RISKING A SERIOUS MISTAKE

“The Role of FASB and the Role of Congress
In Stock Options Accounting Policy”

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Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board

Subcommittee on Financial Management, the Budget, and International Security
Peter G. Fitzgerald, Chairman

Committee on Governmental Affairs
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Mr. Chairman, members of the subcommittee:

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute, where much of my work focuses on financial regulatory matters and economics. I am also host of the website TechCentralStation.com, established in 2000 to address the nexus among finance, technology and public policy. Since 1993, I have written a syndicated financial column for the Washington Post that seeks to inform small investors. I am also a member of the Policy Advisory Board of Intel Corp.

Today's hearing is critical. On March 31, 2004, the Financial Accounting Standards Board (FASB), a private-sector board that sets U.S. accounting rules, published an exposure draft of a proposal that would require stock options be treated as an immediate expense in financial statements of corporations.[1] The comment period for the proposal ends June 30.

FASB intends to move swiftly to implement the proposal. The immediate result of expensing will be a reduction in reported earnings for thousands of U.S. corporations. Earnings for companies that comprise the benchmark Standard & Poor's 500 Index "would have been 10.6 percent lower in 2003, 19.2 percent lower in 2002, and 21.5 percent lower in 2001 if all of the member companies had treated options as an expense."[2]

One result, which we may already be seeing, is lower stock prices than would otherwise obtain. Another result, as many corporate managers have already stated, is that, if the FASB proposal is enacted, companies will discontinue or reduce options programs, which have provided important incentives for employees well below the top management level. Discontinuing or reducing options programs will have an adverse effect on U.S. competitiveness, innovation and jobs.

It is my view, as this testimony will show, that mandated expensing of stock options is a serious mistake. The current regime -- which allows companies to choose whether to expense options immediately or to provide extensive disclosures and record the dilutive

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[1] Financial Accounting Standards Board, *Exposure Draft, Proposed Statement of Financial Accounting Standards, Share-Based Payment: An Amendment of FASB Statements No. 123 and 95*, March 31, 2004, p. i.

[2] "Congressman Disappointed in FASB, Sets Hearing," Phil McCarty, Wall Street Journal Online, April 1, 2004.

effects of options on earnings per share – is a far better approach. I also believe strongly that Congressional and executive-branch policymakers have the responsibility to exercise their own judgment in the matter of options expensing. The issue is far too important to be decided alone by an accounting board in Norwalk, Conn.

The purpose of this hearing is: 1) to explore "the importance of FASB's independence," 2) to "evaluate its proposal for mandatory expensing of stock options" and 3) to "determine the economic and accounting/financial reporting impact" of the proposal.[3] Let me take each of these three items in turn. First, however, some background is in order.

Background

An option is literally a choice. The owner of a fixed employee stock option typically 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, for example, $30 per share. Employee stock options – unlike call options traded on exchanges – usually have a vesting period of around three years. If the employee is still working at the company, he or she may exercise the option by paying the company $30 per share. The employee can then either sell the stock at a profit or hold it for a longer period. It is not difficult to see how such options help align the interests of employees with those of shareholders, whose main concern is that the value of their stock increase.

Over the past 10 to 15 years, smaller businesses, as well as large, have turned to employee stock options as a reasonable means to achieve success:

"Offering stock options in lieu of cash compensation allows companies to attract highly motivated and entrepreneurial employees and also lets companies obtain employment services without (directly) expending cash. Options are typically structured so that only employees who remain with the firm can benefit from them, thus providing retention incentives…. Stock option plans give executives a greater incentive to act in the interests of shareholders by providing a direct link between realized compensation and company stock-price performance."[4]

Encouraging managers, especially, to adopt a shareholder orientation became a major concern in the 1970s when managers, who often owned little stock, were appropriately 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. By the end of the 1990s, roughly one-third of the compensation of CEOs came in the form of stock options, up from one-fifth in the 1980s.[5]

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[3] Senate Committee on Governmental Affairs, website at http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=170

[4] Hall, Brian J., and Murphy, Kevin J., "The Trouble With Stock Options," *Journal of Economic Perspectives*, Summer 2003, 17:3, p. 49.

