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Statement of Senator Joseph I. Lieberman
November 17, 1993
Stock Options -- The Equity Expansion Act of 1993

Mr. President, last June I introduced legislation creating a new class of stock option, the Performance Stock Option, and directing the Securities and Exchange Commission to overturn a proposed FASB rule to change the current accounting treatment of stock options. Not surprisingly, the second piece of my legislation has received most of the attention. Because of the growing opposition to FASB's stock option proposal, I wanted to come to the floor this morning and briefly describe my rationale for this Bill.

Mr. President, I firmly believe that markets operate freely and efficiently only with full and accurate information. I also believe that financial statements must be credible and comparable, and that the accounting standards that drive financial reporting ought to be set by the private sector. Notwithstanding, I came to believe the FASB proposal must be rejected after reaching three conclusions.

1. Economic Costs vs. Accounting Benefits

First, Mr. President, I concluded that -- in weighing the costs and benefits -- the FASB stock option proposal is so potentially damaging to the economy and offers so little in terms of improved comparability and integrity of financial statements that this proposal must not go forward. I believe FASB is ignoring its charter responsibility to promulgate rules "only when the expected benefits exceed the perceived costs." FASB's mission statement clearly establishes a standard where the expected benefits must exceed the perceived costs. This is a significant standard for FASB to meet and a higher standard than a mere cost vs. benefit analysis.

Mr. President, an employee stock option represents the right of an employee to purchase a set number of company shares for a fixed price at some defined time in the future. Stock options make it possible to start new companies and create new jobs. They enable small companies to stretch scarce venture capital dollars and attract key employees. Stock options also encourage risk-taking and spur technological innovation by putting employees on the same team as the stock holders. In short, they represent an integral and indispensable tool for economic growth and job creation.

Stock options are accounted for today the same as other inherently difficult to value items -- by disclosure. For example, since the cost of a pending law suit cannot be known in advance, current accounting rules (FAS 5) require the fact of the suit to be disclosed to investors. In the same way, since the value of an employee stock option depends on unknown variables, the proper accounting is full disclosure to the shareholders.

Specifically, stock options authorize a future capital transaction between a company's stockholders and employees. The cost of that transaction is borne entirely by the shareholders -- not the company -- through a dilution in the value of their shares. This cost to shareholders is fully disclosed by current stock option accounting as a reduction in earnings per share. Stock option plans are also the only element of corporate compensation that already require the express approval of shareholders. Yet the FASB proposal will require a charge to the company's financial statements, regardless of whether the stock price ever rises or whether the options expire absolutely worthless. In both cases the real cash value to the employee is zero.

FASB suggests that current accounting recognizes all other equity transactions involving the issuance of stock in exchange for goods and services. In other words, if I gave you stock and you gave me a Ford Pick-Up truck, such a transaction would be accounted for over the depreciable life of the truck. So when I give you stock and when you give me something we will call "employee services" we should account for that as well. Presuming stock options are compensation -- and the company is getting something of value -- that would be theoretically correct.

The problem is we can't measure something called "employee services." So FASB says since we can't measure what we are getting -- employee services -- we have to measure what we are giving up. They propose to measure this by using an option pricing model -- Black Scholes or a Binomial model -- by measuring the exercise price, the expected term of the option, the current price of the underlying stock, its' expected volatility, the expected dividend yield on the stock, and the risk-free interest rate for the expected option.

But since the real cash value to employees -- today -- on fixed options offered at the market is indeed ZERO, we are really not measuring "today's value," but rather we are measuring the employees "right to participate." There is no question that there is some limited, theoretical justification for FASB's position. But there is significant debate as to whether or not we can measure this "right to participate." Bottom line. When you can't count it, disclose it.

One of the problems with the "mouse trap" -- Black Scholes -- or any other option pricing model -- is that they were designed to measure traded options. These options -- unlike fixed employee stock options -- are transferable and subject to continual market verification of price. Their value comes from their transferability and volatility. Would anybody really suggest that these options would retain their value if they were no longer able to be traded? Of course not. Yet employee options are not transferable to anyone. The fact is that accurately estimating the present value of a fixed employees stock option -- measured in terms of his or her "right to participate" -- is impossible, making these charges imprecise and speculative. No model yet offered comes close. But FASB proposes to force such guesses about the future onto the company's income statement as a reduction of its hard-won earnings.

