash flows – and most likely in positive ways, though the effect cannot be precisely determined. What this committee needs to recognize is that, in the investor's quest to estimate future cash flows, a wide range of information – not merely GAAP earnings – must play a role. Some of that information is contained in the footnotes of 10-K statements and annual reports. Some of it is in cash flow statements. It is my hope that other information, not included in any official reports, will be made available regularly, clearly and promptly by corporations in the future.

My American Enterprise Institute colleague Peter Wallison, with Robert Litan of the Brookings Institution, have argued forcefully that GAAP earnings do not by themselves reflect corporate health and prospects.[29] "GAAP and all other methods of financial reporting, including International Accounting Standards, are inherently malleable, and results can be easily adjusted by corporate managements to meet predetermined targets."[30] GAAP earnings are also incomplete and often misleading. These facts will not change with mandatory expensing of options.

The response of public officials to the corporate scandals involving Enron, WorldCom and other large companies, has been "to enshrine the audited financial statement...as the principal disclosure of companies whose shares are traded in the public securities markets."[31] But, in fact, "there is strong evidence that investors are relying on many factors other than audited earnings in making judgments about the value of companies, particularly free cash flow."[32]

Rather than trying to quantify the unquantifiable, as mandatory expensing attempts to do, accounting policy should follow a different strategic path, in this age when the value of many corporations resides not in buildings and machines but in patents, reputation and the training of employees. Policy needs to move instead toward other, non-GAAP metrics, which can tell investors more.

For example, in 1991, Skandia International Insurance Corporation began "developing ways to measure its largely intangible assets as a supplement to its conventional accounting statements."[33] Skandia, in 1994, asked, for example, "What price does one assign to creativity, service standards or unique computer systems? Auditors, analysts and accounting people have long lacked instruments and generally accepted norms for accurately valuing service companies and their 'intellectual

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[28] Ibid.
[29] Peter Wallison and Robert Litan, *The GAAP Gap* (2000), American Enterprise Institute.
[30] Peter Wallison, "Poor Diagnosis, Poor Prescription: The Error at the Heart of the Sarbanes-Oxley Act," On the Issues, American Enterprise Institute, March 18, 2003, p. 1. See http://www.aei.org/publications/pubID.16589/pub_detail.asp. See also "Give Us Disclosure, Not Audits," by Wallison, *Wall Street Journal*, June 2, 2003, p. A16.
[31] Ibid.
[32] Ibid.
[33] *The GAAP Gap*, p. 53.

capital.'"[34] In a subsequent report, Skandia cited "hidden assets, consisting of the employees' competence, computer systems, work processes, trademarks, customer lists, and so on" as particularly valuable to investors' understanding of the company's worth and prospects.[35]

Exactly how these metrics will be determined is no easy matter, but it is the direction in which accounting policy must now proceed. And the best way to find the metrics is not through strict rules promulgated by the FASB but by the promotion of competition and innovation in presenting information by corporations. The SEC and Congress need to state clearly that GAAP is not everything, that policymakers want businesses to develop their own best methods for presenting information clearly – and quickly. The FASB proposal is not only economically dangerous and misleading to investors, it is also a relic and an irrelevance in the continuing quest to represent the truth, on paper, about corporations.

But, finally, what of the corporate scandals, which are the reason we are here today?

Those who perpetrated fraud at Enron and WorldCom would not have been in the least deterred by a rule requiring the mandatory expensing of options. They were far too clever. They could easily have manipulated such a rule to serve their own ends. No single accounting rule will ever be able to stop the worst of crooks, just as a law against murder does not prevent murder.

I do not question the desire of the FASB and its supporters, including many in Congress, to restore investor confidence through mandatory expensing. But, in fact, investor confidence will probably be affected negatively, if at all, and the economy will be placed seriously at risk. This subcommittee, under such circumstances, cannot sit idly by and watch the consequences of this misguided accounting policy unfold.

Thank you.

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[34] Ibid.
[35] Ibid.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services
June 3, 2003

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Prepared Remarks

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am Robert H. Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization subject to oversight by the United States ("US") Securities and Exchange Commission ("SEC"). Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the US economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased information to make rational resource allocation decisions.

Our work is technical in nature, designed to provide investors and the capital markets with the most accurate possible yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent and objective FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to assess and implement the public policies they support. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run a crooked yardstick (or a biased accounting standard) is harmful to investors, the capital markets, and the US economy.

In March of this year, at a public meeting, the Board unanimously decided to add a project to its agenda to address issues relating to improving the financial accounting and reporting for stock-based compensation. That decision was based largely on three factors: (1) the high level of public concern expressed by individual and institutional investors, pension funds, mutual funds, creditors, financial analysts, and other users of financial statements, and the major accounting firms, about the need to improve the reporting for stock-based compensation, in particular the need to eliminate the exception for so-called fixed plan employee stock options, which are the only form of stock-based compensation that is not currently reported as an expense in the financial statements, (2) the noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting stock-based compensation that has been magnified by the recent trend of companies (sometimes as the result of shareholder resolutions) to adopt the voluntary fair value provisions of our 1995 standard on accounting for stock-based compensation, and (3) the opportunity to achieve convergence to a common, high-quality international accounting standard for stock-based compensation.

In April, the Board began its initial public deliberations to consider improvements to the recognition, measurement, and disclosure of stock-based compensation. We have to-date held four public meetings in which the Board has reached tentative decisions on several issues, which are described in detail in the full text of my testimony.

In the coming weeks and months, at public meetings, the Board will continue its deliberations of the many issues relating to this project. The Board's public deliberations of the issues will be systematic, thorough, and objective. The deliberations will benefit

from the FASB's ongoing review and analysis of the vast amount of research and other literature in this area. The deliberations also will benefit from the ongoing input of our constituents, including the advice of leading valuation and compensation experts that the FASB will continue to consult with throughout the entire public process.

The Board currently plans to be in a position to issue a proposed standard for public comment in the fourth quarter of this year. Any proposal must be approved by an affirmative vote of the majority of the Board. Consistent with the FASB's Rules of Procedure, the proposal will be exposed for an adequate public comment period so that all interested constituents will have the opportunity to provide detailed responses. The Board also will consider whether to hold public roundtables or public hearings to solicit additional input on the proposal.

Prior to making any final decisions on any changes to the accounting for stock-based compensation, the Board would consider, at public meetings, all of the input received in response to the proposal. The Board will not issue any final standard until it has carefully considered, at public meetings, the views of all constituents. Like any proposal, any final standard must be approved by an affirmative vote of a majority of the Board.

We have reviewed H.R. 1372, the "Broad-Based Stock Option Plan Transparency Act of 2003" ("HR 1372"). We note that, if enacted, HR 1372 would impose a more than three-year moratorium on any FASB improvements to the financial accounting and reporting for stock-based compensation. The FASB strongly opposes HR 1372 for a number of reasons, including the following.

First, the moratorium would unduly intervene in the Board's independent, objective, and open process to make unbiased decisions on the substance and timing of improvements to the accounting for stock-based compensation. Such intervention would be in direct conflict with the expressed needs and demands of many investors and other users of financial reports. Such intervention would also appear to be inconsistent with the language and intent of the Sarbanes-Oxley Act of 2002 ("Act") and the related and recently issued SEC Policy Statement reaffirming the FASB as the nation's accounting standard setter.

Second, the moratorium would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality international accounting standards on stock-based compensation. The FASB is actively working with the International Accounting Standards Board and other national standard setters in an effort to achieve convergence in this important area. The moratorium would likely hamper those efforts, and again appears to be inconsistent with the language and intent of the Act and the related SEC Policy Statement, both of which indicate support for the FASB's international convergence efforts.

Finally, and perhaps most importantly, the moratorium would establish a potentially dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to intervene in the independent, objective, and open accounting standard setting process based on factors other than the pursuit of sound and fair financial reporting. That signal would likely prompt others to seek political intervention in future technical activities of the FASB.

We all have witnessed the devastating effects and loss of investor confidence in financial reporting that have resulted, at least in part, from companies intentionally violating or manipulating accounting requirements. What impact then on the system, and on investors' trust in financial reports, might there be if it were perceived that accounting standard setting was being biased toward the pursuit of objectives other than those consistent with sound and fair financial reporting?

For these and the other reasons set forth in the full text of my testimony, the FASB strongly opposes HR 1372 and any other legislation that would impair the Board's independent, objective, and open standard setting process.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

Testimony of
Robert H. Herz
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Full Text of Testimony

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am Robert H. Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. My testimony includes a brief overview of (1) the FASB, (2) the basis for the Board's unanimous decision to undertake a project to improve the financial accounting and reporting for stock-based compensation, (3) the current status of, and the FASB's plans relating to, that project, (4) the FASB's tentative views about some of the more common arguments offered by some opponents of the project, and (5) the FASB's views on H.R. 1372, the "Broad-Based Stock Option Plan Transparency Act of 2003" ("HR 1372").

The FASB

The FASB is an independent private-sector organization.[1] Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

[1] See Attachment 1 for information about the Financial Accounting Standards Board.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[2] is fundamental to our mission because our work is technical in nature, designed to provide investors and the capital markets with the most accurate possible yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run a crooked yardstick (or a biased accounting standard) is harmful to investors, 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.[3]

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[2] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).
[3] 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).

The Policy Statement, consistent with the language and intent of the Act,[4] also reemphasizes the importance of the FASB's independence described earlier. 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 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.[5]

The SEC, together with the private-sector Financial Accounting Foundation,[6] maintains active oversight of the FASB's activities.

What Is the Basis for the Board's Unanimous Decision to Undertake a Project to Improve the Financial Accounting and Reporting for Stock-Based Compensation?

A Brief History of the Accounting for Stock-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*

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[4] Sections 108-109; The legislative history of the Sarbanes-Oxley Act of 2002 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.

[5] Page 5 of 8.

[6] See Attachment 1 for information about the Financial Accounting Foundation.

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.[7] 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 options) are not reported as an expense. All other options and all other forms of stock-based transactions result in expenses to be included in the financial statements consistent with the general principle.

Statement 123

Many constituents 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. In 1995, however, when the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation,* it permitted companies to continue to apply

[7] 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.

Opinion 25, while also requiring annual footnote disclosures of the fair values 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 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.*[8]

Last year, 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 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.*[9]

Statement 148

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

[8] Paragraphs 61 and 62 (emphasis added).

[9] 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).

statement. In addition, for many years, few investors and other users of financial statements expressed significant concerns with that practice.

Over the past year, however, following the highly publicized bankruptcies of 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 stock-based compensation consistent with the requirements of Statement 123.

In July 2002, as a number of US enterprises began announcing their intention to switch to the fair value method of reporting stock-based compensation, the FASB, in response to requests from some of those enterprises and other constituents, decided to add a limited-scope project to its agenda to address issues related to the transition and disclosure provisions of Statement 123.[10] In December 2002, the FASB issued Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure.*

Statement 148 provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based compensation. In addition, that Statement amends the required disclosures of Statement 123 to provide for more prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results.

[10] As of May 23, 2003, 281 enterprises expense or intend to expense employee stock options using the grant date fair value method. See Attachment 6 for a list (alphabetical and by state) of those enterprises.

International

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.

After a year of thorough deliberations by the IASB, like the FASB decided almost 10 years ago in developing Statement 123, it proposed 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.[11] And, also like 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 are somewhat different from those under the fair value method developed by the FASB in Statement 123. There also are some other important differences between the IASB's proposal and the Statement 123 approach. Nevertheless, the fundamental conclusions are the same.

The IASB has begun discussing at public meetings the issues raised by constituents in response to its proposal. Of note, a majority of commentators from industry indicated full or qualified support for treating all stock-based compensation as expenses and for

[11] IASB Proposed IFRS, *Share-based Payment* (November 2002); FASB Exposure Draft, *Accounting for Stock-based Compensation* (June 1993).

measuring them at their fair value.[12] The IASB currently plans on issuing a final standard in the fourth quarter of 2003.

Beginning January 1, 2005, all listed companies in the European Union ("EU") will be required to adopt IASB standards. Other countries outside the EU, including Australia and Russia, are also expected to adopt IASB standards en masse. Furthermore, other national accounting standard setters around the world, including those in Canada, are expected to adopt new requirements for the accounting for employee stock options that are the same or similar to those adopted by the IASB.