[5] Byran, 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."

"Options," as two distinguished economists, William Baumol and Burton Malkiel, wrote last year, "are needed to insure compatibility of the interests of stockholders and management, whose divergence has recently been so dramatically demonstrated."[6] This principle received a boost in 1993, when tax legislation disallowed "the deductibility of compensation paid to executives that exceeds $1 million – unless that compensation is 'performance-based.' Fixed stock options are deemed performance-based compensation for tax purposes."[7]

Most holders of employee options, however, are not in upper management. A new study by Joseph Blasi and Douglas Kruse of Rutgers University and Richard Freeman, professor of economics at Harvard, found that 94 percent of options are held by employees below the top levels of management. About 13 percent of the nation's private-sector workforce holds options, including 57 percent of workers in computer services companies, 43 percent of workers in communications and 27 percent in the finance industry.[8] Another study found that options are mainly used by "New Economy" firms. The average grant-date value of options per employee of such firms was $18,882; for "Old Economy" firms, $2,856.[9] This disparity explains part of the interest of many more established firms in pushing for an options-expensing regime. Older firms may want to deny New Economy firms a powerful competitive tool.

The controversy over the accounting treatment of stock options goes back more than 30 years. In 1972, the Accounting Principles Board, predecessor to FASB, issued Opinion No. 25, which stated that no compensation expense need be recognized for fixed stock options granted to employees at the time of the grant "because of the concern that stock options could not be reliably valued at the exercise date."[10]

As the use of such options increased, FASB in 1984 began to reconsider the earlier ruling by its predecessor. The current standard was spelled out eventually in October 1995 in FASB Statement No. 123 (FAS 123). It allows companies to choose between two methods of valuing stock options: "fair value" or "intrinsic value."

Companies that use "fair value" – about 500 of them at last count, including about 100 of the components of the S&P 500 Index – record an estimate of the fair, or market, value of the options as an expense at the time they are granted. Calculating fair value is necessarily difficult, if not impossible, since no established method exists. The "Black

[6] "A False Cure for the Ills of Stock Options," William Baumol and Burton Malkiel, Financial Times (London), April 3, 2003.
[7] Congressional Budget Office, "Accounting for Stock Options," April 2004, p. 4.
[8] "As Regulators Propose New Stock Option Rules, Rutgers Professors Have New Data on Who Owns Them," press release, March 31, 2004. See www.rci.rutgers.edu/~blasi.

[9] Hall and Murphy, pp. 51-52.
[10] 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.

Scholes" model, which won its inventors, economists Robert C. Merton and Myron S. Scholes, the Nobel Prize in 1997, is the dominant method for valuing call options that are traded on major exchanges. But "employee stock options differ from call options in several respects."[11] For example, employee options have a vesting period, are non-transferable, extend for long periods (two to four years) and are corporate securities. While FAS 123 makes reference to Black Scholes (and to the similar "binomial model" for options pricing), these models have been shown to have significant deficiencies for valuing long-term instruments such as employee stock options.

Even Warren Buffett, an advocate of expensing options, derides the most popular options-pricing model for these purposes: "It's crazy to use Black-Scholes," he said.[12] The investment firm of Warburg Pincus advised FASB: "We feel very strongly that these models [Black-Scholes and binomial] do not recognize the fact that employee options are non-transferable [and] are not liquid."[13] And, as an SEC commissioner stated recently, "I have yet to meet anybody who suggests that Black-Scholes is a good or even a fairly good indicator of the value of long-term compensation options, especially those in broad-based option plans."[14] Thus, as two think-tank scholars concluded, "Financial economists are still uncertain how to value these options."[15]

Companies that use intrinsic value usually record no expense at the time of grant. "The intrinsic value of an employee stock option" is defined as "the extent to which an option's strike price – the specified price at which the underlying stock may be purchased – is below the stock's current market price."[16] In other words, if the strike price is $30 and the stock currently trades at $35, then the intrinsic value is $5, but if, as is usually the case, the strike price is equal to or higher than the current trading price, then the intrinsic value is zero.

