



BNA, Inc.

Daily Report for Executives

No. 107

Wednesday June 4, 2003

ISSN 1523-567X

Page G-7

Tax, Budget & Accounting

Stock Options

Witnesses at House Hearing on Options

Disagree at Every Turn on Expensing Issues

Witnesses at a House hearing on stock option accounting disagreed on nearly every question raised, including the central question of whether companies should be required to treat fixed-price stock options as an expense on their balance sheet.

In a hearing before the House Financial Services Capital Markets Subcommittee, Reps. David Dreier (R-Calif.) and Anna G. Eshoo (D-Calif.) advocated passage of H.R. 1372, a bill they introduced to do battle with those who believe companies should be required to expense stock options (55 DTR G-4, TaxCore, 3/21/03).

Proponents of mandatory expensing who testified included Robert Herz, chairman of the Financial Accounting Standards Board; Paul A. Volcker, chairman of the International Accounting Standards Committee Foundation Trustees and former Federal Reserve Board chairman; and Roderick Hills, a partner at Hills & Stern, and a former Securities and Exchange Commission chairman.

Besides Dreier and Eshoo, Deborah Nightingale, a project manager at Sun Microsystems; Craig Barrett, chief executive of Intel Corp., and James K. Glassman, resident fellow at the American Enterprise Institute, testified in opposition to mandatory expensing and in favor of H.R. 1372.

30 Co-Sponsors Added to Bill

The proposed Broad-Based Stock Option Plan Transparency Act, which has more than 30 additional co-sponsors, was introduced March 20, eight days after FASB voted to put stock option accounting on its agenda.

On April 22, FASB tentatively concluded that stock-based compensation should be recognized as an expense in income statements and the amounts should be recorded at their fair value measured at the date of granting of awards (78 DTR GG-1, 4/23/03). FASB hopes to issue a proposal, or exposure draft of the new standard on stock-based compensation, by the end of 2003 and finalize the standard in early 2004.

Public companies currently may account for stock options in the footnotes of their financial statements. However, in the past year, an increasing number of companies have begun voluntarily to expense their stock options. Wal-Mart and Home Depot, for example, are among those companies with broadbased stock option plans that have announced they will start expensing this year.

Meanwhile, the International Accounting Standards Board is in the third year of its effort to fashion a new standard on share-based payment, or stock-based compensation (89 DTR G-8, 5/8/03). IASB tentatively has embraced the expensing of such compensation, which includes stock options. IASB plans to issue final rules on share-based payment by the end of the year.

Last Decade's Fight

In the mid-1990s, the stock options debate was perhaps even more vociferous than the current controversy. At that time, FASB set its sights on a proposed standard to require the expensing of stock-based compensation, but ultimately withdrew the proposal in response to strong corporate and congressional criticism. At the hearing, Herz said that FASB has been "gun-shy" of pursuing a stock-option accounting standard in the years following the

episode. He argued strongly against H.R. 1372 on the basis that, under the bill, Congress would intervene with FASB's independent processes and sets a "dangerous precedent" of such interference. The legislation also conflicts with the Sarbanes-Oxley Act and the SEC's recent statement reaffirming FASB as the U.S. accounting standard setter, he said.

Under H.R. 1372, the SEC would be required to adopt rules to require public companies to increase their disclosures about their use of stock options plans, particularly with respect to the dilutive effect of such plans. In addition, there would be a three-year moratorium on the SEC recognizing any new accounting standard related to stock options. At the end of that time period, the commission would be required to submit a report to Congress on the effectiveness of the new disclosures.

Finally, the bill would require a Commerce Department study of the impact of broadbased employee stock option plans on expanding corporate ownership, recruiting skilled workers, stimulating research and innovation, and growth in the U.S. economy

The California lawmakers' present initiative against expensing options is backed by the Employee Stock Options Coalition, a large coalition of business groups and companies, the majority from the high tech sector. The coalition's chairman, Rick White, has said that mandated expensing of employee stock options is flawed public policy (67 DTR G-2, 4/18/03). White is also the chief executive officer of TechNet, a public policy and political service organization.

Eshoo, Dreier, Nightingale, Barrett, and Glassman said that stock options provide incentives for employees by making them partners in their company's success. Eshoo said, without naming the source of her information, that 80 percent of the stock options granted at the top 100 technology companies were given to rank and file employees, not senior executives.

However, Herz said that, according to the U.S. Bureau of Labor Statistics, in 2000 only 1.7 percent of the nonexecutive work force has actually received stock options. Moreover, Volcker argued that stock options are "deeply flawed as an incentive in business management." They are "basically flawed as a compensation instrument," he said, because, since they are not expensed, there is a great temptation to management to abuse them. Options tempt some executives "to manage short-term earnings and market expectations in a manner counter to the basic interests of the company," Volcker told the subcommittee.

Summing up his views, Volcker said that he believes that "large companies with widely dispersed ownership should, not as a matter 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," he continued, "then that would be constructive."