Invitation to Comment

As the IASB released its exposure draft in November 2002, the FASB issued an Invitation to Comment that explains in detail the similarities of and differences between the IASB proposal and the existing US standards and that solicits comments on those differences.[13] 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 stock-based compensation and (2) to assist constituents that were planning to respond to the IASB's proposal.

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[12] Andrew Parker, "IASB to Push on with Option Reform," *Financial Times* (May 3, 2003).
[13] 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).

The FASB received nearly 300 comment letters in response to the Invitation to Comment. Most commentators from industry that made general observations about the accounting for stock-based compensation, many of whom were from the high-technology industry, were generally against mandatory expense recognition of all stock-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 the real cost of issuing fixed plan employee stock options is potential dilution of existing shareholders' equity interests; (3) whether the cost of fixed plan employee stock options is already reported in corporate financial statements; (4) whether existing option pricing models, including Black-Scholes and binomial models, even when adjusted, produce inaccurate and misleading information; (5) whether expensing all employee stock options is likely to lead to an even more distorted picture of an enterprises' financial performance and condition; and (6) whether mandated expensing of fixed plan employee stock options will destroy broad-based plans and the productivity, innovation, and economic growth they generate.

In contrast, most commentators that were users of financial statements, including individual investors, pension funds, mutual funds, creditors, and financial analysts, were generally supportive of mandatory expense recognition of all employee stock options.[14]

[14] Attachments 4 and 7 include excerpts and letters, respectively, from some of those constituents who responded to the Invitation to Comment.

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 entities), 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 stock-based compensation. Some 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*

Current Project to Improve the Financial Accounting and Reporting for Stock-Based Compensation

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to stock-based compensation.[15] That decision was based largely on three factors.

The first factor was the high level of public concern expressed by individual and institutional investors, pension funds, mutual funds, creditors, financial analysts, and other users of financial statements, and the major accounting firms, about the need to improve the financial accounting and reporting for stock-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists *only* for fixed plan employee stock options.[16]

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)

[15] See Attachment 3 for a summary of the project on stock-based compensation.
[16] See Attachment 4 for excerpts from investors and other users of financial reports expressing concerns about the existing accounting for stock-based compensation.

- 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)[17]

[17] 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).

- 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, 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 stock-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.

As indicated above, 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 the 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. Clearly, many investors and other users of financial reports want this issued addressed and resolved in the near term.[18]

Last year, President Bush announced a ten-point plan to improve corporate responsibility.[19] That plan including the following statement: "The authors of accounting standards must be responsive to the needs of investors."[20] In my opinion, there is no other issue on the Board's agenda in which investors have been more clear about the need for an improvement in the existing accounting standards.

The second factor was the noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting stock-based compensation that have been magnified by the recent trend of enterprises to adopt the voluntary fair value provisions of Statement 123.

More than 280 major US enterprises have adopted or will adopt fair value expensing of all stock options, including fixed plan employee stock options.[21] Those enterprises represent 19 percent of the S&P 500 based on number of companies and 36 percent of

[18] The major US accounting firms are also generally supportive of expensing of all employee stock options. "Big Four Shift View on Expensing Options," *Financial Executive's News* (May 1, 2003).
[19] Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders (March 7, 2002).
[20] Ibid.
[21] See Attachment 6.

the S&P 500 based on market capitalization. Those enterprises include Amazon.com Inc.; American Express; Bank of America Corp.; Bank One; BellSouth Corp.; Calpine Corp.; Choice Hotels International, Inc.; Citigroup Inc.; Comerica Inc.; CSX Corp.; Dole Food Co. Inc.; Dow Chemical Co.; Entergy Corp.; Federal Home Loan Mortgage Co.; Ford Motor Company; General Electric Co.; Hartford Financial Services Group, Inc.; Home Depot, Inc.; Household International Inc.; J.P. Morgan Chase & Co; Morgan Stanley; PNC Financial Services Group Inc.; Proctor & Gamble Co.; Provident Financial Group, Inc.; Saks Inc., SBC Communications Inc.; Scotts Co.; State Street Corp.; Sunoco Inc.; Wachovia; and Wal-Mart Stores, Inc., to name a few.

Some of those enterprises, including Citigroup Inc. and J. P. Morgan Chase & Co., have expressly requested that the Board mandate the expensing of all employee stock options. It is also interesting to note that some of those enterprises, including Wal-Mart Stores, 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 any curtailment of those programs.[22]

And, during the current proxy season, more than 100 major US companies will be required to issue proxies containing shareholder resolutions calling for expensing of all

[22] News From Carl Levin, U.S. Senator, Michigan, "Stock Option Roundtable Dismissed as One-Sided" (May 8, 2003), page 2.

employee stock options.[23] As recently reported in *BusinessWeek Online*:

> Of the more than 40 proposals on expensing that already have been put to a vote, "yes" ballots have averaged more than 48% -- a degree of across-the-board shareholder support almost unheard of in recent history.[24]

The management of some of the companies in which the nonbinding resolutions on expensing all employee stock options have been approved, including Apple Computer, Inc. and MBNA Corp., has indicated that it will comply with the resolution, but not until the FASB completes its current project on stock-based compensation.[25]

The third factor was the opportunity to achieve convergence to a common, high-quality international accounting standard in this area. As noted earlier, the IASB currently plans on issuing a final standard in the fourth quarter of 2003 that would require that all share-based payments to be expensed at their fair value at grant date. By 2005, many companies in Europe and around the world will be applying the identical or a very similar standard.

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.[26] Both the Act[27] and the

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[23] Louis Lavelle, "Shareholders Unite to Expense Options," *BusinessWeek Online* (May 27, 2003). See Attachment 5.
[24] Ibid.
[25] Jonathan D. Epstein, "MBNA listens, will deduct stock options from earnings," *The News Journal* (May 7, 2003); "Apple Won't Expense Options Before Rule Change," *Reuters* (May 13, 2003).
[26] FASB, *Rules of Procedure* (December 1, 2002, as amended), page 2.
[27] Section 108(a)(2).

Policy Statement[28] indicate the 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 Project on Stock-Based Compensation?

For administrative purposes, the Board plans to divide the project on stock-based compensation into two distinct phases. In phase one, the Board will address issues relating to improving the accounting for employee stock-based compensation. In phase two, the Board will address issues relating to improving the accounting for nonemployee stock-based compensation and stock-based compensation arising from employee stock ownership plans and employee stock purchase plans.

The Board began its initial public deliberations of issues related to the project in April. At its April 22, 2003, meeting the Board tentatively decided:

- Goods or services received in exchange for stock-based compensation result in a cost that should be recognized in the income statement as an expense when the goods or services are consumed by the enterprise.
- The measurement attribute for an exchange involving stock-based compensation is fair value.
- With respect to stock-based compensation transactions with employees:

[28] Page 4 of 8.

- The economic event being measured is the exchange of goods or services received for stock-based compensation.

- The measurement objective for equity-settled awards is to determine the fair value of the goods or services received in the exchange, which should be based on (1) the fair value of the goods or services received or (2) the grant-date fair value of the stock-based compensation given, whichever is more reliably measurable.

At its May 7, 2003 public Board meeting, the Board tentatively decided:

- Compensation cost should be recognized over the service period.

- Stock-based compensation awards should be accounted for using the modified grant-date measurement approach in Statement 123; therefore, compensation cost should be adjusted to reflect actual forfeitures and outcomes of performance conditions.

- For awards with service conditions, an enterprise should base accruals of compensation cost on the best available estimate of the number of equity instruments that are expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from initial estimates.

In the coming weeks and months, at public meetings, the Board will continue its deliberations of issues relating to the project. Any and all decisions reached by the Board

at those meetings will be tentative decisions subject to further review by the Board before considering whether to issue a proposed standard for public comment.

The Board currently expects to hold at least ten additional public meetings to discuss issues in connection with developing a proposed standard for public comment for phase one of the project. Those meetings will include discussions of measurement methods, option valuation, attribution methods, modification and settlements, income taxes, disclosures, nonpublic enterprises, transition, and effective date.

The Board's public deliberations of those issues will be systematic, thorough, and objective. The deliberations, consistent with the FASB's Rules of Procedure, will address all of the key conceptual, measurement, disclosure, and cost-benefit issues, including those offered by those constituents who oppose the expensing of all employee stock options.

The deliberations will benefit from the FASB staff and Board's ongoing review and analysis of the vast amount of research and other literature in this area.[29] The deliberations also will benefit from the FASB staff and Board's ongoing discussion of the

[29] Some of the relevant published and unpublished research papers and other materials issued just since January 2003 include: Bettis, Bizjak, and Lemmon, "The Cost of Employee Stock Options," working paper, Social Science Research Network (May 2003); Bodie, Kaplan, and Merton, "For the Last Time: Stock Options Are an Expense," *Harvard Business Review* (March 2003); Finnerty, *Valuing Employee Stock Options: A Comparison of Alternative Methods* (Morristown, N.J.: Financial Executives Institute Research Foundation, 2003); Gooch and Lipe, "An Empirical Comparison of Grant-Date and Exercise-Date Measurements in Employee Stock Option Accounting," School of Accounting, University of Oklahoma (February 2003); Mollen, Rodney, Harper, and Jones, *Does the Black-Scholes Model Predict the Value of Employee Options?* (New York: Sibson, 2003); Olagues, "Wrestling with the Value of Your Employee Stock Options," *SFO Magazine* (April 2003).

key issues with a broad range of constituents, including valuation and compensation experts that the FASB will continue to consult with throughout the entire process.

The Board currently plans to be in a position to issue a proposed standard for public comment on phase one of the project in the fourth quarter of this year. Consistent with the FASB's Rules of Procedure, any proposal issued will be exposed for an adequate comment period so as to allow all interested constituents to provide detailed responses. The Board also will consider whether to hold public roundtables or public hearings to solicit additional input on the proposal.

Prior to making any final decisions on any changes to the accounting for stock-based compensation, the Board would consider, at public meetings, all of the input received in response to any proposed standard. Only after carefully evaluating all of the input received in response to a proposal would the Board consider whether to issue a final standard. No final standard may be issued without approval by majority vote of the Board.

As with all of the FASB's activities, the FAF and the SEC will monitor and oversee the Board's due process on this important project.

What Are the FASB's Tentative Views about Some of the More Common Arguments Offered by Some Opponents of the Project on Accounting for Stock-Based Compensation?

The following are three of the more common arguments made by some of the opponents of the Board's project to improve the financial accounting and reporting for stock-based compensation: (1) fixed plan employee stock options do not represent a cost and, therefore, should not required to be expensed; (2) the cost of fixed plan employee stock options cannot be estimated; and (3) the mandatory expensing of fixed plan employee stock options will have negative economic consequences. The Board will, consistent with the FASB's Rules of Procedure, carefully and thoroughly address all three of those arguments. The following is a brief discussion of the Board's deliberations to-date with respect to each argument.

Fixed Plan Employee Stock Options Do Not Represent a Cost

As indicated above, at the public Board meeting on April 22, 2003, the Board tentatively decided by a unanimous vote that goods and services received from any party in exchange for stock-based compensation should result in a cost that is recognized in the financial statements. The tentative decision would eliminate the existing exception that permits fixed plan employee stock options to avoid expense recognition.

The basis for the Board's tentative decision is that the Board agreed that all employee stock options, including fixed plan stock options, have value and that 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 such options and warrants to outside parties to acquire goods and services and in connection with acquisitions and financing transactions (and the 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 constituents that stock-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 stock 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 stock-based compensation transactions.[30]

[30] 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).

In addition to potential dilution, stock-based compensation transactions also impact the amount of the enterprise's employee compensation costs. As noted earlier, under existing accounting standards, all forms of stock-based compensation, except for fixed plan stock-based compensation, 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.

The Cost of Fixed Plan Employee Stock Options Cannot Be Estimated

In its current project, the Board has not yet deliberated all of the issues relating to the method of determining the fair value of stock-based compensation. In response to the Invitation to Comment, the FASB received significant input from constituents on more than two dozen issues relevant to determining the fair value of stock-based compensation.[31] Some of those constituents questioned whether existing pricing models, including Black-Scholes and binomial models, even when adjusted, could produce an accurate and reliable fair value for stock-based compensation. As indicated above, the Board will systematically, thoroughly, and objectively deliberate those issues at future public meetings.