Under FAS 123, however, companies that elect the intrinsic-value method must "disclose the effects of fair value recognition on their income."[17] Such recognition comes in footnotes to financial statements, which are read closely by analysts and investors. Footnoted information on stock options can run to several pages (three pages, for example, in the annual report of Intel Corp.) and lists such details as number of options at various exercise prices, weighted average of the remaining contractual life of the option, and the weighted average exercise price – both for options outstanding and those exercisable.[18] Footnotes also explain methods of estimating the value of the options and

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[11] CBO, p. 6.
[12] "Buffett and Munger: In Their Own Words," Andrew Hill, Financial Times, May 5, 2003.
[13] FASB Comment Letter No. 194.
[14] Remarks by Paul Atkins at the American Enterprise Institute, Jan. 8, 2004, unedited transcript available at www.aei.org/events/filter.all,eventID.710/transcript.asp.
[15] Hassett, Kevin A., and Wallison, Peter J., "The Economic and Legal Consequences of Requiring the Expensing of Employee Stock Options Without Specifying the Valuation Method," unpublished paper presented at a conference at the American Enterprise Institute titled "Expensing Employee Stock Options Looks Like a Major Mistake," Jan. 8, 2004, p.
[16] CBO, p. 2.
[17] Ibid.
[18] See, for example, the annual report of Biogen, Inc., Cambridge, Mass., 2002, Financials, p. 29.

state the estimates. Many corporations provide more information about their stock options than about the sources of their revenue, their debt outstanding, and the other forms of compensation for their employees.

On March 12, 2003, FASB moved ahead on its long-held desire to require the mandatory expensing of options. On March 31, 2004, it issued its exposure draft, stating in a press release that the proposal came "in response to requests from investors and many other parties to improve the current accounting standards relating to employee stock compensation in financial statements."[19]

FASB says that the proposal "provides more complete, higher quality information for investors."[20]

That statement is highly questionable, as I shall explain.

The Role of FASB

Much has been made of the importance of maintaining the independence of the Financial Accounting Standards Board,[21] which is a private organization of trustees and executives. But the board is, by law, subject to oversight by the SEC, the federal agency with responsibility for financial markets and, thus, to the executive branch and the Congress, which oversees that agency. As FASB's website states: "The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934."[22] FASB was designated in 1973 by the SEC to set financial standards for U.S. corporations.

America's elected representatives not only have the authority but also the moral and legal responsibility to oversee the activities of the FASB, especially when its decisions can imperil the U.S. economy. 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."[23]

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

[19] "FASB Publishes Proposal on Equity-Based Compensation to Improve Accounting and Provide Greater Transparency for Investors," press release, Norwalk, Conn., March 31, 2004.
[20] Ibid.
[21] Examples abound of claims that FASB's independence will be compromised through activity by federal policymakers. For example, two years ago, Edmund L. Jenkins, then FASB's chairman, stated, "We caution Congress that *any* legislation mandating particular actions or procedures by the FASB can compromise the very independence that the legislation seeks to enhance." ("FASB Chairman Comments on Proposed Legislation," press release, Norwalk, Conn., March 19, 2002; emphasis in original.)
[22] From the FASB website, at www.fasb.org.
[23] Ibid.

increasing jobs, innovation and competitiveness. Even if FASB's expensing proposal were cogent from an accounting and financial viewpoint (and it is not), it would be the duty of Congress to consider its economic impact. I do not have to remind you, as members of the national legislature of this responsibility. It is your job. You can't abdicate it. You can't farm it out to a group of unelected accountants.

Beyond economic matters, policymakers have a legitimate role in examining FASB decisions on their financial and accounting merits as well, as this subcommittee is now doing. Certainly, Congress does not wish a role in the day-to-day operations of FASB, but, in a decision of the magnitude of the proposal on options expensing issued March 31, Congress would be derelict if it did *not* review FASB's assumptions and reasoning and their new rule's consequences.