So we come back to the basis for any accounting change -- the costs vs. the benefits. In other words will the improved integrity and comparability of financial statements outweigh the economic costs. I have concluded that they will not, and I am not alone in my analysis. The FASB rule is opposed by the vast majority of the investment community including, the Council of Institutional Investors, the United Shareholders Association, National Venture Capital Association, hundreds of pension funds, three of the four SEC Commissioners, the Financial Executives Institute, the NASDAQ stock market, and each of the "big six" accounting firms, to name a few. And this does not even begin to count the dozens of high technology industry groups opposing the decision.

The Board says the market will learn to overlook these charges and discern the true nature of the companies earnings. Presuming a thoroughly efficient marketplace, this could be true for the Fortune 500, but 48% of all NASDAQ stocks are never followed by any analyst. These companies -- the smaller, more volatile, job creating companies -- will be seriously impacted. The result of this change will be lower earnings which will impact the ability of these firms to raise capital and will curtail their ability to offer options to a broad-base of their workforce.

At a recent Senate Hearing, the Council of Institutional Investors said it best:

"There is no group that has a greater interest in the principled "right" answers to accounting questions than we do. We are the people who invest real money -- huge amounts of money -- based upon what we read in financial statements. We are America's employees and America's retirees, and we will not get our pensions if we do not invest wisely based on accurate financial information. So no one will be hurt more than we if any other agenda -- however virtuous -- is pursued at the expense of the accuracy and usefulness of

financial statements. This is real people's grocery money." She goes on to say: "The exposure draft requires companies to put something in their financial statements that simply isn't true."

Indeed, Mr. President, FASB is trying to impose the first Generally Accepted Accounting Principle, which is generally accepted by no one.

2. What are the Benefits of Stock Options and Who Gets Them?

Mr. President, the second reason I introduced my legislation was because there seems to be a looming mis-understanding about what stock options are and who gets them. There has been a lot of attention paid to the "horror stories" about a relatively small number of extravagantly compensated executives. These stories are true and the outrage is understandable. But that does not paint an accurate picture of the role stock options play in the U.S. economy today. Nor does it paint an accurate picture of who gets them.

The fact is that there are many thousands of companies who offer stock option packages, and many hundreds of thousands of employees who receive them. Some of the companies which have broad based stock option plans include Nynex, General Mills, Microsoft, Genentech, Wal-Mart, Intel, Motorola, Wendy's, Pepsi-Co, DuPont, Nation's Bank, and Pfizer. And the practice is even more widespread among smaller, newer companies. The fact is that America's most dynamic, job-creating companies consistently rely on employee stock options to attract and motivate their employees. Not just their top executives, all their employees. Let me just mention one recent survey which concluded that of companies offering stock option plans with fewer than 100 employees, fully 9 out of 10 offer options to every single employee.

Mr. President, as I eluded to earlier, stock options represent enormous economic benefits for businesses and employees alike. Stock options make it possible to start new companies and create new jobs. They stretch venture capital dollars, enhance recruitment, and motivate employees. Indeed, nearly every study of "what works" in successful companies advocates encouraging employees to buy and own meaningful portions of their company's stock.

Stock options also represent significant benefits for employees. I am speaking of the hundreds of thousands of mid-level middle class employees who receive options. For these people, stock options represent the difference between working for a company and having a ownership stake in a company. And, in many cases, stock options also represent an extra bonus -- a

dividend, if you will, -- that makes it possible to afford a home, a child's college education, a retirement nest egg, or even start-up capital to open a business and create more jobs.

3. The FASB Process is Broken

Mr. President, the third reason I introduced my legislation was because I believe that, in this instance, the FASB process is broken. Arthur Levitt, Chairman of the Securities and Exchange Commission has taken exception with my view, but nonetheless has taken a position that I believe to be rational and reasoned. Chairman Levitt has argued that the FASB process is fair and open. He has encouraged a thorough debate; has encouraged opponents of the FASB rule to participate in that debate; and has said he will withhold judgement until such a debate occurs. But, Mr. President, this morning I received a copy of a letter sent to Chairman Levitt from 10 industry organizations which makes clear that, in this case, the FASB process is fatally damaged. To quote from the letter: "there is no longer any basis for believing that FASB has maintained the open-mind that is essential for regulatory due process." While this is not exactly like a "regulatory" process, their point is well taken and noteworthy.

Allow me to elaborate. As part of FASB's on-going "deliberative" process the Financial Accounting Standards Board issues an "Exposure Draft" which is described as a "proposed statement of financial accounting standards", akin to a governmental rule-making proposal. Simply stated, this exposure draft sets forward the conceptual basis for its' proposed standard and the process by which written and oral comments may be made. The first page of the exposure draft for "Accounting for Stock-based Compensation" reads:

"The proposals that the Board believes are the most significant are summarized below to assist recipients of the proposed Statement."

