

Congress of the United States

Washington, DC 20510

June 30, 2004

Letter of Comment No: 5865
File Reference: 1102-100

Financial Accounting Standards Board
Director of Major Projects
File Reference No. 1102-100
401 Merritt 7
P.O. Box 5116
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Sent by electronic mail to director@fasb.org

RE: Employee Stock Option Accounting

To Members of the Financial Accounting Standards Board:

We are writing in strong support of the Exposure Draft on Share-Based Payments, which has been proposed by the Financial Accounting Standards Board (FASB) to amend Financial Accounting Standards No. 123 and 95 on accounting for stock options. The signatories to this letter, Members of Congress from the U.S. House of Representatives and U.S. Senate, are strong supporters of an honest accounting standard that would require all employee stock option compensation to be shown as an expense on corporate financial statements.

Current U.S. accounting standards allow companies to choose whether or not to report stock option compensation as an expense in their financial statements. Many companies have chosen not to report any expense, even when claiming stock option expenses on their tax returns. Stock options are the only form of compensation expense that may be completely omitted from a corporation's financial statements. All other forms of compensation – including stock grants, stock appreciation rights, performance awards, golden parachutes, health and retirement benefits – must appear as an expense. The issue is not whether these forms of compensation provide useful incentives, but whether all of them should be reflected honestly on company financial records as company expenses.

Stealth Compensation

The unique and unwarranted accounting treatment afforded stock options has fueled stock option abuses linked to excessive executive pay, inflated company earnings, dishonest accounting, and corporate misconduct.

Since the 1980s, stock option compensation has funneled millions of dollars to U.S. corporate executives and contributed a substantial portion of the compensation paid to chief executive officers (CEOs) at U.S. corporations. Business Week has estimated that, in the aggregate, employee stock options now account for "a staggering 15 percent of all shares outstanding" at U.S. publicly traded corporations. In 2003, CEO pay at 350 major U.S. public companies averaged \$8 million, with stock options typically providing the largest single compensation component. Stock options have frequently provided such striking sums as the \$123 million paid to Enron's CEO in 2000, the \$700 million paid to the CEO of a high technology company in 2001, and the \$130 million paid to another CEO in 2003. At many companies, this compensation never appears on the company's financial statements as an expense, despite the size of the payment and the common practice of deducting it as an expense on the company's federal corporate tax return. At these companies, stock options have functioned as stealth compensation.

In addition to fueling excessive executive pay, the omission of stock option expenses from company financial statements, combined with the inclusion of this expense in company tax returns, have resulted in overstated earnings. Federal Reserve Chairman Alan Greenspan has stated that "[t]he failure to expense stock option grants has introduced a significant distortion in reported earnings" and estimated that, from 1995 to 2000, stock options were used to overstate reported company earnings by an average of 3 percent. Focusing primarily on high technology companies, Bear Stearns has calculated that, if companies in the Nasdaq 100 index had included stock option expenses, their reported 2003 earnings would have fallen by as much as 40 percent.

But overstated earnings are not the only accounting problem associated with stock options. A September 2002 report issued by a blue-ribbon panel established by The Conference Board found that the current accounting treatment of stock options helped "foster[] what appears to be a vicious cycle of increasing short-term pressures to manipulate earnings in order to bolster stock price in order to cash in on options." A more recent study by Texas A&M University of 100 companies that restated their financial results in 2000 and 2001, used regression analysis to determine that the factor most likely to result in a financial restatement was whether the CEO had substantial, in-the-money stock options. Stock option abuses and the dishonest accounting associated with them have damaged the credibility of not only individual companies, but also overall investor confidence in the accuracy and reliability of U.S. corporate financial statements.

In response to this loss of confidence, since 2002, nearly 600 U.S. corporations have decided voluntarily to begin expensing their stock options, including such American giants as Coca-Cola, General Motors, General Electric, Dow Chemical, Amazon.com, Home Depot, and Wal-Mart. Other companies, however, especially in the high technology sector, have announced that they will not expense stock options until required to do so, even when pressed by a shareholder majority vote to begin expensing. This division of approach means that, until FASB acts, there will be a discrepancy between those companies that are voluntarily expensing options and those that are not, when there ought to be a level playing field in which everyone operates under the same accounting

rules. Failure to correct this discrepant accounting would continue to disadvantage companies that openly report their stock option expenses and continue to hinder investors attempting to compare corporate performance.