Evaluation of the Expensing Proposal

In 1972, FASB's predecessor determined that options should not be expensed when issued because they could not be "reliably valued." As a result, the majority of public companies provide copious information for investors to make their own judgments. In other words, instead of shoehorning vast amounts of information into a single, necessarily inaccurate number, firms give investors the data and let them come to their own conclusions. Over time, dilution reduces earnings per share accordingly.

This approach is perfectly sensible, and it offers investors what they need to know to establish sensible market prices for shares. The key to determining market prices, at any rate, is cash flow, not accrual accounting statements based on GAAP, or Generally Accepted Accounting Principles (which are the issue with the FASB proposal). As Charles Calomiris, Henry Kaufman Professor of Financial Institutions at Columbia Business School, and Glenn Hubbard, the dean of that school and former chairman of the President's Council of Economic Advisors, have written:

"Market prices are determined by informed buyers and sellers who devote their energies to estimating free cash flow and deriving the appropriate discount factors to apply to free cash flow estimates. Even if informed investors constitute only a small fraction of the total number of buyers and sellers, they play a central role in determining securities prices on the margin as buyers and sellers because they can marshal substantial resources to buy when prices are low and sell when prices are high relative to their informed view of appropriate valuation."[24]

Calomiris and Hubbard argue, therefore, that the "potential benefits of developing a single accounting standard for measuring the cost of stock options are small (or non-existent)."[25] Investors already have the information they need. Of course, if a single standard were readily apparent, then it would probably do no harm to adopt it. But there

[24] Calomiris, Charles W., and Hubbard, R. Glenn, "Options Pricing and Accounting Practice," unpublished paper presented at a conference at the American Enterprise Institute titled "Expensing Employee Stock Options Looks Like a Major Mistake," Jan. 8, 2004, p. 3.
[25] Ibid., p. 5.

is no such standard. We are in the same position as the earlier accounting standards board in 1972. "The valuation of stock options is a highly complex endeavor, an area where reasonable people can, and do, disagree significantly."[26]

The Congressional Budget Office states that "employee stock options are difficult to value precisely."[27] But this is surely an understatement. They are *impossible* to value precisely at the time of issue. "The likely value of employee stock options," says the CBO, "is likely to be different from the value predicted by models developed for exchange-traded options."[28] But those are the only models we have.

How different are the results likely to be? Calomiris and Hubbard use, as an example, options with a strike price of $45 that were issued to Microsoft employees and "were expected to be purchased" by J.P. Morgan for 25 cents, according to a report in the Seattle Times on July 9, 2003. Microsoft's 10-K report, filed on Sept. 5, 2003, Calomiris and Hubbard note, "valued its average stock options granted in 2001, 2002, and 2003, using the Black-Scholes formula, at prices ranging from $12.08 to $15.79." According to updated Black-Scholes analysis, using reasonable assumptions of volatility, the options were worth $8 – still, very far from the 25-cent market value.

So how does FASB handle the problem first identified in 1972? By fudging. The exposure draft says that "the fair value of equity share options awarded to employees [must] be estimated using an appropriate valuation technique." And what is that? First, the board says that since "closed-form models" (i.e., Black-Scholes and similar models) "may not be the best available technique," its members decided that a "lattice model…is preferable." (A lattice model attempts to take into account past records of early exercise and forfeitures of options.) But then the board decides "not to require the use of a lattice model at this time."[29] In short, "companies can choose from a variety of mathematical models, so long as they take certain factors into account, including estimates of a stock's volatility."[30]

The absurdity of FASB's decision is in full view. Robert Herz, FASB's chairman, stated in a speech in December that he agrees that accounting "should better reflect economic reality" and that "we are very cognizant of the real-world issues and concerns over fair value measurements, particularly the farther one gets from traded markets."[31] But those real-world issues are brushed aside in the effort to find a number – any number! – to stick onto a financial statement to represent the complexities of the fair value of an employee stock option.