Under the first heading, "Recognition of Compensation Cost," the Exposure Draft asks:

Issue 1: ... Should the issuance of fixed stock options like the issuance of other equity instruments, result in recognition of the consideration and the subsequent cost incurred as the consideration -- employee services -- is used in the entity's operations?

Indeed, this is the fundamental question of the debate. Stated simply the issues raised are: (1) are stock options "compensation" and (2) should fixed stock option grants result in a charge against earnings. Moreover, these are the questions to which many distinguished and accomplished accountants, financial information users, and financial officers hold different views.

The exposure draft goes on to raise issues related to Measurement Date, Measurement Method, Attribution Period, and Disclosures.

But, Mr. President, last month -- more than two months before the end of the official public comment period FASB made it clear their minds are already made up on this central issue. Mr. James Leisenring, Vice Chairman of the Financial Accounting Standards Board, stated in both written and oral testimony before the United States Senate Securities Subcommittee:

"Have we made up our minds that stock options are compensation that should be recognized? Yes. Have we made up our minds about how to exactly measure the compensation expense? No."

In other words, Mr. President, sending FASB any opposing views is a waste of time. Fundamental requirements of due process and fair administrative procedure require that those affected by proposed regulations have a right to have their views heard and considered before the regulations are implemented. FASB's declaration of its conclusions two months before its public comment period has closed is a clear breach of fairness and administrative due process. FASB has undermined their own process -- a process which has turned out to be neither fair nor open. This process by FASB's own statements is a sham. And, this is not the first time they have made these statements. In virtually every public meeting and in virtually every press report, the message is the same. The FASB has made clear that they are not respecting the public comment process that FASB itself set up to resolve the key questions set forth in their own exposure draft. They are making clear that any public comments on the central issues will not be considered and that their position is non-debateable. That being the case, what is the purpose of this comment period?

Mr. President, I believe it is now necessary and appropriate for Chairman Levitt to stop deferring to the FASB process. It is time for the Chairman to step in and exercise the SEC's statutory oversight responsibility and put an end to this misguided exercise in accounting theory. He should do so because the process is flawed. More importantly, Mr. President, he should do so because -- on the substance -- the FASB proposal is bad policy, bad economics, and bad accounting.

Mr. President, let me just conclude by quickly addressing a couple of additional points raised by the FASB. FASB has argued that they have no responsibility to take the economic impact of its' actions into account. And, they argue that Congress should not become involved in the standard setting process. Generally speaking, I agree with both points. However, do not be fooled into thinking that this is like past accounting debates, despite FASB's attempt to raise the stakes of this proposal. This debate

is not about post retirement health benefits, unfunded pensions, or thrift accounting. There is no comparison, and, in this case, there are no identifiable victims.

FASB also states that "Current accounting produces financial statements that are neither credible nor representationally faithful." This statement -- like the statement comparing this debate to the Savings and Loan crisis -- is an outrageous exaggeration of the facts. Let me quote Jim Bunt, Comptroller of General Electric, at last month's Senate hearing testify on behalf of the Financial Executives Institute: "I can assert that during the past 20 years, not one share owner, securities analyst, not one member of the business press, has ever suggested that my Company's financial statements are flawed or misleading as a result of our accounting for employee stock options." Let me also quote from a letter sent to me last summer by the United Shareholders Association, representing 65,000 individual investors. They stated:

"As investors and regular users of corporate financial reports, USA members are the very people the accounting rules are designed to protect. Our members oppose charging earnings for stock options. We do not believe FASB's proposal would clarify the reports we receive. In fact, we believe that including speculative estimates of future stock option values in corporate earnings statements diminishes rather than enhances their usefulness."

Finally, Mr. President, let me just make clear that this debate is not about the independence of the Financial Accounting Standards Board. I am a full supporter of the FASB and their independence, but this debate is not about the FASB. This debate is about employee ownership, economic growth, and job creation. Nobody is arguing that the threat of job loss justifies bad accounting. We are arguing for a pragmatic approach to financial accounting -- an approach which recognizes that when you weigh the economic costs against the theoretical accounting benefits -- the outcome is clear. What we get is a highly debateable accounting standard, what we give up is a vital tool for economic growth and job creation. This proposal should be withdrawn.