From a historical perspective, it should be noted that in the development of Statement 123 almost 10 years ago, when the valuation methodologies for complex financial instruments

[31] Paragraph B1.

were less advanced and far less routine than in today's environment, the Board unanimously concluded that the value of employee stock options could be estimated within acceptable limits for recognition in financial statements. The basis for the Board's conclusion included the following:

> [U]ncertainties inherent in estimates of the fair value of employee stock options are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pension and other postretirement benefit obligations. All estimates, because they are estimates, are imprecise. 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 nothing—which is what Opinion 25 accounting recognizes for most employee stock options. Zero is not within the range of reasonable estimates of the value of employee stock options at the date they are granted, the date they vest, or at other dates before they expire, with the possible exception of deep-out-of-the-money options that are near expiration. Even those latter options generally have nominal value until very shortly before expiration.
>
> The Board continues to believe that use of option-pricing models, as modified in this Statement, will produce estimates of the fair value of stock options that are sufficiently reliable to justify recognition in financial statements. Imprecision in those estimates does not justify failure to recognize compensation cost stemming from employee stock options. That belief underlies the Board's encouragement to entities to adopt the fair value based method of recognizing stock-based employee compensation cost in their financial statements.[32]

More recently, in the development of the IASB proposal, the IASB unanimously decided that ". . . estimated fair value of employee share options at grant date can be measured

[32] Paragraphs 111 and 117.

with sufficient reliability for the purposes of recognising employee share-based payment transactions in the financial statements."[33] The basis for the IASB's decision included the following:

> The Board noted that there is evidence to support a conclusion that it is possible to make a reliable estimate of the fair value of employee share options. First, there is academic research to support this conclusion (eg Carpenter 1998, Maller, Tan and Van Ed Vyver 2002). Second, users of accounts regard the estimated fair values as sufficiently reliable for recognition in the financial statements. Evidence of this can be found in a variety of sources, such as the comment letters received from users of accounts who responded to the Discussion Paper. Users' views are important, because the objective of financial statements is to provide high quality, transparent and comparable information to help users make economic decisions. In other words, financial statements are intended to meet the needs of users, rather than preparers or other interest groups. The purpose of setting accounting standards is to ensure that, wherever possible, the information provided in the financial statements meets users' needs. Therefore, if the people who use the financial statements in making economic decisions regard the fair value estimates as sufficiently reliable for recognition in the financial statements, this provides strong evidence of measurement reliability.
>
> In summary, if expenses arising from grants of options to employees are omitted from the financial statements, or recognised using the intrinsic value method (which typically results in zero expense) or the minimum value method, that means that there is a permanent error embedded in the accounts. So the question is, which accounting method is more likely to produce the smallest amount of error and the most relevant, comparable information—a fair value estimate, which might result in some understatement or overstatement of the associated expense, or another measurement basis, such as intrinsic value, that will definitely result in substantial understatement of the associated expense?[34]

[33] Paragraph BC294.
[34] Paragraphs BC291 and BC293 (footnote omitted).

Relevance and reliability are the two primary qualities that make accounting information useful for decision making.[35] The balancing of those two qualities is a key element of the Board's objective decision-making process in each and every project it undertakes.

The nature of financial accounting and reporting requires that enterprises utilize numerous methods, estimates, and judgments in the application of accounting standards to their particular economic transactions. Those methods, estimates, and judgments often have a significant impact on the resulting information reported in the enterprise's financial statements.[36]

At upcoming public meetings the Board will continue its systematic, thorough, and objective deliberation of issues, including those relating to the method or methods of accurately valuing the fair value of stock-based compensation. Those deliberations will benefit from enterprises' seven years of experience in valuing and reporting the fair value of stock-based compensation in their audited financial statements; the ample existing research and other literature on the issue; the ongoing input from the FASB's constituents; and the advice and expertise of leading valuation and compensation experts that the FASB will continue to consult with throughout the life of the project.

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[35] FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (May 1980), paragraph 90.

[36] The SEC has provided cautionary advice about public companies' disclosure of critical accounting policies used in financial statements (Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Releases Nos. 33-8040; 34-45149; FR-60 [December 12, 2001]). The required disclosures identify methods, estimates, and judgments that companies' use in applying those accounting policies that have a significant impact on the results reported (page 2 of 3). As one example, Intel Corporation's ("Intel") critical accounting policies disclosure contained in their Form 10-K for the fiscal year ended December 28, 2002, describes methods, estimates, or judgments used in its accounting for goodwill, nonmarketable equity securities, inventory, long-lived assets, and income taxes (Intel, 2002 Form 10-K, pages 29-31). Some companies have disclosed critical accounting policy estimates in over 12 separate areas (see Jack T. Ciesielski, "Ignorance Is Not Bliss: Critical Accounting Policies in the S&P 100," *The Analyst's Accounting Observer* [April 23, 2003]).

Mandatory Expensing of Fixed Plan Employee Stock Options Will Have Negative Economic Consequences

As indicated earlier, the mission of the FASB is to develop and improve financial accounting and reporting standards that result in transparent, credible, and unbiased financial information. Unbiased financial information enhances economic and policy decisions, comparisons between companies, capital allocation, and investor trust and confidence in financial reporting and the capital markets. Conversely, biased accounting standards and the resulting financial information that favor or disfavor a particular transaction, industry, or special interest group thwart the attainment of those objectives.

There will always likely be many different business, economic, and social objectives that many may agree are worthy of encouraging, promoting, or otherwise subsidizing in some manner, but distorting financial accounting and reporting standards and the resulting financial information is not the way to achieve those objectives. The purpose of financial accounting and reporting standards is to facilitate and promote sound, fair, and credible information. Diverging from that purpose to fulfill some other objective severely impairs the benefits and utility of accounting standards.

On a historical note, in the development of Statement 123, the FASB addressed the argument that ". . . a requirement to recognize [stock-based] compensation would have adverse economic consequences. . . ."[37] The Board stated:

> The Board's operating precepts require it to consider issues in an even-handed manner, without

[37] Paragraph 83.

> intentionally attempting to encourage or to discourage specific economic actions. That does not imply that improved financial reporting should not have economic consequences; a change in accounting standards that makes available more relevant and representationally faithful financial information often will have economic consequences. For example, the availability of the new information resulting from application of this Statement may lead an entity to reassess the costs and benefits of its existing stock option plans.[38]

Similarly, in the development of the IASB proposal, the IASB addressed the argument that the required recognition "of employee share-based payment would have adverse economic consequences. . . ."[39] The IASB noted:

> [T]he role of accounting is to report transactions and events in a neutral manner, not to give 'favourable' treatment to particular transactions to encourage entities to engage in those transactions. To do so would impair the quality of financial reporting. If expenses are omitted from the income statement, profits are overstated. The financial statements are less transparent. Comparability is impaired, given that expenses arising from employee share-based payment transactions vary from entity to entity, from sector to sector, and from year to year. More fundamentally, accountability is impaired, because the entities are not accounting for transactions they have entered into and the consequences of those transactions.[40]

The Board is aware that some commentators, like the International Employee Stock Options Coalition, believe that requiring the expensing of all stock-based compensation will likely have a negative economic impact because in their view it "will destroy broad-based plans and the productivity, innovation and economic growth they generate."[41]

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[38] Paragraph 84.
[39] Paragraph BC53.
[40] Paragraph BC55.
[41] Letter from International Employee Stock Options Coalition to the FASB (January 30, 2003), page 4 of 29.

Others, like the Conference Board Commission on Public Trust and Private Enterprise, have indicated that requiring the expensing of employee stock options will likely have a positive economic impact, in part, because the existing accounting treatment discourages the use of "grants of actual stock and other forms of stock options more closely related to performance."[42]

Many other constituents have explicitly commented on the economic impact of requiring the expensing of all stock-based compensation. One example is Federal Reserve System Chairman Alan Greenspan. Chairman Greenspan stated:

> 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.[43]

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[42] The Conference Board, "Commission on Public Trust and Private Enterprise. Findings and Recommendations, Part I: Executive Compensation" (September 17, 2002), page 6. See Attachments 4 and 7.

[43] 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. See Attachments 4 and 7.

Another example is the Republican Senate Staff of the Joint Economic Committee. Their Economic Policy Research Report on "Understanding the Stock Option Debate," concluded:

> Commentators differ greatly on the practical impacts of stock option expensing. Opponents believe it would discourage firms from granting options, reduce investor willingness to invest in option granting companies, and confuse investors. Proponents, however, believe that it would improve the quality of reported earnings, improve the investment decisions of investors who rely on reported earnings, and increase public confidence in financial reporting. *In evaluating these competing claims, policy should focus on one goal: informing investors so they allocate their capital as effectively as possible. Accounting policies should not be designed to favor or disfavor particular forms of compensation or types of companies. Although some arguments can be made for both sides, the weight of evidence appears to favor a switch to stock option expensing.*[44]

Some opponents of virtually every major improvement to accounting that the FASB has promulgated since its origin in 1973 have argued that the proposed accounting standard would have negative economic consequences. Addressing this argument in testimony before Congress last year, former FASB Chairman Edmund L. Jenkins stated:

> Members of Congress . . . must avoid the urge to legislate . . . and must reject the facile arguments and emotional appeals sometimes made by constituents claiming that FASB proposals will destroy Western civilization. Over 60 years of history conclusively demonstrate that accounting standards that result in more transparent financial reporting enhance, rather than hinder, the US economy.[45]

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[44] Joint Economic Committee, Republican Senate Staff, Economic Policy Research, "Understanding the Stock Option Debate," Report 107-04 (July 9, 2002), page 18 (emphasis added). See Attachments 4 and 7.
[45] Prepared remarks by Edmund L. Jenkins in testimony before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce (June 26, 2002), page 3.

What Are the FASB's Views on HR 1372?

The FASB has serious concerns about the requirements of HR 1372, particularly the provisions that would prohibit the SEC from recognizing "as generally accepted accounting principles any new accounting standards related to the treatment of stock options" for a period of more than three years following the enactment of the legislation.[46] The Board strongly opposes such a moratorium on improvements to the financial accounting and reporting for stock-based compensation for a several reasons, including the following.

First, the moratorium would unduly interfere with the Board's independent, objective, and open process to make unbiased decisions on the substance and timing of improvements to the accounting for stock-based compensation. As indicated above, such intervention would be in direct conflict with the expressed needs and demands of many investors and other users of financial reports. Such intervention would also appear to be inconsistent with the language and intent of the Act and the related Policy Statement, both of which were intended to enhance the independence of the FASB.

Second, the moratorium would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality international accounting standards on stock-based compensation. The FASB is actively working with the IASB and other national standard setters in an effort to achieve convergence in this important area. The moratorium would likely hamper those efforts, and again appears to be inconsistent with the language and

[46] Section 4(b).

intent of the Act and the related Policy Statement, both of which indicate support for the FASB's convergence efforts.

As indicated above, the IASB plans to complete its project on stock-based compensation by year-end. Other national accounting standard setters are pursuing similar improvements within similar time frames. To facilitate convergence in this area, the FASB must have maximum flexibility and control over the timing of its project on stock-based compensation so that common issues might be addressed concurrently.

Finally, and perhaps most importantly, the moratorium would likely establish a potentially dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to intervene in the independent, objective, and open accounting standard setting process based on factors other than the pursuit of sound and fair financial reporting. That signal would likely prompt others to seek political intervention in future technical activities of the FASB.

We all have witnessed the devastating effects and loss of investor confidence in financial reporting that have resulted, at least in part, from companies intentionally violating or manipulating accounting requirements. What impact then on the system, and on investors' trust in financial reports, might there be if it were perceived that accounting standard setting was being biased toward objectives other than those consistent with sound and fair financial reporting? For all of the reasons set forth in my testimony, the FASB strongly opposes HR 1372 and any other legislation that would impair the Board's independent, objective, and open standard setting process.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

THE TESTIMONY OF

THE HONORABLE RODERICK M. HILLS

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

June 3, 2003

I appreciate this opportunity to appear before this Subcommittee. My specific purpose today is to offer my views as to H.R. 1372; legislation that would instruct the Securities & Exchange Commission to not accept any new accounting standard relating to the treatment of stock options for three years.

