Beyond the FASB

Mandatory Expensing of Stock Options
Will Harm Small Businesses,
Drive Talented Managers and Workers Offshore,
And Harm the U.S. Economy at a Critical Time

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Mr. Chairman, members of the subcommittee:

The determination of the Financial Accounting Standards Board to require mandatory expensing of stock options by U.S. firms threatens to harm small businesses and imperils the fragile economic recovery. The FASB's self-stated mission is to improve accounting standards. I do not believe that its proposed expensing of options achieves this aim, but, even if it did, you as policymakers have a more comprehensive mission than the FASB. Your concerns include improving the economy and increasing job opportunities.

In the testimony that follows, I review the importance of small business, the key role played by stock options and the potential damage that the expensing of options will do to businesses, jobs and the economy. One inevitable result will be to send U.S. jobs offshore. I urge you to rein the FASB in by acting immediately to delay implementation of new standards on options.

Accounting rules may seem arcane and boring, but they are far too important to be left in their entirety to an unelected board in Norwalk, Connecticut.

Small Business and Stock Options

Small business is the engine that drives the U.S. economy. Businesses with fewer than 500 employees represent 99.7 percent of all American firms, employ more than half of private-sector employees, create more than half of private Gross Domestic Product and, perhaps most important at a time of economy recovery, create 60 percent to 80 percent of net new jobs annually.[1] According to the most recent data, in 1999-2000, "small businesses created three-quarters of U.S. net new jobs (2.5 million of the 3.4 million total)."[2]

Small businesses, moreover, grow to large businesses. For example, Microsoft, stated in Bill Gates's garage, began with two employees as a partnership in 1975 and now has 47,000 employees, 118,000 shareholders and $282 billion in stock-market value.[3]

Three of the key ingredients in the success of small businesses are attracting a talented and motivated workforce, limiting compensation outlays and conserving cash during their early years of growth.[4] Over the past 10 to 15 years, small businesses, as well as large, have turned to employee stock options as a reasonable means to achieve success:

> 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. In

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[1] Small Business Administration, "Small Business by the Numbers," online publication updated May 2003: http://www.sba.gov/advo/stats/sbfaq.pdf.
[2] Ibid.
[3] Value Line Investment Survey, Aug. 29, 2003, p. 2207; Yahoo Finance; Microsoft Corp. annual report, 2003, Form 10-K, p. 17.
[4] A survey by the National Federation of Independent Business asked respondents to list problems in order of importance. Ranking third (after health insurance and federal taxes) was "locating qualified employees." Ranking seventh, out of more than 70 listed problems, was "workers' compensation costs." Ninth was "cash flow." See http://www.nfib.com/cgi-bin/NFIB.dll/Public/SiteNavigation/home.jsp.

> addition, offering employee 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 also providing retention incentives.[5]

It is evident that the use of options is critical to smaller, early-stage businesses and that the use of options has broadened and deepened.[6] For example, top managers and employees below the top five executive officers in 2002 received more than 90 percent of the total value of options granted – up from less than 85 percent in the mid-1990s. Both "Old Economy" and "New Economy" firms issue options. For Old Economy firms, the average grant-date value of options per employee (below the top five executives) went from $522 in 2001 to $2,856; for financial firms, from $1,007 to $5,562; for New Economy firms, from $1,684 to $18,882. (All of these figures are adjusted for inflation, using 2002 constant dollars.)[7]

High-tech companies are not alone in relying on stock options to motivate their workforces. One of the great options success stories, for instance, comes from Staples,

[5] Brian J. Hall and Kevin J. Murphy, "The Trouble With Stock Options," Journal of Economic Perspectives, vol. 17, no. 3, Summer 2003, p. 49.

[6] For a good overview of the subject, see Josph Blasi, Douglas Kruse and Aaron Bernstein, *In the Company of Owners* (Basic Books, 2003).

[7] Hall and Murphy, op. cit., pp. 51-52.

Inc., the office-supply chain, which was launched in 1986 with a single store in Brighton, Mass., and now has 1,500 stores worldwide and employs 58,000.[8]

Expensing Options Would Reduce Issuance of Options to Lower-Level Workers

Unfortunately, the FASB is moving quickly to change an accounting rule in order to require mandatory expensing of stock options on corporate Income Statements issued under Generally Accepted Accounting Principles (GAAP).