[26] Ibid., p. 6.
[27] CBO, p. 5.
[28] Ibid.
[29] FASB *Exposure Draft*, p. ii.
[30] "FASB Unveils Expensing Plan on Option Pay," Jonathan Weil, Wall Street Journal, April 1, 2004, p. C1.
[31] Robert Herz, "The Financial Reporting Partnership," speech to The American Institute of Certified Public Accountants, Dec. 12, 2003, p. 15, at www.fasb.org/herz_aicpa_12-12-03.pdf.

As Calomiris and Hubbard write, "Option valuation is a complex valuation problem that is best left to market analysts to estimate and debate. It is disingenuous, and not helpful to investors, to pretend that this difficult valuation can be solved adequately by an accounting rule."[32] Indeed, it is worse than unhelpful. It is downright misleading and confusing. Instead of shining a light on a company's financial health, expensing of options "may leave hapless investors blinded by a fog of incomprehensible calculations," writes Howard Gleckman in Business Week.[33]

Perhaps if a single method were prescribed – even an imperfect one – investors could gain a small benefit, at least knowing that every company is using the same system of calculation. But FASB rejects that approach and, within broad parameters, allows firms to make the choices themselves. Thus, FASB is introducing a new element of noise and distortion into reported earnings. The opportunities for manipulation by unscrupulous managers are enhanced, and no analyst will be able to take the GAAP accrual earnings of an options-using company seriously. Instead, FASB will, unwittingly, make pro-forma statements, which pull out the fair-value options estimates, the coin of the financial realm.

In their paper, Kevin Hassett and Peter Wallison write that, without a single options-pricing methodology, corporations – forced to choose among many possibilities – would open themselves up to expensive class-action lawsuits by disgruntled shareholders: "The state of affairs creates a serious legal risk for both companies and auditors to which the Board [FASB] seems oblivious."[34]

The shame is that all of these adverse consequences (and more, which I will explain below) are utterly unnecessary. Kip Hagopian, a well-known venture capitalist who sits on the board of several technology companies, says that, while "the fact that [employee stock options] *may* be a cost to the issuing company or to its shareholders has never been in dispute," the cost is contingent on many factors – such as whether the employee is still with the company and whether the stock is above or below the strike price years from now. Investors can see the effect of the contingency examining potential "diluted earnings per share," a figure that takes into account shares that are likely to be exercised.[35] They can also examine the extensive footnoted detail on the options themselves.

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[32] Calomiris and Hubbard, p. 14.
[33] "The Imperfect Science of Valuing Options," Howard Gleckman, Business Week, Oct. 28, 2002, p. 122.
[34] Hassett and Wallison, p. 22.
[35] Kip Hagopian, "Stock Option Expensing: Getting the Accounting Right," unpublished paper, March 29, 2004. Two years ago, President Bush came to a similar conclusion, saying, "I think once options are 'in the money,' they ought to be calculated in the dilution, that they ought to be dilutive in their earnings-per-share calculations." That's the current system. Options are "in the money" when the stock's market price is above an option's exercise price." A reporter at the time wrote that the president "said stock options shouldn't be treated as a corporate expense" and instead "should be handled precisely the way they currently are in annual reports." ("Bush Supports Businesses in Debate Over Changing Options Accounting," Michael Schroeder, Wall Street Journal, April 10, 2002.)

Again, there is no reliable method for valuing employee options. But FASB marches on. Why?

"My own fear," said Paul Atkins, an SEC commissioner, "is that FASB is basically getting into an area that's more of a political issue than a technical or accounting issue."[36] Atkins implied that the aim of FASB was to improve – according to its own vision – corporate governance and management. In the wake of the Enron scandals, some observers have argued that stock options were an incentive to the excesses and deceptions committed by managers.[37] In fact, the rise of stock options coincides with the greatest period of prosperity in American history, a stretch of more than two decades with only two shallow recessions. Still, at a time when roughly half of Americans own stocks,[38] Congress has become appropriately concerned about finding ways to discourage abuses like those at Enron.