First, I would like to allude briefly to the broader issue to which H.R. 1372 is a reaction. It is the fact that a number of problems have created a crisis for the accounting profession and are putting such enormous pressure on it that some doubt it can survive in its present form: that is, as four major firms.

What problems?

- The failure of the profession on so many occasions to stop clients from falsifying their reported accounts;
- The failure, as stated recently by the Economist, to "keep up with the tricks that were devised to help companies inflate their profits";
- The fact that accountants are becoming or have become rule checkers, applying the myriad of FASB pronouncements and clarifications rather than using their judgment as to what is a fair presentation of financial statements;
- The fact that far too many CEOs regard the annual audit as a commodity required by government rather than an exercise that has intrinsic value: and

- The belief by many, also noted by the Economist, that this crisis has created an "opportunity to [fundamentally] change the shape and content of accounts": to move inexorably to the use of "market values" rather than "historic costs" to gauge profits and losses.

The question of whether options should be accounted for is in large part a reaction to these circumstances. The answer to me seems clear: ***They should be accounted for:***

- Options have become a material factor in how a company compensates its employees;
- Options, when exercised, can significantly affect stock prices.
- That options are not now accounted for has distorted the compensation policies of too many companies. A grant of stock or cash compensation reduces reported earnings, while options do not. As a result CEOs are encouraged to grant far more options than might otherwise be granted;
- Also, it has become apparent to me over the past 34 years that many CEOs do not understand the real cost that option grants have for their companies. Because the grants do not affect the bottom line when granted, these CEOs treat options as "freebies" that can be given without cost.

So why is there such a fuss about the issue?

The fierce opposition to proposals to require the accounting of options comes from a very large number of CEOs. They believe, probably justifiably, that their stock prices can be severely hurt if the "cost of options" is used to reduce earning per share.

This view is that analysts and investors who previously thought well of their companies will punish stock prices if management, ***using information already in publicly filed papers***, applies a Black-Scholes type formula to that information and uses the resulting number to reduce reported earnings per share.

If this were not such a serious issue, it would be comic opera. Analysts are able to take a company's public information, use Black-Scholes, and find a number that can be a charge to earnings. Why would an analyst have any different view of a company just because the company does the same math?

The problem exists because the accounting profession and the analyst community have not been doing that kind of work. They have not been making the kind of judgments about the earnings, and the assets of corporations that would, long ago, have made the effect of stock options understood by both management and investors.

I do not mean that comment as a criticism of accountants. They have not been asked to make such judgments and they are not paid to do so. It is no wonder

that they have neither the inclination nor, far too often, the capacity to do so.

So, we can sympathize with CEOs who argue that they should not be required "to shoot themselves" by using a Black-Scholes type formula. They also claim, with some justification, that a Black-Scholes number will not be a precise gauge of cost and certainly will not be understood by the average investor.

So why do the members of FASB and the IASB insist that the cost of options be calculated by management and put into earnings per share? And why do so many organizations and spokesmen, and I include myself, constantly call for option accounting?

Why, in short, is not H.R. 1372 a perfect answer? It would call for three years of education, with some new disclosure. This cooling off period could make it easier to account for options later and perhaps make more people understand the issue.

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.

Only when companies, accountants and analysts begin to wrestle with the various approaches to option valuation and start to explain their formulas to the investing world,

will the investing world understand how the grant of options affects stock values.

H.R. 1372 if passed would have, in my view a most serious side effect. The costing of options is not the only accounting problem facing corporate America, nor is it the most serious. I have attached to my statement the Economist article of April 24, 2003 that I referred to earlier. Along with stock options the article identifies five other areas that cry out for reform, and describes the wide-ranging efforts underway here and in Europe to make the audit, and the accounting profession far more effective.

At the outset of my remarks I listed the circumstances that have created a crisis in accounting. That the audit has become a commodity in which few CEOs see intrinsic value and that auditors are too often just rule checkers who avoid exercising judgment are problems that urgently need the attention of the new structures created by the Sarbanes/Oxley Act.

The profession is being pushed to move toward a more principle based system and away from reliance on specific rules. And, as noted earlier, there is a growing use of "market values" rather than "historic costs" to present a companies financial position. The Economist notes these two trends and acknowledges that:

> "Profits may come to be stated as a range of figures, each of them arrived at by using different accounting assumptions."

> "This" continues the article "may sound worryingly uncertain, but it might be better than trying to rely on a ***brittle illusion of accounting exactitude***, which is liable to collapse during times of economic strain."

My point is that the accounting profession is in a period of profound change based largely on a growing realization that we have for far too long relied upon the ***brittle illusion of accounting exactitude.*** To some extent the string of accounting failures that we have had in the past few years are a result of that reliance.

My strong suggestion is that Congress allow the transformation to continue with the role of self-regulation intact but with far stronger oversight with the new Public Company Accounting Oversight Board and a newly staffed SEC with far more resources to do its job. An effort now by Congress to stop this fledgling effort to value options would seriously interfere with the development of the accounting profession that we so badly need.

I have no love for the Black-Scholes formula. It was not conceived to value options to determine earnings per share. I sincerely hope that it is not made the required way to value options.

More important, I very much hope that FASB and the SEC will allow flexibility in the costing of options. Let different companies use different formulas. The fact that there will be no precise formula or number should be a

vivid illustration of the fact that much of the information in profit and loss statements is equally imprecise.

Robert Frost, the poet, knew this as early as 1905 when he wrote.

Never ask of money spent
Where the spender thinks it went
No one was ever meant
To remember or invent
What he did with every cent.

What Robert Frost understood almost 100 years ago is beginning to be understood by us today. I fear that H.R. 1372 would impede the development of that understanding.

STATEMENT OF
DEBORAH NIGHTINGALE
PROJECT MANAGER, SUN MICROSYSTEMS, INC.

BEFORE
THE HOUSE SUBCOMMITTEE ON CAPITAL MARKETS,INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES

HEARING ON
"THE ACCOUNTING TREATMENT OF EMPLOYEE STOCK OPTIONS"

TUESDAY, JUNE 3, 2003

Thank you Mr. Chairman and Committee Members for allowing me to be here today to speak to you about the importance of broad-based stock options plans to rank and file employees across the country. I'd also like to thank Representatives Dreier and Eshoo for their leadership on this important issue. I'm here today speaking as one individual, but I know I represent the views of thousands of my colleagues at Sun Microsystems, and hundreds of thousands of workers at companies that provide broad-based stock option programs across the United States.

About Debbie Nightingale
Today, I have a dual career, working full-time for Sun Microsystems and serving part-time as a lieutenant colonel in the Army Reserves. I served on active duty early in my career and decided to leave the Army to pursue opportunities a civilian career provides. However, I chose to remain in the Reserves because I enjoy the military. Having been mobilized for over 6 months shortly after 9/11 to help lead the airport security effort in northern California airports, I am honored to continue to serve my country. In 15 years since leaving active duty, I have worked for four companies – high-tech and non-high tech - and have been with Sun Microsystems for the last five years.

Stock Options Create Employee Commitment and Loyalty
While I have enjoyed working for all four companies, there is no doubt that I am more committed to Sun Microsystems because of stock options. The reason is simple. In reward for good performance, Sun has given me a lot of stock options. While my options are currently all "under water," I am committed to staying at Sun and helping Sun succeed, expecting to reap the benefits when things turn around. Moreover, I continue working hard to keep getting stock options.

Stock Options Attract and Encourage Innovators and Entrepreneurs
Having worked both in high-tech and non-high tech companies, one big differentiator, in my opinion, has been that employees in high-tech tend to be more innovative and entrepreneurial than non-high tech. Granted high-tech typically pays more, but how do high-tech companies continue to motivate secure, well paid employees to keep innovating and taking risks? Based on my own experience, stock options provide the solution to this challenge. I work and think differently as a result of having stock options. While I have always been dedicated, stock options incent me to do more than simply work hard and please the boss. I am motivated to drive Sun's results so that I can benefit in some sizable sharing of profits, not just a slightly better-than-average pay raise. I am constantly focused on identifying innovative new ways to cut operating costs so that Sun can continue its R&D investments. I feel I have a real stake in the company's future success: Sun does well – I do well.

Stock Options Give U.S. Companies a Competitive Edge
As a member of the armed forces, I am very aware that the technologies US high-tech companies develop are a key element of our military strength and our national security. A unit, which was under my command as a battalion commander is currently deployed to the Middle East. While these soldiers are 'in harms way' every day, I feel just a bit better

knowing that they have absolutely every advantage that technology and superior equipment can give them. If we want to continue to have the strongest military force in the world, then we need to ensure U.S. high-tech companies retain their competitive edge. Maintaining global leadership in high-tech innovation is key to a strong economy, and to our national security.

Broad-based stock options are good news for U.S. companies and employees alike. Companies who include them as part of their compensation plans find themselves more able to attract and retain talented employees who are highly motivated for the success of their employers. One could argue that should our foreign competitors start using broad-based stock options just when the U.S. is considering steps to curtail them, this would be bad for our competitiveness, and possibly bad for our long-term national security.

Broad-based Stock Options REALLY matter to 'rank and file' employees
Stock options are a key reason I came to work for a top high-tech company and one of the reasons I stay. Employees like me need you to address concerns regarding accurate financial disclosure, while still ensuring that broad-based stock option plans remain a viable part of our compensation.

Stock Options Create Employee Commitment and Loyalty
Stock Options Attract and Encourage Innovators and Entrepreneurs
Stock Options Give U.S. Companies a Competitive Advantage
Stock Options REALLY matter to 'rank and file' employees

In summary, HR 1372 makes a lot of sense. It increases disclosure requirements now without discouraging broad-based employee stock option plans, gives more time to study the issue and to look for true win-win solutions. This issue is important to me and to my fellow employees. We do not want to see broad-based stock option plans eliminated.

Testimony by Paul A. Volcker
before
The U.S. House of Representatives
Committee on Financial Services
Washington, DC
Tuesday, June 3, 2003

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to address the question of the appropriate accounting treatment of employee stock options.

As you know, I am chairman of the Trustees of the International Accounting Standards Committee Foundation. That position reflects my interest in encouraging international convergence toward a single set of global accounting standards, a matter strongly in the interests of the world business and financial communities. As Trustee, I also feel a strong responsibility to assure that the standard setting process is coherent and appropriately disciplined. To that end, the decision-making International Accounting Standards Board (the IASB) that we Trustees appoint is made up of experienced professionals, working full time and committed to the broad public interest in consistent and reliable financial reporting. To help assure their independence and freedom from more parochial concerns, they have been provided with fixed terms.

I do not suggest that standard setting can or should take the characteristic of edicts from an insulated ivory tower. Far from it. The Trustees who exercise broad oversight over the IASB have richly varied experience and come from around the world. The decision-making Board has been drawn not only from the accounting profession but from operating businesses and "users" of financial information. There is a sizable Advisory Council regularly meeting with the Board. Elaborate consultative procedures to take account of the variety of perspectives among both reporting companies and the investing community have been developed.

Given inevitable differences in particular national, industry, and political concerns, controversy -- sometimes strong controversy -- cannot be avoided. What is essential is that, at the end of the day, the decisions reflect well-

reasoned judgments about how to best serve the needs of investors for reliable and consistent reports that fairly reflect the financial results of publicly traded companies.

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.

Obviously, the proper accounting treatment of the stock options is one of the highly controversial areas under review. As a Trustee of the IASC Foundation, I do not think it appropriate for me to comment on the substance of particular matters before the Board. However, I believe it has become clear that the great weight of professional opinion here and abroad is that as a part of employee compensation, the grant of a stock option has value, represents a cost to the issuer, and therefore should logically be reflected as an expense in income statements.

I might note in that respect that even companies that oppose expensing of stock options on their public financial statements have, when options expire, reported an expense in preparing their tax returns, a treatment long sanctioned by the IRS. Present American practice has another odd and counter-productive anomaly. Stock options with performance criteria, a seldom used but preferred approach in the opinion of many compensation experts, must be expensed. Much more widely used fixed-price options, with much more questionable and uncertain characteristics in aligning employee and investor interests, are not expensed.