Such a change, it is widely agreed, would cause a significant reduction in the issuance of stock options, especially to employees below the top five corporate officers. For example, America's best-known venture capitalist, John Doerr, said in testimony he that thought "broad-based employee stock ownership…will disappear if expensing is mandated."[9] A study by consultants at Mellon's Human Resources & Investor Solutions also found that companies intend to cut back significantly on options programs for employees below the top executive level if expensing is enacted.[10] 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 stock options] would result in granting fewer options, especially to rank-and-file workers."[11] Dozens of chief executive officers have publicly stated that their firms will reduce or eliminate options if expensing

[8] Value Line Investment Survey, Oct. 17, 2003, p. 1151; www.staples.com.
[9] 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 firm of Kleiner, Perkins, Caulfield & 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.
[10] Mellon, "SFAS 123: Responding to Mandatory Option Expensing," September 2003 survey, p. 9.
[11] Hall and Murphy. op. cit., p. 68.

is enacted. Typical is the CEO of Advanced Fiber Communications, which stated in a letter to the 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."[12]

It is reasonable to predict that, without the incentive tool of stock options, many of America's most innovative firms – small businesses and large, in technology and non-technology industries – will suffer declining productivity, with dangerous consequences for national competitiveness, growth and employment.

Talented Workers Will Move from U.S. to Asia

Already, the consequences are becoming apparent. In an article in Barron's last summer, George Chamillard, the CEO of Teradyne, a Boston-based maker of automatic test equipment for the electronics industries, wrote that one major factor in the "flight of the semiconductor industry from Route 128 [in Massachusetts] 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 start-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. Best of all, the cost didn't hit the P&L – an important point, since there usually were little or no profits in the early years of a start-

[12] 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 tall you that a small company like the Vermont Teddy Bear Company will no longer grant them."

up…. Other industries learned the lesson well, using options to drive new companies and inject excitement into older ones."[13]

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 United States to Asia – Taiwan in particular. As a result, says Chamillard, the U.S. is losing "engineers educated at MIT and Stanford and CalTech."[14] Asian nations understand the attraction of options, and they do not have the same taste for the fetish of expensing options as American regulators.

In its 2001-2005 five year plan, China officially encourages the use of stock options to motivate managers.[15]

A recent study by the consulting firm Towers Perrin found that, with the exception of Singapore, " stock options still remain companies' most popular long-term incentive for their executives."[16]

So, where did the fetish for expensing options -- which, at a critical time, imperils U.S. small businesses and the economy as whole – come from?

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[13] "Go West Again? Lured by Stock Options, Techland's Best and Brightest Moved to California; Next Stop, Asia?" Barron's, July 21, 2003.
[14] Ibid.
[15] Five-Year Plan of the People's Republic of China. (2001-2005)
[16] Agence France Presse, Sept. 24, 2003. http://asia.news.yahoo.com/030924/5/singapore49820.html

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. Options helped change that situation, and they played a key role in the economic revival in the United States that began in the early 1980s and has lasted, on an unprecedented scale, for two decades. "Options, as two distinguished economists recently wrote, "are needed to ensure compatibility of the interests of stockholders and management, whose divergence has recently been so dramatically demonstrated."[17]

[17] "A false cure for the ills of stock options," by William Baumol and Burton Malkiel, Financial Times (London), April 3, 2003.

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 clearly 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."[18] As the use of such options increased, the FASB in 1984 began to reconsider the earlier ruling by its predecessor.[19]

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.

The FASB, however, has made it clear that it will shortly require U.S. companies to adopt "fair-value" accounting under FAS 123. The problem of valuing the options, however, remains. The FASB acknowledged that its proposed standard on stock options "should not prescribe a particular option-pricing model. Rather the objective would be to use the option-pricing model that produces the best estimate of fair value given all the facts and circumstances."[20] And what is that model? Either a Black-Scholes or a binomial

[18] 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.
[19] Ibid, p. 3.
[20] Financial Accounting Standards Board User Advisory Council Meeting, Attachment 2, Memorandum on "Equity Based Compensation," FASB User Advisory Council, Oct. 7, 2003, p. 1.

model, it appears – both of which seriously lack reliability and accuracy.[21] In other words, the same deterrent that prevented the FASB's predecessor from requiring the expensing of options in 1972 still exists today: no one can place an accurate value on them.

But there is another reason that the past 30 years of economic history have confirmed: Options help improve the operations of small and large businesses and improve the economy. For that reason, President Bush supported the current accounting treatment of options in an interview a year and a half ago, saying that "they ought to be dilutive in [a company's] earnings per share calculations"[22] – the situation that currently prevails. In addition, leading Democratic presidential candidates also oppose expensing of options. Rep. Richard Gephardt (D-Mo.), for example, supported the current accounting treatment, saying in June that "stock options are a very important way to get employees to think like owners."[23] Howard Dean said he would "not favor expensing stock options if at least 65 percent of the options were distributed widely throughout a company"[24] – a description of the majority of businesses today.