But the role of rectifier does not lie with FASB. As Atkins said, "One thing that I am certain of…is that FASB should not be in the business of dictating what type of compensation should be paid by corporations to their employees. So I hope that this new stock options approach is not an attempt to dissuade companies from using stock options as a form of compensation."[39]

The reasons behind the FASB proposal – other than the professed clamor for accounting change (strikingly absent from public-opinion surveys) – are unclear. The effect will certainly be to "dissuade companies" from issuing options. And that discouragement may have adverse effects on the economy.

The Economic Impact of the Proposal

The expensing proposal raises an important question: If, as nearly all economists agree, the information currently provided about options by firms in their financial statements is adequate for investors to make sound judgments about the value of those firms, then how can the new proposal – which adds no new information – change the value of those firms in the stock market and, thus, have an effect on the economy?

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[36] Atkins.

[37] 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," *Forbes*, Dec. 23, 2002, p. 67.) In addition, the U.S. Secretary of the Treasury, John Snow, derided stock options in an Oct. 15, 2003, speech as a "freebie," claiming that, in many cases [options] shortened the time horizon of management and accentuated the 'short-term-ism' that addicted the markets in the '90s." There is, not surprisingly, no economic evidence for such views. In fact, the problem in the 1990s was that investors took too long a view, not too short. They were encouraged by long-term-thinking managers that companies that were losing money would make money somewhere in the future – lots of money – and bid up stock prices accordingly.

[38] American Council for Capital Formation, "Equity Ownership in America," October 2002, at www.accf.org. At the time of the study, 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.

[39] Atkins.

The Congressional Budget Office, in its new report, says, indeed, that the economy is "unlikely to have a significant effect on the economy" specifically "because the information has already been disclosed."[40]

But, with this judgment, the CBO raises a paradox: If the information is already disclosed, then why change the rule? It has only a weak answer: The FASB proposal "could make fair value information more transparent to less sophisticated investors."[41] In fact, the proposal will make that information far more confusing, as Calomiris and Hubbard show.

But what about the basic argument? No new information; therefore, no economic effects.

I believe this analysis is dangerously wrongheaded. I have spoken with many chief executives of companies that rely on stock options to lure the best and the brightest to their firms. Nearly all of these CEOs have the same reaction to expensing. It will reduce their reported earnings and thus their stock prices.[42] They will move quickly, therefore, to pare back their stock option programs, especially to employees below the top five corporate officers.

For example, America's best-known venture capitalist, John Doerr, said in testimony that he thought "broad-based employee stock ownership…will disappear if expensing is mandated."[43] A study by consultants at Mellon's Human Resources & Investor Solutions found that companies intend to cut back significantly on options programs for employees below the top executive level if expensing is enacted.[44] A review of the economic literature by Brian J. Hall and Kevin J. Murphy concluded that "parties on both sides of the debate agree that such a change [expensing options] would result in granting fewer options, especially to rank-and-file workers."[45] Dozens of chief executive officers have publicly stated that their firms will reduce or eliminate options if expensing is enacted. Typical is the CEO of Advanced Fiber Communications, who wrote in a letter to FASB: "The expensing of stock options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees."[46]

And what will happen if options are reduced or eliminated? According to Andrew S. Grove, chairman of Intel:

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[40] CBO, p. vii.
[41] Ibid.
[42] Using Black-Scholes would cut the reported earnings of high-tech firms by 70 percent, reported The Economist ("Now for plan B: expensing share options"), March 15, 2003.
[43] Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003; transcript at p. 55. Doerr has been a partner in the firm of Kleiner, Perkins, Caulfield & Byers since 1980. The firm has sponsored investments in such companies as Compaq, Cypress, Intuit, Lotus, Netscape, Sun Microsystems and Symantec, which have led to the creation of over 30,000 jobs.
[44] Mellon, "SFAS 123: Responding to Mandatory Option Expensing," September 2003 survey, p. 9.
[45] Hall and Murphy, p. 68.
[46] FASB Comment Letter No. 185. See also many others (Staples, Altera, Genentech, etc.), including, poignantly, FASB Comment Letter No. 29: "If options are expensed, I can tell you that a small company like the Vermont Teddy Bear Company will no longer grant them."