If there is widespread agreement on the logic of expensing fixed-price stock options, the precise method of doing so is certainly arguable. I do not believe, as some have suggested, that fact in itself can justify taking no action. Much less should it be an excuse for political dictation of an intellectually flawed approach. Apart from the consequences with respect to stock option accounting, such an approach would create an exceedingly unfortunate precedent for other controversial issues bound to arise. In fact, as you deliberate about stock options, the European Commission is being strongly lobbied to reject a Financial Reporting Standard proposed by IASB which largely

incorporates an approach toward financial instruments already in place in the United States for some years.

The IASB has proposed one approach toward the manner of expensing stock options. As you well know, the U.S. FASB has the whole question under review. The common hope is that a convergence of views might be reached. While it would be inappropriate for me to intrude on that decision-making process, I cannot repress a related thought. If, instead of rejecting the logic and stonewalling acceptance of the basic idea of expensing grants of fixed-price stock options, the business community might usefully attempt to reach a consensus within its ranks about how expensing might best be measured and reflected in income statements. That, it seems to me, might be a real contribution to sensibly resolving what is clearly a difficult problem.

One final thought. I think it clear that the grotesque escalation of executive pay over recent years has been importantly a function of the greatly expanded use of fixed-price stock options for a small group of senior executives. That development has been encouraged and defended by the theory that such options align the interests of managers and owners. Obviously, the fact that those options are not expensed has provided a practical incentive even if the theory has proved weak.

Experience provides ample evidence that the relationship between reward and performance is capricious. In bull markets - and in the 1990's, we here in the United States experienced the greatest of all stock market bubbles - the payoffs from options became enormous, for the exceptional performer certainly, but for the mediocre and too often for relative failures as well. The image of executives exercising options worth tens of millions of dollars shortly before market collapse and even bankruptcy are fresh in mind.

In contrast, in prolonged bear markets, even the best of managers may not benefit. Then the temptation to reprice options or issue new ones at depressed prices seems nearly irresistible, hardly in keeping with the notion that options are rewards for exceptional performance. Increasingly, it is becoming more widely recognized that options may and do tempt some executives to manage short-term earnings and market expectations in a manner counter to the basic interests of the company.

I recognize that start-up companies, long on ideas and short of cash, may find stock options a useful form of compensation -- a rational decision by an owner-entrepreneur who understands and bears the cost. There are also large companies that have long made a practice of spreading stock-options widely among employees and find that a useful approach.

But none of that argues against recognizing a real expense in financial reporting. I am afraid that the absence of expensing has, quite obviously, encouraged the obvious abuse of large stock options, concentrating the benefits on a limited group of top management personnel.

In my own view, large companies with widely dispersed ownership should, as a matter not of law but of good corporate practice, be discouraged from active use of fixed price stock options, particularly when concentrated on a small group of executives. If expensing of such options leads to that result, and greater use of more effective means of aligning management and owner interests, then that would be constructive.

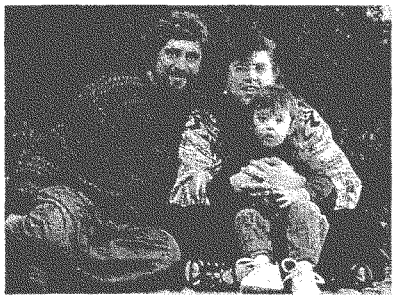
Employee Stock Options: The Untold Story

To date, the debate over stock options has focused primarily on issues surrounding executive compensation, complex valuation models and accounting regulations. In the mean time, the stories of millions of rank & file workers who have benefited from stock options have yet to be told.

These stories, from secretaries, bookkeepers and engineers, offer a valuable insight into what stock options mean to everyday people – and why widely distributed options have become such a valued tool for employers seeking to build and reward a loyal workforce.

The following pages include just a few of these stories.

Name: Richard Berlin
Residence: Campbell, CA
Employer: Sun Microsystems, Inc.
Position: Sr. Staff Engineer
Years on job: 15



In 1996, stock options paid off most of my wife Mika's graduate student loans from the University of San Francisco, where she earned her degree and is now a licensed marriage and family therapist. They also allowed us to replace her car, without which she could never have done her job, which at the time was an executive director of a nonprofit agency that served battered women.

After California's energy crisis hit, our stock options helped pay for photovoltaic (solar electricity) panels on our roof. They also provided the down payment money for that home.

And most recently, they provided seed capital for my wife's small business, "Secure Beginnings," which we hope will allow her to improve the lives of mothers and children throughout the Bay Area.

Perhaps most importantly, though, they paid the doctors and hospital that made it possible for us to overcome infertility and realize our dream of becoming parents ourselves.

Name: Scott Armitage
Residence: Suwanee, GA
Employer: Sun Microsystems, Inc.
Position: Systems Engineer
Years on the job: 6

As a recipient of Sun stock options, I feel as though I am not simply an employee fulfilling a role, but rather, an employee that has a vested interest in the company's financial goals and success. Holding Sun stock options makes me feel as if I own a piece of the company.

Stock options, combined with faith and discipline are for me, a long-term source of inspiration and morale which in turn fuels good deeds and a hard work ethic. Much of the financial planning I have in place, which in part has been built on my stock options, will hopefully one day allow me and my family an opportunity to fulfill our goals. These goals are modest, not wasteful and lavish uses of stock option spending recently exemplified by some corporate America executives.

Name: Dickie Conn
Residence: Haymarket, VA
Employer: Sun Microsystems, Inc.
Position: Group Mgr., Partner Marketing Services
Years on job: 7

I was married when my oldest son Brian started college at Yale. Together my husband and I couldn't manage to come up with all the money to pay for his school, and he had to take out student loans to cover the part we couldn't. We hadn't received any stock options at this point. By the time my daughter Taysanna started college 3 years later, we had both been given stock options at our respective companies and we were able to pay for her first year at Arizona State by cashing in our stock options.

The next year I was divorced and faced with having to cover most of her expenses at school myself. I used the options I had vesting at the time to do that. My ex husband helped where he could, again with his stock options.

By the time my youngest son Michael started college at Embry Riddle, I was paying my share through stock options. This lasted until 2001. When the stock market dropped and the options weren't really worth much of anything, he had to take out student loans to cover his expenses. When the market recovers I will again use my stock options to help pay off his student loans.

Without the options I could never have contributed anything to my children's college education. They were the one benefit that I got at work that I could use for this purpose. I felt at the time that if I did my job really well, I could get awarded stock options. I think this motivating factor helps contribute to the company being a success -- which made me feel like I was actually part of that success rather than just putting in time for a paycheck.

Stock options give me a vested interest to do well for the company. With today's economy being down, I still view options as a strong incentive for the future. Options are a way of letting employees know that the company thinks you are doing well and that you are a valued part of the team.

I feel like I am part of Sun's success, and in a way, I feel Sun has been like my family. I think this is in large part due to the options. I 'own' some of the company and it's up to me to do what I can to make it successful. That makes a powerful alliance for any company.

Name: Calvin Fox
Residence: Lithia, FL
Employer: Sun Microsystems, Inc.
Position: Regional System Support Engineer
Years on the job: 15

I have been with Sun for almost 15 years now and a lot has changed. However, one of the things that has not changed is my excitement to be working for Sun. In 1988 when I started as a field engineer in the Washington, D.C. area, the workload was overwhelming. We would work an average 70+ hours per week.

The feeling of accomplishment and the potential for financial success at Sun helped shape my plans for the future. By the late 1990's, the economy was booming and all my hard work was starting to payoff.

I have 7 kids and I work to provide the best for them. My stock options have provided me with financial success and the ability to buy items such as a car, college education, and a home.

Stock options are no guarantee, yet they provide companies like Sun the ability to keep employees happy and retention high. I would be saddened to see this program become unavailable in the future because it is great to see my dedication and work achieve a profitable return to Sun's shareholders.

The bottom line is that stock options are a powerful tool when shared among all employees.

Name: Scott Gaspard
Residence: Austin, TX
Employer: Sun Microsystems, Inc.
Position: System Support Engineer III
Years on the job: 3.5

Before I came to work for Sun, I dreamed of a day when I would be a good enough technician to go to work for Sun. I had heard about the culture at Sun; how its employees truly had a sense of community, and how they identified themselves as Sun Employees with pride.

After working hard to perfect my skills, and successfully achieving my goal to be a Sun employee, I truly understood where they were coming from. The experience reinforced my belief that through hard work and determination my goals would be achieved, and that I would be rewarded.

Since I have been with Sun, I have had no reason to seek employment elsewhere. One reason is that Sun has rewarded my hard work and determination to achieve my goals with stock options. Stock options make me think about the future; they make me strive to achieve my goals, because I know that I will be rewarded.

I enjoy knowing that I have stock options, and I watch the stock reports to see how they are doing. I keep up with news affecting Sun and its competitors. This makes me a better employee because it helps me to see the big picture. Without a sense of ownership in the company, I might not be inclined to keep up with the news, or to make decisions other than those that affect my immediate situation.

This sense of ownership, and community helps individuals to navigate through tough times. We know that Sun is doing the right thing, and that if we all keep rowing, the ship won't sink. We all hope that eventually through our hard work and determination, as the company succeeds, we will succeed in achieving our personal goal of wealth. As I understand it, this is the American way.

Without programs like stock options however, individuals might be more inclined to jump ship, and seek wealth elsewhere. This would be a bad thing, both for the company, and its stock-holders. Lets keep the employees happy, and determined to succeed, by giving them something to look forward to, and something to hope for. Let's not mess up the great culture of Sun Microsystems by taking away the very thing that makes the company great; its employees.

Name: Margaret Herrera
Residence: Golden, CO
Employer: Sun Microsystems, Inc.
Position: Campaign Manager, Sun Services Marketing
Years on job: 3

Sun is only the third corporation I have worked for in my 20 some year career, but this message is actually about stock options and how they have made a difference in my life.

In my previous job as an administrator at Silicon Graphics, I earned a fair wage but the one thing that really made a difference were the stock options. As an administrator I didn't receive many. The first time I received options, I received 100 shares. Over the first 5 years of my employment the stock price doubled and the stock split, eventually, I earned more shares and the value of the stock went up. I exercised my options and had enough money to put a down payment on a home we could call our own.

At Sun I have earned many more stock options and I think of them as an incentive to continue to work hard and do my part to keep Sun the best computer company in the world.

I have appreciated the stock options Sun has awarded me as much as or more than other benefits because with these options, I can see how I can support myself and family after retirement. We all know that Social Security won't be enough for most of us to live on, and these options (along with 401K and other investments) are a way for some of us to retire long before the 65-67retirement age.

I don't want to spend my later years working, I've worked at a full-time job for far more than half of my life. I have worked hard to save my money and invest so that my money works for me. These options are part of my retirement plan. If the government takes them away now the opportunity for my "nest egg" to continue to grow becomes limited.

Some of the stock options I received from my previous company were also used to help support my nephew in college. I was able to help him pay for tuition as well as keep him fed for a few years. We also plan to use some of funds from my options to pay for college for our children.

I am from an ethnic background and was the only one of my siblings who completed college. Stock options helped me subsidized my tuition because my folks didn't have the money to help me pay for it. With the options, I didn't have to borrow much and my school loans were paid off a month before graduation.

Please don't let the government take away the Stock Options companies like Sun give to workers. I'll never earn a six-figure income or be set for life. I've followed the advice of financial analysts and the government to work hard, save my money, and have put money aside in a 401K so that I won't have to depend upon the government and Social Security for my retirement.

Name: John Jennings
Residence: Fremont, CA
Employer: Sun Microsystems, Inc.
Position: Director, Systems Integration
Years on the job: 9

I really must protest the consideration of expensing stock options. I have been in the high tech business for 17 years and the reason I stay is because of the stock options. The innovations that this industry has driven have been phenomenal and are largely driven by hard working individuals working at a pace far beyond what companies that don't offer stock options experience.