Why, then, has intense pressure developed to expense options?

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[21] Many statements attest to this fact. See, for example, criticism of Black-Scholes ("it's crazy to use Black-Scholes") by Warren Buffett, the chairman of Berkshire Hathaway, Inc., in Andrew Hill, "Buffett and Munger – In Their Own Words," Financial Times, May 45, 2003. Also, the investment firm Warburg Pincus advised the 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" (FASB Comment Letter No. 194).

[22] "Bush Supports Businesses in Debate Over Changing Options Accounting," by Michael Schroeder, Wall Street Journal, April 10, 2002.

[23] "Gephardt Backs Foes of Options Expensing," by Laura Kurtzman, San Jose Mercury News, June 18, 2003.

[24] "Dean Castigates Bush During Visit to San Jose," by Dana Hull, San Jose Mercury News, Sept. 8, 2003.

There is little doubt that the campaign for expensing originated in the wake of the corporate scandals involving such firms as Enron and WorldCom – although in no case did options play a role in the fraud and deception at the root of the scandals. There is, as well, an earnest desire by policymakers to provide investors with accurate information about the companies in which they invest. But it is my belief that expensing options will confuse such investors, not enlighten them.

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 for 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.[25] 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 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

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"The Imperfect Science of Valuing Options," by Howard Gleckman, Business Week, Oct. 28, 2002.

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."[26]

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.[27]

In fact, for typical companies, the information provided on stock options far exceeds information provided for far more important aspects of the business, including intellectual-property assets, cash compensation expenses, leases, and investments.

[26] "Much Ado About Stock Options: The Epilogue," editorial, Wall Street Journal, April 23, 2003.
[27] Gilead Sciences, Inc., Form 10-K, submitted to the Securities and Exchange Commission, March 11, 2003.

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.

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.

Investors Understand the Cost of Options

The case for expensing stock options is built on a faulty premise: that investors don't understand, from the current data with which they are presented, the true status of the firm. In their article, Hall and Murphy write, “Several studies have shown that the costs of options are indeed reflected in stock prices.”

That leads to two further questions:

First, if investors already can figure out the cost of options without an accounting change, then why make the change to expensing and jeopardize small businesses and the economy as a whole? And

Second, if options are already reflected in stock prices, then why should small businesses fear the change to expensing? If the costs are known already, then stock prices should not change.

Let me take the second question first and let Hall and Murphy answer it: “The fact that financial markets see through the ‘veil of accounting’ does not imply that accounting considerations are irrelevant since accounting rules affect – and sometimes distort – managerial decisions.” In other words, whatever economists think, managers fear that a change in the rules will indeed hurt their companies in the stock market and raise their costs of capital. Such managers – and we have heard from dozens of them – will cut back their options programs, with an adverse effect on the economy. My guess, as well, is that stock prices will fall in the short term and the cost of capital will rise. Stock prices may rebound, but the damage will be done. Why, at this critical time in the economic cycle, should we tamper with a system that provides incentives and conserves capital?

Which brings me back to the first question: Why make a change if the change threatens to harm the economy and produce no benefit? There is no reason at all. The number-one rule in public policy should be that of the Hippocratic Oath in medicine: First, do no harm.

So why is the FASB, an unelected group of accounting mavens, bent on making such a dangerous change?

The FASB's Mission

The answer lies in FASB's sole 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."[28]

But 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

[28] On the home page of the FASB website: www.fasb.org.

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.

Some issues, quite literally, are beyond the FASB.

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."[29] 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, at least in the short term, 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. 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,[30] the truth is that firms issue options because they work. They represent an

[29] "Now for plan B: expensing share options," The Economist, March 15, 2003.
[30] 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. 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-it-is' that addicted the markets in the '90s." There is, no surprisingly, no economic evidence for this view. In fact, the problem in the 1990s was that investors took too long a view, not too short. They thought that companies that were losing money would make money somewhere in the future – lots of money – and bid up stock prices accordingly. Since stock-

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.[31] 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 – including the small businesses that have made the U.S. economy the envy of the world.

Thank you.

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option use started to accelerate, the U.S. has enjoyed a period of enormous prosperity, with only two brief and shallow recessions.

[31] Bryan, S., op. cit