'Wiping Out' Options

H.R. 1372 is based on the premise that a requirement to expense stock options would eliminate them. Eshoo and Dreier said that mandating the expensing of stock options would, in Eshoo's words, "wipe out" the use of such options.

Dreier said that, if stock options were eliminated, there would be a "devastating impact on job creation and quality of life." According to Dreier, 45 percent of gross domestic growth in the United States is from the high-tech sector, which traditionally has used stock options to compensate employees in start-up companies.

Glassman and Barrett concurred that, under a mandatory expensing regime, companies would be forced to take massive charges against earnings, ultimately depressing job creation and economic growth. Barrett said that mandatory expensing would present the "potential danger" of exporting high-tech jobs to Asia and elsewhere.

According to Barrett, during the period 1995 through 2002, if Intel had used the complex so-called Black-Scholes method of valuation to expense its options, the cost to the company would have been more than \$3 billion for options that were underwater--that is, their strike price was below the current market price, and might never be exercised.

Separately, despite Intel's opposition to mandatory expensing, in a recent shareholder vote at Intel, a proposal asking the company to begin expensing options was supported by 47.55 percent of shares eligible to vote.

Herz responded to arguments that the economy would be harmed by saying that FASB is striving to achieve the "right accounting." Better accounting information, he said, translates to enormous economic benefits. Herz said that FASB will "look at private companies separately from large public companies." The issue will break out as companies with actively traded stock versus those that do not trade, he added.

Valuation Issues

Herz stressed to the subcommittee that fixed-price employee stock options, of all stock-based options, represent a "30-year anomaly." These are the only stock-based compensation that are not reported as an expense on financial statements, Herz emphasized.

However, Dreier argued that stock options do not cause a company to incur costs. Stock options are "not actually an expense," Dreier maintained. He said that there is "no cash outflow for the options and no liability created at any time; not when they are granted, vested, or are exercised."

Herz disagreed, saying that the cost to the company is the "economic cost of issuing that option." For example, he explained, the company could have issued the instrument to the market, gotten the cash, and given the cash to the employee.

According to Dreier, who chairs the House Rules Committee, and Eshoo, it is virtually impossible to make a determination as to what the value of a stock option is. In other words, to account for options as an expense, a company must use inaccurate information, they said. Eshoo and Dreier also said that top executives would be unable to certify the company's financial statements, as required by the Sarbanes-Oxley Act, if the financials included inaccurate valuation of options. "We are potentially criminalizing [by mandate] mistakes on assumptions made on valuing these options," Dreier maintained.

Footnotes Insufficient, Herz Says

However, Herz said that FASB is looking at the issue of reliable valuation. Footnote disclosure is not sufficient, he said. People retrieve information on accounting from a database, so unless the information is in the income statement, it will not be picked up, he said.

After the panel, Herz told BNA that the Black-Scholes method is accurate for all options other than fixed-price stock options, including interest rate options, currency options, and the like. There are, he acknowledged, features of fixed-price stock options that must be accounted for in modifications to the Black-Scholes method. These include the feature of forfeiture due to vesting and nontransferability. Herz also said that stock option numbers are more reliable than the numbers that have been disclosed for years as critical accounting estimates in financial statements.

For his part, Barrett offered a five-point approach to improving the current system of stock-option accounting. Employee stock option plans should be approved by shareholders and should be broadbased, with no more than 5 percent of options going to top executives. In addition, companies should provide investors with expanded, more frequent, and more understandable disclosures in plain English, as provided by H.R. 1372. Further, he said, stock options should vest over terms of at least four years. Finally, the compensation committee should be made up entirely of outside directors, Barrett suggested.


Hills said that he hopes that "FASB and the SEC will allow flexibility in the costing of options."

In other remarks, Hill argued that the best way to align shareholders' and managers' interests is to provide stock compensation, as opposed to stock options. However, Glassman said that stock options provide better, more dramatic incentives.

As to whether the need for stock option accounting reform was demonstrated by the recent debacles, such as Enron, even on that point the witnesses disagreed. Barrett and Glassman said that the scandals did not demonstrate such a need, while Hills and Glassman suggested that stock options and their abuse were a

contributing factor in Enron.

Glassman said that talking about expensing is simply "fighting the last war ... the Crimean War." The current system for disclosing stock options, he said, gives investors more information than "trying to shoe-horn information into a single [generally accepted accounting principles] GAAP number."

Separately, a Senate bill similar to H.R. 1372, S. 979, was introduced May 1 by Sen. John Ensign (R-Nev.) and Barbara Boxer (D-Calif.) and is pending in the Senate Banking Committee. No hearings have yet been held on S. 979, the proposed Broad-Based Stock Option Plan Transparency Act (85 DTR G-6, TaxCore, 5/2/03). 

By Rachel McTague

Copyright © 2003 by The Bureau of National Affairs, Inc., Washington D.C.