Prior to working at Apple and Sun, I worked in the aerospace industry where the pace was very slow, innovation almost non-existent, and people worked from 9 to 5. In the high tech business, people regularly work 12 hour days, sometimes at the expense of health and family, so they can either make ends meet or to make a little extra to pay for college for their kids. This type of effort is exactly what this country is all about. You work hard, get ahead, and make sure your family is taken care of and that the kids all make it to college.

As a single income family, my stock options are the best way for me to provide all the things my family needs.

The abuses of the past few years are not because of the current use of stock options. The abuses were criminal acts of blatant manipulation that must prosecuted. Don't punish the innocent hard working rank and file employees who for once have a shot at living comfortably.

Compare the innovation and wealth created in this country by the high tech industry that offers stock to rank and file workers to other industries that don't offer stock options, and I would bet all my options that the innovation difference is enormous.

Personally, I've used my stock options for college funds, family vacations, a bigger house for a growing family, and other expenses related to relocating from outside the area.

We also bought a cabin in the mountains where we can spend quality time with the kids away from all the distractions of school, work, and other engagements. I've also been able to loan money to a nephew just starting out and needing some cash to buy a house. And, I bought a car that would have otherwise been difficult to make the payments on given the high cost of housing in the valley.

Finally – I've paid a ton of taxes!

Name: Janet Koenig
Residence: San Francisco, CA
Employer: Sun Microsystems, Inc.
Position: Sr. Software Engineering Manager
Years on job: 6

I feel extremely fortunate to have received stock options from Sun. It is very expensive to live in the Bay Area so I pretty much live check to check.

However, I have an aging mother who needed a living situation where she would have the help she needs, and I was able to use my stock options to get her into a condominium in an assisted living environment in San Diego.

While she's not living in luxury, she is safe and when I'm not available, I know there are people who will take action if something happens.

Without stock options, I would never have been able to afford to care for my mother and maintain my current job (which is the most challenging and most gratifying job I've ever had!) I would have had to move us both to a less expensive city and I would most likely find job opportunities that don't motivate and excite me the way my current job does.

While I would do what I can to continue to afford to keep my job and stay in the bay area, I do hope that this form of compensation is not taken from my company. I feel an incredible amount of loyalty to my company because I have been compensated in this way.

I love Sun, it has been very good to me professionally and financially.

Name: Chris Kordish
Residence: Tyngsboro, MA
Employer: Sun Microsystems, Inc.
Position: Solaris Technology Engineer
Years on job: 14

I have been at Sun for almost 14 years. My stock option exercises helped me buy a new house that is more secluded so my special needs little boy John (who has Williams Syndrome) won't wander near the corner of the busy street we used to live on. Williams Syndrome kids are attracted to spinning objects, such as fast moving car tires. Needless to say, our new surroundings, in a housing development with a bigger fenced yard, has greatly reduced my fear. More importantly, we've enhanced his ability to be free and play - two freedoms that every child should have and that every parent strives for.

Our new town also has a school system that caters to special needs children more so than the town we used to live in. WS kids in some cases have even gone to college - I hope and pray my little guy will get to go. My wife Susan and I feel we are now one step closer.

Our new neighborhood also has younger kids that are same age as mine (not so in our old housing development which was largely much older kids and older folks). Now my little John (4-yrs) and little Annmarie (2-yrs) have playmates of the same age. My family's quality of life is better as a result.

I am 6'8" tall. In our old house I hit my head on the 80" "standard" doorways. In the new house, we paid extra for 84" doorways so I don't hit my head anymore - most wouldn't care about this but I sure do.

Finally, could you blame a guy for wanting to "retire early" (6-7 years from now) so I can give my special needs son the attention he needs? Stock option exercises let me at least dream of this as an option.

Name: Kelly Lyon
Residence: Superior, CO
Employer: Sun Microsystems, Inc.
Position: Software Engineer
Years on job: 12

I'm a single female and stock options have been a wonderful financial incentive for me.

When Sun bought-out the company I worked for in Ft. Lauderdale, Florida (Encore), I would never have moved to Colorado had it not been for the stock option incentives. (I'm a software engineer and had 11 years experience at that point).

Stock options helped me with the down payment for a house in Colorado (until my condo in Florida sold).

I even cashed some out to help my mother save the family house in suburban Kansas City when she was out of work and got behind in her payments.

I'm not interested in playing politics and moving up the management ladder, so it's nice that we technical engineers have motivating financial incentives as well.

Name: Dick Marin
Residence: Niwot, CO
Employer: Sun Microsystems, Inc.
Position: WRIT Manager
Years on the job: 14

I've been at Sun since May 1989. Prior to Sun, I worked at Fireman's Fund Insurance, Control Data Corp., IBM and Pacific Bell. None of those companies gave rank and file stock options.

I received my first grant approximately 6-months after joining Sun. I thought I'd died and gone to heaven! That a company would give me stock options was unfathomable! I have since received other options, some of which are under water, but they will bounce back – of that I'm sure. Here's what stock options have helped me do:

- buy a house
- pay for our two daughter's weddings
- pay cash for our automobiles
- helped my wife start a small business
- establish trust funds for our daughters and their children
- helped create a Charitable Remainder Uni Trust to help us in our retirement, and after our demise, give the remainder to three charities and the Battered Woman's shelter of Boulder, CO.
- given me the chance to donate to help fund the Holocaust Museum in Washington, DC
- helped set up college funds for our grand children
- they have given me the opportunity to regularly give donations to help the poor and hungry of our community

Would any of this been possible without the stock options? Maybe, but it would have been very difficult!

Stock options have allowed my wife Liz and I the opportunity to fulfill our parents dream of giving back to our community and our fellow man. We have been lucky enough to help countless others through our good fortune.

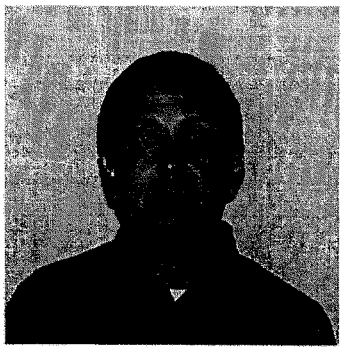
I am a first generation Italian American. As long as I can remember my Father would say: "you live in the most wonderful country in the world, with opportunity to aspire to whatever level you wish. Remember who you are, where your roots came from, and in some way find a way to give something back before it's all over." And he said, "You better, because I'll be watching!"

I know he watches, and I know/hope he's proud.

That's what Sun stock options have helped me do, and will help me to do more in the future!

Name: Neal Matsunaga
Residence: San Ramon, California
Employer: Sun Microsystems, Inc.
Position: Principal IR Manager
Years on job: 6

I started at Sun in November 1996 and began receiving stock options shortly thereafter. I first exercised some stock options in January of 2000 and used the proceeds to help my family in several ways:



First, I have a daughter who started college in September 2000. We had set aside some funds for her college, but her final choice of school, Willamette University in Salem, Oregon was about twice as expensive as we had provided for. We were able to use some of the proceeds to insure that we could provide for four years of college for her.

Second, my family has lived in our home in San Ramon, California, since 1986. Our home is on a hillside and over the years we have experienced slow earth movement under our home. Finally, in 1999 the problem had become severe enough that we had difficulty locking exterior doors and decided we had to fix the problem. Estimates for the work required were in the $70,000 range, which was still worth doing due to the value of the property. We were able to use some of the proceeds from our January 2000 exercise to pay for the work and eliminate our worry about losing our home.

Finally, my family has practiced tithing a portion of our income to charitable uses over the years. With the exercise of options in January 2000, we were able to make significant donations to such organizations as:

-- Loaves & Fishes in Concord, CA
-- Shepherd's Gate, a home for abused women with families
-- Friends Outside, helping to provide equipment for a prison woodworking shop
-- Our local high school, in support of instrumental music and science classes

Our exercise of stock has helped my wife and I provide for our family, insure our safety, and help others. I hope the above helps describe how options help "ordinary" families and the communities we live in.

Name: Jeff Solof
Residence: North Andover, MA
Employer: Sun Microsystems, Inc.
Position: Group Marketing Manager, Editorial and Communications
Software Outbound Marketing
Years on the job: 5

While I love working at Sun for many reasons, at a certain point, my responsibility is to do what's in the best interests of my family, for whom I am the primary breadwinner. The stock options I have received from Sun are an important part of my family's long-term financial picture, and as such, are a significant incentive for me to work hard on Sun's behalf, tune out non-productive distractions, and focus on making a solid contribution to the success of the company.

I am not expecting to strike gold; the market doesn't have to repeat the unnatural acts of the late '90s. 'Normal' growth, based on hard work, smart leadership, and a recovering economy, mean that my options will make it possible for my kids to receive a great education. I may even be able to retire early -- say, at 60, instead of 65 -- and start a second career in the ministry.

If stock options were to go away -- i.e., if by the fact that they must be expensed, Sun is forced to discontinue the program -- I would still work hard for the company. The kinds of people Sun hires would do that. But I would be much more open to exploring other job opportunities, which would deliver perhaps more compensation in the short term. The net result would be a less loyal, dedicated, and hard-working work force, which would inevitably, absolutely, erode Sun shareholder value.

Transient workers, looking for the fattest monthly paycheck in any given month, are not a strong base on which to build a strong company. You have to be in it for the long haul, incented to work hard for the success of the company. And there's no better way to do that than to align my interests 100% with those of our shareholders.

Name: Thomas Valine
Residence: San Jose, CA
Employer: Sun Microsystems, Inc.
Position: Hardware Design Engineer, Processor & Network Products
Years on the job: 3

I couldn't imagine a life without stock options. I bought my house using options, a new car with options, and look forward to cashing in on the success of my contributions to Sun and on the success of Sun as a company.

My options are invaluable. Although I am happy with my base compensation, my options provide me with a unique connection to the company. My effort is linked to the success of the company and the success of the company is linked back to me by my options.

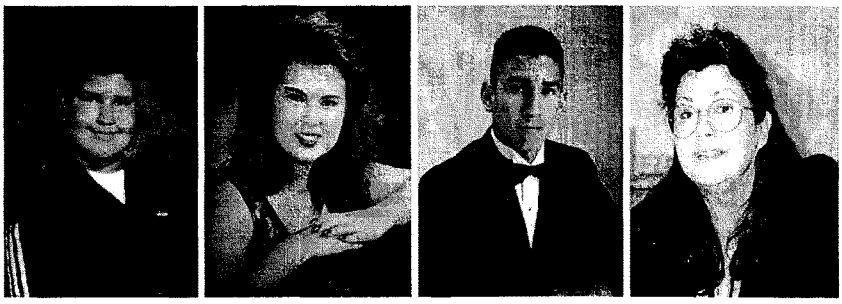
Would I be less motivated if I didn't have options? Definitely!!! Even if my base compensation was improved, the mere possibility of exercising my options to purchase that dream plot of land, or that 25th anniversary ring my wife wants, or my daughter's first car... No amount of caffeine can produce the same effects as the very real possibilities for regular employees to obtain what might be out of their reach otherwise.

Most good products are 5% great idea and 95% blood, sweat and tears. When the initial enthusiasm passes, what then will be left to motivate us to grind out that 95%?

This is about more than options, it's about peoples lives, families, and futures... Dreams are the greatest motivator of all, and our options represent a vehicle to achieve those dreams.

Name: Deborah Wasserman
Residence: Morgan Hill, CA
Employer: Sun Microsystems, Inc.
Position: Documentation Specialist
Years on job: 13

I am a single parent who would not have been able to purchase a home for my three kids, Frank, Geraldine and Jesse, if not for my stock options. Because of high child care costs, and the way child support collection is enforced in this country, I had to rely on public subsidies to help pay my rent.



I would not have been able to afford to buy a home for my family. I used my stock for the down payment and closing costs. Now when I pass on, I can feel good about leaving my kids something.

Name: Nick Wilde
Residence: Boulder, CO
Employer: Sun Microsystems, Inc.
Position: Java Architect, Software Services
Years on the job: 3

I've worked for Sun as part of Sun Professional Services for the past 3 years. During that time, I've been fortunate enough to receive a grant of additional stock options on a few occasions, as a performance bonus.