Consensus Position

The position taken in the Exposure Draft in favor of stock option expensing reflects the consensus position of most accounting experts. The International Accounting Standards Board, for example, has already issued a standard requiring stock option expensing beginning in 2005. This standard will apply to companies in over 90 countries around the world, including in Europe, South America, Africa, and Asia. Canada began requiring stock option expensing this year. A 2002 survey of financial experts by the Association for Investment Management and Research found that more than 80 percent supported stock option expensing. All four of the major accounting firms in the United States, Deloitte & Touche USA, Ernst & Young, KPMG, and PricewaterhouseCoopers, also favor expensing.

Other economic, financial, and accounting leaders also support stock option expensing as good for investors and good for markets. They include Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, Securities and Exchange Commission (SEC) Chairman William Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, former SEC Chairman Arthur Levitt, former Comptroller General Charles Bowsher, investors Warren Buffett, John Biggs and Pete Peterson, Nobel Prize winners Joseph Stiglitz, Robert Merton and Myron Scholes, as well as respected groups such as the Council of Institutional Investors, the Investment Company Institute, Financial Services Forum, Consumer Federation of America, National Association of State Treasurers, Institute of Management Accountants, and The Conference Board's Commission on Public Trust and Private Enterprise.

Opposing Arguments

Some opponents of stock option expensing argue that, due to the difficulty of precisely estimating stock option values, expensing would confuse rather than educate analysts and investors about a company's financial condition. But financial statement users already rely on many estimated valuations called for by accounting rules, from the value of goodwill to the reserves required to protect against uncollectible receivables or loans. As Warren Buffett once said, the only value that everyone agrees is incorrect for a stock option is zero. The better approach is the one taken in the Exposure Draft, which requires use of stock option valuation methodologies that produce a reasonable estimate of stock option compensation expenses.

Some opponents warn that requiring stock option expensing would impose significant costs on new businesses and deter investment; however, evidence provided at a Senate Committee on Small Business and Entrepreneurship hearing on April 28, 2004 shows the opposite. One of the hearing witnesses, Mr. Roberto Mendoza, testified that

his startup company, Integrated Finance Limited, decided from its inception to expense all stock option compensation, and found that its stance actually attracted investors by demonstrating the company's adherence to transparent accounting. Mr. Mendoza also testified that when he determined that the company's draft audited financial statement had failed to include any stock option expense, his accountant agreed to include that expense at no additional cost and was able to calculate the expense itself in less than 20 minutes. This testimony shows that calculating stock option expenses can be quick and inexpensive, and need not be burdensome to new or small businesses.

Other opponents claim that, by lowering company earnings, stock option expensing would cause company stock prices to fall and depress investment prospects. But the facts, again, show otherwise. In March 2004, a leading compensation firm, Towers Perrin, issued a study examining 335 companies that switched to stock option expensing and found that stock performance was the same, on average, as the rest of the S&P 500 and Mid-Cap 400 indices. Stock option expensing did not affect company stock prices. The same dire prediction had been made and shown to be unfounded when FASB first required companies to begin accounting for their obligations to employees relating to retiree health care benefits.

Other financial analysts have also rejected dire predictions about depressed share prices and investment. They include Goldman Sachs Global Equity Research ("We do not expect a material impact on the share prices of most firms."); UBS Investment Research (Expensing is "medicine for the long-term health of companies and investors. It will shed light on the true profitability of many companies, helping to separate those that deserve investor capital from those that do not."); Merrill Lynch (The argument that expensing options will harm U.S. technology leadership and job creation is based on "the following faulty logic: U.S. technology leadership and job creation depend on the systematic misrepresentation of financial statements. One might as well argue that money spent on R&D shouldn't count as an expense because it provides employment and helps industries advance."); Credit Suisse First Boston Equity Research ("We expect companies to pay closer attention to the economic cost of their stock option plans. Companies don't focus much on costs that they don't have to account for."); and Congress' own nonpartisan Congressional Budget Office ("[R]ecognizing the fair value of employee stock options is unlikely to have a significant effect on the economy . . . however, it could make fair value information more transparent to less-sophisticated investors.").

Still other opponents claim expensing stock options would stifle innovation in business. But many of the nearly 600 companies currently expensing options are successful, high technology innovators like Microsoft, Netflix, and Amazon. They also include such diverse companies as Boeing, General Motors, Dow Chemical, BankOne, and UPS, each of which relies on technical innovation for business success. The CEO of Netflix, a high technology company that began expensing stock options last year, has stated: "[I]nnovation continues unabated. . . . We innovate because it thrills us, not because of some accounting treatment."

