June 29, 2004

Letter of Comment No: 5055
File Reference: 1102-100

Dear Financial Accounting Standards Board:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") and our affiliated unions' 13 million members, I appreciate the opportunity to comment on the proposal by the Financial Accounting Standards Board ("FASB") to require the mandatory expensing of stock options. The AFL-CIO strongly supports FASB's proposed statement on share based payments, and urges FASB to stand firm in the face of tremendous pressure from Silicon Valley CEOs and their allies in Congress, who would like to keep the cost of stock options off the books.

Stock option expensing will have an unambiguously positive impact on the economic security of America's working families. The retirement savings of America's working families depends on all companies having honest accounting practices. Companies that do not expense stock options are hiding their true cost from investors, creditors and other consumers of financial reports. As former Enron CEO Jeffrey Skilling explained in his Congressional testimony, "you issue stock options to reduce compensation expense and, therefore, increase your profitability."

Our interest in stock option expensing stems from the fact that our members are also investors. Union members participate in benefit plans with over $5 trillion in assets. Pension plans sponsored by unions affiliated with the AFL-CIO hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors. Audited financial statements are the primary source of information available to guide our members' investment decisions, both individually and collectively through employee benefit funds. The integrity of these statements is critical to investors, who overwhelmingly favor mandatory expensing.
Since 2003, a majority of shareholders at 44 companies have voted in favor of resolutions to require stock option expensing. These include high-profile technology companies such as Intel, Apple Computer, Adobe Systems, IBM, and Texas Instruments, whose Boards of Directors have expressed strong opposition to expensing. All told, 576 companies have announced their intention to voluntarily expense stock options, including companies representing over 40 percent of the market capitalization of the S&P 500 Index, according to Bear, Stearns & Co.

The stock option accounting loophole has promoted the overuse of stock options in CEO pay at the expense of alternative forms of equity compensation that may better align the interests of executives and shareholders. Under the current accounting rules, performance-vesting restricted stock as well as performance-based stock options that are indexed or premium priced must be expensed. For this reason, the preferential accounting treatment for fixed-price stock options has hindered executive compensation innovation.

Corporate executives have the most to gain from preserving the stock option accounting loophole. The failure to expense stock options has widened the pay gap between workers and CEOs, who disproportionately benefit from stock options. Largely because of the growing role of stock options in executive compensation, the ratio of CEO-to-worker pay increased from 42:1 in 1980 to 301:1 in 2003. Moreover, keeping the cost of stock options off the books has artificially boosted profit reports, thereby generating further increases in CEO pay.

In contrast to CEOs, ordinary workers receive relatively few stock options. According to SEC filings, the CEOs of the ten public companies who are the corporate members of the so-called International Employee Stock Option Coalition (the “IESOC”) hold on paper a combined $916 million in unexercised stock options. The authors of the book In the Company of Owners estimate that “roughly 30 percent of all options are in the hands of top five executives” and “most of the remaining 70 percent is spread very narrowly among other executives and managers.”

The IESOC has backed two bills in Congress, S.1890 and H.R. 3574, which purport to require the expensing of stock options for the top five most highly paid executives. However, these supposed compromise bills are a sham. In addition to creating an accounting fiction that some stock options are a cost while others are not, these bills would dramatically understate the true cost of CEO stock options by mandating a “minimum value” approach that falsely assumes that the stock price has zero volatility.

Opponents of mandatory expensing have exaggerated valuation issues related to stock options. They claim, for example, that options cannot be accurately valued because they are not publicly traded and vary in value after they are granted. The same can be said for numerous other line items on corporate financial statements, including depreciation, amortization, and inventory-related adjustments. No one would suggest that these should be left off the companies’ financial statements.
FASB’s proposed fair value approach, which allows companies to choose between a Black-Scholes-Merton formula and a binomial lattice model, will result in reliable estimates of the cost of stock-based compensation arrangements. The proposed disclosures provide useful information about the number and value of share-based payments and the methodology used to value the awards. The fair value approach also allows companies to make adjustments to account for options that are exercised early or forfeited.

We nonetheless believe that there can be diminishing gains in transparency from increased complexity in options valuation models. We urge the Board not to be trapped by the bad faith argument that suggests the valuation models must be perfectly accurate, and thus they must be so complex that they are impractical to adopt. We believe Black-Scholes-Merton with modest adjustments is adequate for providing reasonable, comparable, and cost efficient estimates of the cost of employee stock options.

While the proposed disclosures of the variables used to estimate fair value are helpful, we agree with the Council of Institutional Investors that the FASB should consider expanding the disclosure of volatility to include three years of data on actual volatility, as determined by some consistent standard. Such disclosure would greatly enhance investors’ ability to assess the reasonableness of the volatility assumption.

The goal of accounting is to facilitate accurate comparisons between companies—a goal not being met under the current system, when some companies expense options and others do not. Companies that do not expense stock options are hiding their true cost from investors, creditors, and other consumers of financial reports. FASB’s decision to require stock option expensing in 2005 will strengthen investor confidence in financial statements. By helping to ensure that the U.S. capital markets set the world standard for accounting transparency, stock option expensing will reduce the cost of capital for U.S. enterprises.

We appreciate the opportunity to present our views on this important matter.

Sincerely,

Richard L. Trumka

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