To me, using stock options as a performance incentive for the "rank and file" is one of the major things that distinguish Sun, as an employer, from many of its competitors in the high-tech arena. My wife works for one of the "other guys" - in her close to 15 years with that particular company, and a successful career to date, she has been offered a stock option bonus only once.

Stock options are one way Sun tells me I'm "part of the team," instead of just an employee for a large, faceless organization. How the company does has a direct bearing on my financial well-being - I like that. I like having a "stake" in where I work. I know that many of my peers feel the same way.

In addition, stock options provide an incentive for good performers to stay with a company for a longer period of time. High technology companies such as Sun are knowledge-based - in a very real sense, the "product" we sell is locked away in the collective experiences and knowledge of the entire organization. Every time someone leaves, they take a little bit of that knowledge with them. Stock options, vesting over a period of time, provide an incentive for good employees to stay with the company for a little longer, preserving that knowledge investment for the company.

If Sun were to expense options, I fear the cost and complexity of doing so would be so great as to discourage management from giving options to employees like myself, and the options as a performance bonus plan would eventually dwindle or go away entirely.

This would be a real shame for both the company and for its employees. A cash bonus, while nice, doesn't have the potential for growth that options have. They don't tie the fortunes of the individual to that of the company, but actually incite "short term" behavior - to maximize bonus payouts - rather than behavior that is best for the company, and its employees, over the long haul. Lastly, cash bonuses don't motivate "high performers" to stay with the company over the long haul, as options, with a vesting period, do.

For my sake, and for the sake of my company, please do not change the way we report and use options as a performance incentive within Sun Microsystems.

I

108TH CONGRESS
1ST SESSION

H. R. 626

To amend the Internal Revenue Code of 1986 to provide that corporate tax benefits from stock option compensation expenses are allowed only to the extent such expenses are included in a corporation's financial statements.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 5, 2003

Mr. STARK (for himself, Mr. POMEROY, Mr. WAXMAN, Mr. GEORGE MILLER of California, Mr. OLVER, Ms. SCHAKOWSKY, Mr. LIPINSKI, and Mr. GRIJALVA) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to provide that corporate tax benefits from stock option compensation expenses are allowed only to the extent such expenses are included in a corporation's financial statements.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Ending the Double Standard for Stock Options Act".

SEC. 2. REQUIREMENTS FOR CONSISTENT TREATMENT OF STOCK OPTIONS BY CORPORATIONS.

(a) CONSISTENT TREATMENT FOR TAX DEDUCTION.—Section 83(h) of the Internal Revenue Code of 1986 (relating to deduction of employer) is amended—

(1) by striking "In the case of" and inserting: "(1) IN GENERAL.—In the case of", and

(2) by adding at the end the following new paragraph:

"(2) SPECIAL RULES FOR PROPERTY TRANSFERRED PURSUANT TO STOCK OPTIONS.—

"(A) IN GENERAL.—In the case of property transferred in connection with a stock option, the deduction otherwise allowable under paragraph (1) shall not exceed the amount the taxpayer has treated as an expense for the purpose of ascertaining income, profit, or loss in a report or statement to shareholders, partners, or other proprietors (or to beneficiaries). In no event shall such deduction be allowed before the taxable year described in paragraph (1).

"(B) SPECIAL RULES FOR CONTROLLED GROUPS.—The Secretary shall prescribe rules for the application of this paragraph in cases where the stock option is granted by a parent

1 or subsidiary corporation (within the meaning
2 of section 424) of the employer corporation.".
3 (b) CONSISTENT TREATMENT FOR RESEARCH TAX
4 CREDIT.—Section 41(b)(2)(D) of the Internal Revenue
5 Code of 1986 (defining wages for purposes of credit for
6 increasing research expenses) is amended by inserting at
7 the end the following new clause:
8 "(iv) SPECIAL RULE FOR STOCK OP-
9 TIONS AND STOCK-BASED PLANS.—The
10 term 'wages' shall not include any amount
11 of property transferred in connection with
12 a stock option and required to be included
13 in a report or statement under section
14 83(h)(2) until it is so included, and the
15 portion of such amount which may be
16 treated as wages for a taxable year shall
17 not exceed the amount of the deduction al-
18 lowed under section 83(h) for such taxable
19 year with respect to such amount.".
20 (c) EFFECTIVE DATE.—The amendments made by
21 this section shall apply to property transferred and wages
22 provided on or after the date of the enactment of this Act.

○

Congress of the United States
Washington, DC 20510

February 3, 2003

Financial Accounting Standards Board
File Reference 1102-001
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Sent by email to director@fasb.org

Re: Employee Stock Option Accounting

To Whom It May Concern:

In response to the Financial Accounting Standards Board's (FASB) Invitation to Comment on the proper accounting for employee stock options, we wish to strongly voice our support for an honest accounting standard that would require all employee stock option compensation to be shown as an expense on corporate financial statements.

The current U.S. accounting standard allows companies to choose whether or not to report stock option compensation as an expense in their financial statements filed with the Securities and Exchange Commission. This accounting treatment has led to a variety of stock option abuses linked to excessive executive compensation, inflated company earnings, dishonest accounting, and corporate misconduct.

Since the 1980s, stock option compensation has funneled millions of dollars to U.S. corporate executives and now accounts for a large share of compensation paid to chief executive officers (CEOs) at U.S. corporations. Business Week has estimated that, in the aggregate, employee stock options now account for "a staggering 15 percent of all shares outstanding" at U.S. publicly traded corporations. The amounts paid to CEOs are striking, including the $123 million paid to Enron's CEO in 2000, and the $700 million paid to the CEO of a high technology company in 2001. Typically, such payments never appear on a company's financial statement, despite the size of the payment and even though the common practice is that the company claims the compensation as an expense on its federal corporate tax return. The omission of any stock option expense in the financial statement, combined with the inclusion of this expense in the company's tax return, means that huge stock option grants lead to overstated earnings. Federal Reserve Chairman Alan Greenspan has estimated that stock options have been used to overstate reported company earnings by an average of 6 to 9 percent.

But this is not the only problem associated with stock options. A September 2002 report issued by a blue-ribbon panel established by The Conference Board found that the current accounting treatment of stock options helped "foster[] what appears to be a vicious cycle of

increasing short-term pressures to manipulate earnings in order to bolster stock price in order to cash in on options." Such earnings manipulation is associated not only with the Enron scandal, but many of the other accounting scandals in 2002. These stock option abuses and the dishonest accounting associated with them have damaged investor confidence in the accuracy and reliability of U.S. corporate financial statements.

In response to this loss of confidence, over 120 U.S. companies, including such American giants as Coca-Cola, General Motors, General Electric, Dow Chemical, Amazon.com, Home Depot, and Wal-Mart, have announced that they will begin expensing options in 2003, joining longtime expensers like Boeing and Winn-Dixie. Other companies, however, especially in the high technology sector, have announced that they will not expense stock options until required to do so. This division of approach means that, until FASB acts, there will be a discrepancy between those companies that are voluntarily expensing options and those that are not, when there ought to be a level playing field in which everyone operates under the same accounting rules. This discrepancy looms large in light of the huge dollars involved in many stock option awards. Failing to impose a uniform expensing requirement would not only allow companies that do not expense options to inflate their earnings, but would also disadvantage the companies that do report stock option expenses as well as hinder financial analysts and investors attempting to understand company financial statements and compare corporate performance.

Some opponents of stock option expensing argue that, due to the difficulty of precisely estimating stock option values, expensing will confuse rather than educate financial analysts and investors about a company's financial condition. But many accounting standards require estimated valuations and, as Warren Buffett has pointed out, the only value that everyone agrees is incorrect for a stock option is zero. The better approach to curtail stock option abuses and restore investor confidence in financial statements is to require all companies to use the same stock option valuation methodology to ensure stock options are expensed and the comparability of financial statements is strengthened.

Some critics also contend that expensing stock options would eliminate broad based stock option plans and hurt average workers, but this contention is contradicted by the factual record. First, successful U.S. companies that offer broad-based stock option plans to their workforce have already determined that they can expense employee stock options without having to end this form of compensation. Two recent examples are Home Depot and Wal-mart, which offer broad-based plans to many average employees and have announced they will begin expensing options this year. Secondly, only a small percentage of U.S. companies now issue stock options broadly to average workers, even when those workers are eligible to receive them. A recent nationwide survey conducted by the U.S. Bureau of Labor Statistics found that in 2000 – a banner year for stock options – only 1.7 percent of non-executive workers actually received any stock options.

This survey, the most extensive review of actual worker receipt of stock options in corporate America, demonstrates that most workers do not now receive stock options and would be wholl unaffected by any changes in stock option plans, even assuming any change were actually to tak place. In short, neither broad based stock option plans nor average workers would be hurt by honest accounting.

Now is the time to end the dishonest accounting of stock options and recognize the expense associated with this compensation. FASB was prevented by political pressures from expensing options in 1994, but has consistently contended over the years that expensing is the correct approach. According to the Association for Investment Management and Research, ove 80 percent of U.S. financial analysts and portfolio managers agree. The International Accountir Standards Board is already advocating this approach in its proposed accounting standard for stock-based compensation. Many others also support stock option expensing, from leading figures like Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul Volcker, investor Warren Buffett, and Nobel Prize winner Joseph Stiglitz, to such groups as the Council of Institutional Investors, the Investment Company Institute, The Conference Board's Commission on Public Trust and Private Enterprise, and the Consumer Federation of America. The more than 120 companies that are now expensing options also deserve a fair accounting standard that will not place them at a disadvantage with competitors who refuse to show this expense.

Requiring companies to expense employee stock options would strengthen the accuracy of financial statements and help restore public trust in our financial reporting system, our companies, and our markets. We urge FASB to issue a proposed stock option accounting standard as soon as possible and to promulgate a final standard by the end of 2003.

Sincerely,

John McCain

Pete Stark

Carl Levin

Stephanie Tubbs Jones

Earl Pomeroy

Mike Castle

Financial Accounting Standards Board
February 3, 2003
Page Four

Ed Case

John W Oliver

The signatories on the February 3, 2003 letter
to the Financial Accounting Standards Board are as follows:

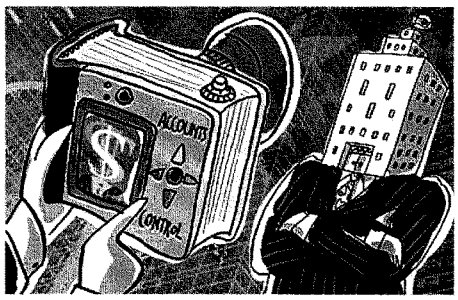
Sen. John McCain
Rep. Pete Stark
Sen. Carl Levin
Rep. Stephanie Tubbs Jones
Sen. Jon Corzine
Rep. Jan Schakowsky
Rep. Tammy Baldwin
Rep. Barbara Lee
Rep. Dennis Kucinich
Rep. Martin Frost
Rep. Bernie Sanders
Rep. Dale Kildee
Sen. Joe Biden
Sen. Dick Durbin
Sen. Russell Feingold
Rep. John Dingell
Rep. John Olver
Rep. Earl Pomeroy
Rep. Michael Castle
Rep. Ed Case
Rep. Benjamin Cardin
Rep. Henry Waxman
Rep. George Miller
Rep. Jerrold Nadler
Rep. Eleanor Holmes Norton
Rep. William Janklow
Sen. Mark Pryor
Sen. Bill Nelson
Sen. Herb Kohl
Rep. William Lipinski

Economist.com **OPINION**

The future of accounts

True and fair is not hard and fast

Apr 24th 2003
From The Economist print edition



For accounts to reflect reality, they need to be more volatile and less precise

THE procession of companies admitting to having lied in their reported accounts has undermined faith in corporate numbers and put the accounting profession under pressure to change its ways. In the 1990s, accountants clearly failed to keep up with the tricks that were devised to help companies inflate their profits. The first priority for those who set accounting rules has been to try to choke off the most obvious loopholes.

Looking further into the future, however, some see the crisis in accounting as an opportunity to change the shape and content of accounts more fundamentally. The growing use of market values for assets and liabilities (instead of the accidental "historic cost" at which they were obtained) is going to make shareholders' equity and profits swing around far more than in the past. Under such circumstances, profits may come to be stated as a range of figures, each of them arrived at by using different accounting assumptions.