Another red herring argument is that expensing would eliminate broad-based stock option plans and hurt average employees. These contentions are also contradicted by the factual record. Companies that currently offer broad-based plans to their workforce such as Home Depot, Wal-Mart, and Netflix, have already determined that they can expense options without having to terminate their stock option plans. Other companies, such as Microsoft, are replacing stock options with stock grants, thereby ensuring that their employees actually receive company stock. It is also important to remember that most U.S. employers, including many private companies, small businesses, and partnerships, don't offer stock option compensation to any of their employees, executive or otherwise. A nationwide survey conducted by the Bureau of Labor Statistics in 2000, a banner year for stock options, found that only 1.7 percent of U.S. private industry employees actually received any options during the prior 12-month period. In short, neither broad-based stock option plans nor average workers would be hurt by honest accounting.

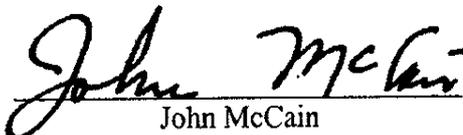
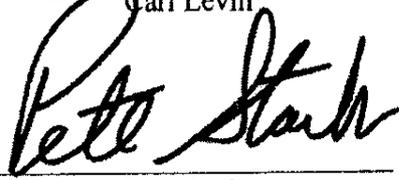
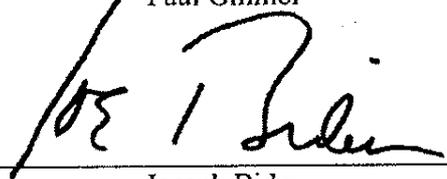
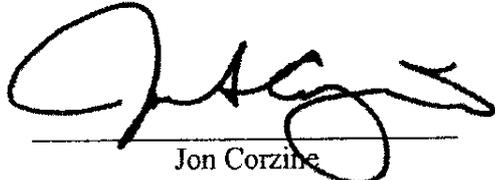
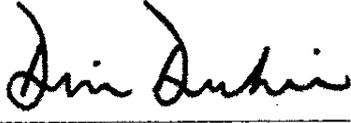
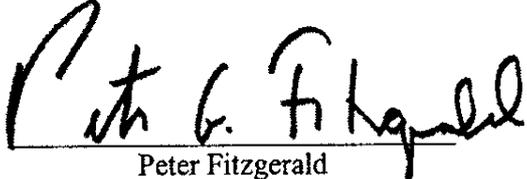
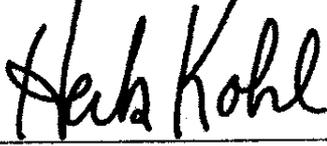
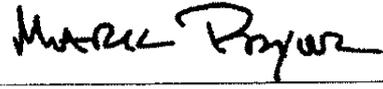
Additional proof that stock option expensing will not hurt American business is the track record actually compiled by the nearly 600 companies that have voluntarily agreed to begin expensing. These companies represent nearly 25% of the number of companies on the Standard and Poor's index of companies and over 40% of that index based on market capitalization. None has experienced the dire consequences predicted by expensing opponents.

Conclusion

Honest accounting will help, not hurt, American business. Now is the time to end years of misleading accounting and recognize the expense associated with stock option compensation. FASB almost took this course of action ten years ago, but retreated due to political pressure. We urge FASB to stand firm this year and do what you think is the right thing to do. We commit to do our part by opposing legislative efforts in Congress to override FASB's judgment and politicize the accounting standards-setting process. Reversing FASB's judgment on this issue would undermine key accounting reforms strengthening FASB's independence, open the door to new Enron-style abuses, and signal that accounting maneuvers to prop up earnings are still acceptable.

Requiring companies to expense employee stock options will strengthen the accuracy of corporate financial statements, bring U.S. accounting standards into alignment with international standards, and help restore public trust in our financial reporting system, our companies, and our markets. We urge FASB to go forward as it has proposed and promulgate a final accounting standard to require stock option expensing beginning in 2005.

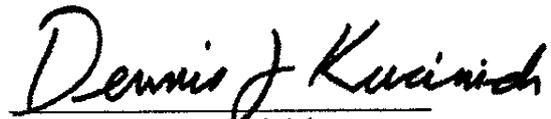
Sincerely,

 _____ John McCain	 _____ Carl Levin
 _____ Paul Gillmor	 _____ Pete Stark
 _____ Joseph Biden	 _____ Jon Corzine
 _____ Richard Durbin	 _____ Russell Feingold
 _____ Peter Fitzgerald	 _____ Herb Kohl
 _____ Bill Nelson	 _____ Mark Pryor

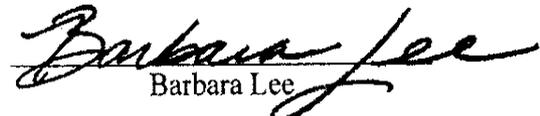

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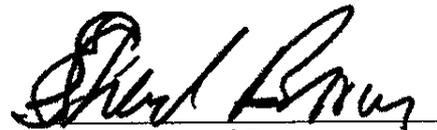

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