"For years, the U.S. economy has increasingly been driven by the contributions of knowledge workers. Broad-based stock option plans offer the opportunity of ownership and provide owner-like motivation to knowledge workers. After 40 years in a knowledge-based industry, I do not know a better way to achieve this sense of ownership – not even a close second…. [W]e routinely grant more than 97 percent of our stock options to employees other than the top five members of management; by doing so, we are using a powerful incentive and retention tool for the benefit of all of our stockholders."[47]

Doerr, the Silicon Valley venture capitalist, says that the fallout from expensing options "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, accounting the effects of dilution."[48]

At a time when Americans worry that jobs are going overseas, the expensing of options could encourage the exodus. In an article in Barron's, George Chamillard, the CEO of Teradyne, a Boston-based maker of automatic testing equipment for the electronics industry, wrote that one major factor in the "flight of the semiconductor industry from Route 128 [near Boston] to Silicon Valley" was "stock options." Bay Area start-ups "were romancing East Coast talent with the opportunity to strike it rich through options…. Stock options were a low-cost way to draw talent away from mature companies and into stat-ups. In return for assuming higher risk, the options-givers offered the recruit the chance for high rewards through equity ownership and a piece of the action…. Other industries learned the lesson well, using options to drive new companies and inject excitement into older ones."[49]

Now, writes Chamillard, the next cycle of "Go West, Young Man" has begun. "While options are under attack in the U.S., elsewhere the stock option as a recruiting tool is on the rise." Options are drawing scientists from the U.S. to Asia – Taiwan, in particular. As a result, he writes, the U.S. is losing "engineers educated at MIT and Stanford and CalTech."[50] Asian nations understand the attraction of options, and they do not have the same fetish for expensing them as American regulators have.

Even China, in its 2001-2005 five-year plan, officially encourages the use of stock options to motivate managers.[51] And a recently study by the consulting firm Towers Perrin found that, in Asia, with the exception of Singapore, "stock options still remain companies' most popular long-term incentive for their executives."[52]

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[47] Andrew S. Grove, "Letter from your chairman," Intel Corp. annual report, 2002, www.intc.com.
[48] Doerr.
[49] "Go West Again? Lured by Stock Options, Techland's Best and Brightest Moved to California; Next Stop, Asia?" George Chamillard, *Barron's*, July 21, 2003.
[50] Ibid.
[51] Five-Year Plan of the People's Republic of China (2001-2005).
[52] Agence France Presse, Sept. 24, 2003.

With the economic recovery in the United States still young and unstable, this is not the time to be gambling with a measure that could chase jobs to Asia.

The Impact of the Proposal on Investors

FASB's proposal is more likely to confuse investors than to enlighten them. For companies that retain options plans, investors will have to rely on pro-forma statements that eliminate the distortions caused by huge, non-cash options-cost estimates. 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. [Stock options] affect the percentage claim someone has on a company's cash flows – the more options outstanding, the lower the potential ownership of the outside investor."[53] 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, at the appropriate time, shows the dilutive effect on earnings per share. In other words, stock options are a cost, not to the company, but to its shareholders.[54] This is a point made cogently as well by Walter P. Schuetze, former chief accountant of the SEC, who told Sen. Charles Schumer in a letter two years ago that "I would not charge expense for stock options issued to employees."[55]

There is another side to options that is missing in the accounting debate. "Granting stock options," writes Prof. Sahlman, "will also affect the level of…prospective cash flows." 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."[56] Others who receive options will have similar incentives.