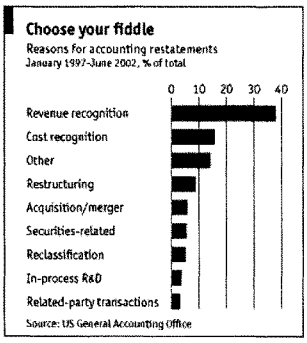
This may sound worryingly uncertain, but it might be better than trying to rely on a brittle illusion of accounting exactitude, which is liable to collapse during times of economic strain. For the moment though, the efforts of regulators and standard-setters are focused on five main areas:

•**Pro-forma accounts**. These are the first sets of results produced by companies in America: they are unaudited and do not follow America's GAAP (Generally Accepted Accounting Principles). In the years of the stockmarket bubble they were shamelessly abused. Companies regularly reported huge profits in their pro-forma earnings statements, only to register even larger losses in their official filings with the Securities and Exchange Commission (SEC). Since the end of March this

year, companies have been compelled to show how they reconcile their pro-forma figures with the numbers subsequently produced according to GAAP rules, of which there are hundreds.

•**Off-balance-sheet vehicles**. These include the "special-purpose entities" made famous by Enron, which gave them the names of suitably fanciful characters in the Star Wars movies. They allowed the Houston oil trader to hide hundreds of millions of dollars of liabilities from investors' eyes. The Financial Accounting Standards Board (FASB), America's private-sector standard-setter, issued guidance on these vehicles in January, which Ford and General Motors say will have a material impact on their profits this year. But some think that the new rules are weak because they allow exemptions for "qualifying" special-purpose entities.

•**Stock options**. Most significant of all, perhaps, is the attempt to force companies to account for stock options granted to their employees. This week, FASB agreed that the cost of employee stock options should be treated as an expense. The question is, how to value them. The standard-setters may yet have a fight on their hands. In 1994, Congress threatened to take away FASB's standard-setting powers if it did not abandon its attempt to make companies "expense" their stock options. Opposition is gathering once more, although this time recent accounting scandals should lend support to FASB's position.



•**Pension funds**. Another controversial aim is to make companies change the way they account for their employee pension schemes. Britain's new standard on pensions, FRS17, forces them to measure pension assets at market value. In future, if a company's pension fund owes its members more than it owns in assets, the difference will be shown on the balance sheet. Outside Britain, such gaps can be smoothed out over years, with the result that some companies are still recording profits from their pension schemes despite the fact that the schemes themselves are in deficit. Britain's approach will spread: in March, FASB said it would start examining ways to improve accounting for employee pension plans, with the aim of publishing a new standard on pension accounting in America next year.

•**Revenue recognition**. This is the vexed issue of when precisely to include revenue in the accounts—for example, when an order is made, when it is shipped, or when payment is received. Revenue recognition has been the main reason for restatements of accounts by American companies in recent years. Sir David Tweedie, chairman of the International Accounting Standards Board (IASB) in London, and his equivalents around the world want to lay down new rules on when a company can recognise revenue. Again, the effect could be far-reaching: companies could be made to look far smaller if they are prevented from pulling revenue forward from future periods, as many do now.

Future standards

Standard-setters hope that today's mood of financial conservatism will allow them to tighten up other areas of accounting too. For example, Sir David wants all leases—contracts in which a company is committed to pay for the use of an asset over a long period of time—to be recorded on companies' balance sheets as debt. The result would be to make balance sheets larger and debt ratios higher.

Yet another goal is to shift the world's body of accounting standards away from rules (the approach favoured in America) towards principles (more influential in Britain). The hard rules embedded in America's GAAP have helped devious financiers to design structures that obey the letter of the law but ignore the spirit.

But Bob Herz, the new chairman of FASB, is not optimistic about his ability to move GAAP towards principles and away from rules. Because companies and auditors demand certainty in America's litigious market place, the most he can do, he says, is to steer somewhere in between the two approaches.

Standard-setters may find it a struggle to bring in tough new measures. But they have a wider agenda that finance directors will eventually find it hard to resist. They want to stop companies using accounting rules to create the impression that profits rise remorselessly every year—by, in effect, smoothing out their earnings. "We are stripping away management's ability to massage their numbers," says Sir David.

Peter Holgate, the head technical partner at PricewaterhouseCoopers in London, asks how it is that corporate earnings move upwards in a straight line while the drivers of those results—consumer demand, stockmarkets, interest rates and foreign-exchange rates—bump around much more unevenly.

Clamour for reform began in the 1990s. As share prices soared, people pointed to the growing gap between the book value of companies (what appeared in their accounts) and their market capitalisation (valued on stock exchanges) as evidence of the irrelevance of accounts. The way to make them more relevant (and to stop executives from fiddling them) is, standard-setters believe, to force companies to value more of their assets and liabilities at market prices, to "mark them to market".

Instead of holding assets and liabilities at historic cost, and depreciating assets by a set amount each year, they maintain that companies should in future be required to mark them to market at the end of each reporting period. Big swings in values will then be passed quickly through the profit-and-loss account or through the shareholders' equity. Inevitably, profits will become far more volatile.

Sir David Tweedie argues that market value is obviously superior to historic cost. When he was an accounting lecturer at the University of Edinburgh in Scotland, he conducted an experiment with a group of 120 18-year-old students. He sent out of the room the few who were already trained in the historic-cost convention, and found that 95% of the remainder, allowed to think from scratch, said that they would value assets and liabilities at their market value, not according to how much a company had paid for them at some arbitrary moment in the past.

Derivative issues

Using market value for all assets and liabilities will make some difference to how fixed assets are valued. But by far the largest impact of "fair-value accounting", as the use of market value is called, will be to bring the volatility of financial markets into companies' results. Fair-value accounting, therefore, will affect banks and insurance companies far more than others, because they have the highest proportion of financial assets.

Under a new rule from the IASB—IAS39—derivatives and all financial instruments held for trading purposes will have to be recorded at fair value from 2005, when the IASB's rules become mandatory for all listed companies in the European Union. Eventually, says Sir David, all assets and liabilities should be recorded at fair value. In the meantime, IAS39's halfway house creates a

particular problem for banks, or so they claim.

French banks, together with German and British ones, are fighting it hard. Philippe Bordenave, finance director of BNP Paribas, France's largest bank, says that as a result of having to mark its hedging derivatives to market—but not the underlying assets being hedged—its shareholders' equity will become far more volatile. The bank's equity of *euro*40 billion ($44 billion), he says, could swing around by as much as *euro*1 billion from one year to the next, just because of the new rule. "This is artificial volatility with no economic substance," he argues.

One solution, says Mr Bordenave, would be to use market values for everything, but that might have a graver consequence. Investors may come to have less confidence in accounts because many of the "fair" market values would be unreliable. Indeed, Enron notoriously made use of fair-value accounting to manipulate the worth of its energy contracts. Insurance companies, which are also facing new rules from the IASB forcing them to mark their assets (but not their liabilities) to market, similarly fear that their earnings will become far more volatile and that investors will shun them.

The slow march to market value is probably unstoppable in the long run, because so many accountants now believe that it is the most intellectually valid way to value assets. But nobody knows what will be the consequences of the volatility that would inevitably follow. In the worst case, large numbers of investors could be frightened away from equities.

In future, accounts are likely to become more volatile, more complex and more subjective. Overall, standard-setters admit that people who are not trained in how to read them will have to rely more than ever on experts. But to help readers cope with the complexity of fair value, they intend to introduce a new way of showing companies' income—instead of a single column with turnover and so on, the profit-and-loss statement will be presented in the form of a matrix, in three columns. One column will show gains and losses from changes in fair value, another would show old-fashioned costs and revenues, and the last would show the total of the two.

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Standard-setters also hope to make things a bit easier by simplifying the language used in financial statements. Instead of "debtors", for example, they would like to have "people who owe us money"; instead of "current assets", "assets we have at the present time"; and instead of "liabilities", "where the money came from".

Try revolution, not evolution

Closing up some obvious loopholes, bringing in more market valuation and taking away some jargon—these are all important changes. Together, though, they amount to patching up the existing system. It is not surprising that accountants have decided to fix what is there already: they are on the whole a conservative bunch and not given to experimentation. Some of them, however, would like to see a far more radical rethink of accounts.

To start with the basics, what are accounts for? Most accountants would probably reply that they are there to give a true picture of a company's performance during a particular period of time. Investors, however, want far more than that: they want a sense of the company's future prospects. In this, though, they are asking accounts to do things that they have never done before, says Robert Merton, a professor at the Harvard Business School. It is a bit like "asking a plough horse to gallop on a racetrack," he says.

In particular, he believes that users of accounts want them to highlight risks, and he thinks that they should include something similar to banks' value-at-risk (VAR) measures, which show the amount of money that a bank could lose from its trading at any moment in time. VAR systems aim to provide a range of gains and losses under various scenarios. An accounting version would show investors the likelihood of big swings in a company's assets.

Regulators also believe that companies should be obliged to give out new sorts of information. There should be new sections in annual reports on companies' intangible assets and on "key performance indicators"—such as employee turnover, customer acquisition cost or inventory turnover. The single most important thing that regulators could do to improve accounts, says Lynn Turner at Colorado State University and a former chief accountant at the SEC, would be to make companies report audited key performance indicators. Proper insights into a company's business, he says, can highlight accounting shenanigans. Harvey Goldschmid, a commissioner at the SEC, says that the regulator will consider how to get companies to publish key performance indicators "as soon as we realistically can".

Most of the numbers in accounts are not facts but estimates

In 2000, at the height of the stockmarket bubble, the SEC asked Jeffrey Garten, dean of the Yale School of Management, to lead a task-force to look into intangible assets and new kinds of performance information for companies. One of the task-force's most provocative ideas was that companies' accounts should include information about their management and founding investors. There could be a record of managers' past successes and failures, and a summary of employment contracts. On founding investors, the report suggests adding details of their track record, the length of time that they have in the past held shares after an initial public offering (IPO), and their current intentions (if any) to sell shares in the company.

None of this, however, will address the deepest flaw in accounts, says Baruch Lev, a professor of accounting and finance at the New York University Stern School of Business. This is the reality that most of the numbers in accounts are not facts but estimates. People are not good at estimating things, he says, and no amount of new accounting rules and auditing will change the fact that estimates are fragile and easy to manipulate.

Mr Lev's remedy is to separate company accounts into two pieces: one "core" and one "satellite". The core part would have the most reliable numbers, or the ones that rely the least on estimates—cashflow would go here, for instance, and perhaps property. The satellite part would contain fair-value numbers and intangible assets, as well as other items.

The company would then have to state in its annual report what percentage of its numbers derive from estimates and what portion are verifiable facts: analysts might choose to apply a discount, reflecting the increased risk, to companies with a high level of estimates. In subsequent years, the company would be obliged to go back and check how well its estimates had measured up to reality, much as governments go back and revise GDP estimates. Over the long run, says Mr Lev, managers of companies would not be able to get away with repeated big misses.

Although companies and their auditors pretend that they can work out a single profit figure and a single net-assets number, the truth is that accountants do not know exactly how much money a company has made, nor exactly how much it is worth at any one moment. Realistically, the best they can hope for is a range—"X corporation made somewhere between $600m and $800m"—depending on, for instance, what assumption is made about the likelihood that its customers will pay all the money that they owe.

Throughout the history of accounting, some folk have called for accounts to be presented in the form of ranges. Mr Holgate, for instance, a partner of the world's largest accounting firm and by

no means a wild-eyed radical, believes that presenting profits in this way would be much more realistic. For understandable reasons, though, the world has clung to the illusion of certainty and exactness.

Mr Lev argues that the 1902 annual report for US Steel gives more useful information to investors—monthly production data, for instance—than do many sets of accounts today. At the start of the last century, of course, there were no accounting rules and no auditors. So companies could respond directly to what their shareholders demanded to know.

Today, the weight of regulation and the ever-present threat of litigation leaves companies with little freedom to experiment with new information and new ways of presenting their numbers. Even though many chief executives say that they would like to show key performance indicators, for instance, they will probably not volunteer any for fear of the consequences. So, although accounts will probably improve over time, do not expect anything radical too soon.

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