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."[57]

Because of the change in accounting rules, small investors are apt to get the impression that serious expenses are at last being charged to companies that had previously evaded

[53] Sahlman, William S., "Some Thoughts on the Accounting for Stock Options, July 24, 2002, p. 2. Sahlman if the Dimitri V. d"Arbeloff-Class of 1955 Professor of Business Administration at the Harvard Business School. See also his article, "Expensing Options Solves Nothing," Harvard Business Review 80, no. 12, pp. 90-96.
[54] This point was made forcefully by Dennis Powell, chief financial officer of Cisco Systems, in testimony before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003, p. 25: "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."
[55] Letter from Walter P. Schuetze to Sen. Charles E. Schumer, March 25, 2002.
[56] Sahlman, p. 3.
[57] Baumol and Malkiel.

them. In fact, the change will not affect cash flow at all – except, perversely, by lowering the prospect of future cash flows as firms are pressured to give up their options plans.

The Impact of the Proposal on Accounting

The accounting profession faces a crisis. But it has nothing at all to do with stock options. My AEI colleague Peter Wallison, with Robert Litan of the Brookings Institution, argue forcefully in their book, *The GAAP Gap*, that GAAP accrual earnings by themselves do not reflect corporate health and cash-flow prospects.[58] One reason is that the assets of companies in a knowledge-based economy do not show up on balance sheet. "An estimated 80 percent of the value of the Standard & Poor's 500 is made up of intangible assets of all kinds. [As a result], the earnings of companies in today's knowledge economy are of higher quality than the earnings of traditional companies. Whatever their absolute amount, the earnings produced by internally generated intangible assets have already been reduced by costs that in traditional companies would be capitalized and written off over time."[59]

In other words, while intellectual work by designers, researchers and engineers provides a business with productive, revenue-producing assets, this work does not appear on the balance sheet; instead, "salaries of employees are written off as they are incurred."[60]

The great challenge for accounting is reconciling this new reality with the antiquated tools of GAAP, developed at a time of large industrial companies with easily identifiable tangible assets like factories and machine tools.

Unfortunately, the response to the scandals at Enron, WorldCom and elsewhere has led accounting policy off the path toward meeting this challenge. Instead, the reaction has been "to enshrine the audited financial statement…as the principal disclosure of companies whose shares are traded in the public securities markets…. [But, in fact,] there is strong evidence that investors are relying on many other factors other than audited earnings in making judgments about the value of companies, particularly free cash flow."[61]

Rather than trying to quantify the unquantifiable, as FASB is attempting in its options-expensing proposal, accounting policy should follow a different strategic path, moving instead toward other, non-GAAP metrics, which can tell investors more. Indeed, the use of intrinsic-value, as opposed to fair-value, disclosure is on the right track. But FASB wants to derail it.

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[58] Wallison, P., and Litan, R., *The GAAP Gap* (2000), American Enterprise Institute.
[59] "Accounting Lags Behind a Knowledge Economy," Peter J. Wallison, Financial Times (London), March 8, 2004.
[60] Ibid.
[61] "Poor Diagnosis, Poor Prescription: The Error at the Heart of the Sarbanes-Oxley Act," *On the Issues*, Peter J. Wallison, American Enterprise Institute, March 18, 2003. See www.aei.org.

Conclusion

The FASB proposal for options expensing must be significantly modified or, better, withdrawn. Congressional and executive-branch policymakers have a responsibility to step in – because FASB's own mandate, which extends only to accounting rules, is so limited and because the law establishes the SEC as the agency to set accounting policy, a role it has assigned to FASB. Elected policymakers must take into account the impact of accounting rules on the economy – and the impact of the proposed rule could be significant, harming U.S. competitiveness and growth and chasing jobs overseas.

FASB's proposal would be more cogent if it provided a single methodology for valuing stock options at the time of issue. But FASB cannot do this, just as its predecessor could not in 1972. No such methodology exists. The result will be confusion for investors and the possibility of expensive class-action lawsuits.

It is remarkable that FASB's proposal has come this far. There is no public clamor for it, and there is much opposition from America's most innovative firms – for good reason. Instead of misleading investors by insisting on a single number for a complex phenomenon, FASB should devote its considerable intellectual capital to solving more significant problems of accounting policy in a knowledge economy.

Thank you.