

**Congressman David Dreier**  
**Testimony Before the House Committee on Financial Services**  
**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**  
**Tuesday, June 3, 2003**

**Hearing on “The Accounting Treatment of Stock Options”**

Mr. Chairman and Members of the Committee, I want to thank you for holding this hearing today on the accounting treatment of stock options and for giving me the opportunity to talk about H.R. 1372, the Broad-Based Stock Option Plan Transparency Act.

There are some who have accused me and our colleague, Congresswoman Eshoo, of trying to politicize the issue of stock option expensing through the introduction of our legislation. For that reason, I want to begin by noting that unlike the Financial Accounting Standards Board (FASB), we as elected officials are the ones who have an obligation to American workers and investors to preserve an environment that allows entrepreneurs to grow our economy. The fact is that although the potential change in accounting treatment proposed by FASB may be arcane to some, it is in the real world that the negative impact of expensing will hurt the risk-takers who are creating jobs and wealth in this country.

For this reason, I want to commend you, Mr. Chairman, for holding this hearing and not being intimidated by those lobbying political attacks on many of us who have legitimate concerns about a mandatory expensing accounting standard. The reality is that when you examine FASB’s proposed expensing rule, you will find that it is not a black and white issue. The discussion about whether to expense resides in a gray area, and the sole responsibility to consider the damage that expensing could have on American innovation, job-creation, and competitiveness rests in the hands of public officials.

How to achieve better transparency for investors should be the real goal of all sides of this debate. To submit that stock option expensing will provide better clarity to investors ignores the pronounced lack of consensus among accounting experts about how to value such options accurately. You will never arrive at a precise number when you attempt to value stock options that have not been exercised, may never be exercised, and are not tradeable in open capital markets. Existing pricing models, when applied to employee stock options, can produce widely differing results depending on subjective estimates that a company would have to make. As noted by Harvard Professor William Sahlman, “[i]f anything, expensing options may lead to an even more distorted picture of a company’s economic position and cash flows than financial statements currently paint.”

But valuation aside, you do not have to be an accountant to recognize that stock options granted to an employee do not cause the company to incur any costs. If one looks at the definition of an expense, *i.e.*, anything that results in an outflow of a company's assets or an increase in a company's liabilities, employee stock options meet neither test. Let us propose for instance, that on January 1<sup>st</sup>, 2003, Company A hires a computer programmer at a salary of \$50,000 per year plus 100 stock option grants that can be exercised at a price of \$10 no earlier than 5 years from date of hire. What is

Company A paying out on the date of hire and throughout the ensuing 5 years? Only the cash salary and nothing for the options. There is no cash outflow for the options and no liability created at any time; not when they are granted, vested, or are exercised. Indeed, when the stock options are exercised, the company actually receives money.

Congress cannot divorce responsibility for accounting standards from the very real impact that a particular standard will have on investors and on the economy. Mandatory stock option expensing not only threatens the high-growth sectors of our economy but it will actually result in investors receiving inaccurate information about a company's use of employee stock options.

We stand on the side of investors in recognizing that while stock options do not incur a cost on the company, they can clearly impact shareholder value. Revisiting my earlier example, if Company A's net income is \$100,000, with 1000 outstanding shares, the additional 100 shares given to the newly-hired computer programmer potentially dilutes the earnings per share for existing shareholders to \$90 per share or 10%, if those 100 shares were exercised on the date of hire. That is precisely the type of information that investors need to have: how stock option grants impact their shareholdings.

Our legislation seeks to give them that information in a uniform and standardized format. Its objective is to improve the transparency and disclosure requirements for all publicly-traded companies issuing employee stock options, whether they are given to high-level executives or lower-level workers.

The Broad-Based Stock Option Plan Transparency Act of 2003 directs the Securities and Exchange Commission to issue regulations that enhance reporting disclosures in their annual and quarterly reports that will include at a minimum:

- (1) "plain English" discussion of share value dilution, including tables or graphic illustrations of the dilutive effects;
- (2) expanded disclosure of the dilutive effect of employee stock options on the company's earnings per share number;
- (3) the prominent placement and increased comparability of stock option-related information; and
- (4) a summary of stock options granted to the 5 most highly compensated executive officers, including any outstanding stock options.

The SEC will not be permitted to recognize any new accounting standard related to stock options until they have submitted a report to Congress on the effectiveness of the new disclosures. That report would be submitted following a 3-year period after the rule was implemented. For 1 year, the Secretary of Commerce will study the role of broad-based plans in expanding corporate ownership, the recruitment and retention of skilled workers, stimulating research and innovation, the international competitiveness of U.S. companies, and in growing the U.S. economy.

The result of this bill is that investors will clearly understand the impact of employee stock options on share value, while the most innovative sectors of our economy will be able to use broad-based stock option plans-stock option plans given to the majority if not all of a company's employees- to

recruit and retain talented workers.

Let me finish by returning to the fact that employee stock options never actually impose an “expense” or “cost” on companies. Since that is the case, why this endless debate with FASB and others in the accounting community over “expensing stock options”, or explaining exactly what the cost to companies is? Well, that brings me to my visual aid.

Mr. Chairman, this is a diagram of the movements of the sun, moon and planets as they revolve around the Earth. It was developed in the Middle Ages. It is based on extraordinarily complicated, even brilliant, mathematical work by Claudius Ptolemy. Ptolemy wrote a 13 volume treatise, entitled The Mathematical Compilation, that explained the movements of the sun, moon and five planets around the Earth. His work was the leading scientific explanation of that truth for almost 15 centuries.

The point is, even if you started with the “fact” that the Earth was at the center of the universe, you could develop very complicated and precise answers to all types of questions, including why the visible planets, in particular, take very unusual paths across the sky. Geniuses like Nicolaus Copernicus improved on the Ptolemaic work by proposing that the sun and earth revolved around a point near the sun, and Tycho Brahe explained how the planets revolved around the sun and the sun and planets revolved around the Earth. Even Galileo did not break completely from the intellectual view underpinning the 15 centuries of Ptolemy’s astronomy.

What does that have to do with FASB? Mr. Chairman, the accountants at FASB, good people that they are, are required to fit the entire universe around a world view that in the end is flawed as much as Ptolemy’s universe was. Their view is that everything must be able to be scored and placed on a corporate balance sheet. Well, the earth is not the center of the universe, and everything doesn’t belong on a balance sheet.

That’s not to say that given enough hard thinking a smart person could not figure out a way to put everything on a balance sheet. Utterly brilliant people figured out a way to explain, with incredible precision, how and why the sun and planets revolved around the Earth. You can explain just about anything with mathematical precision if you want to. But that doesn’t mean it’s true. FASB is not populated by Ptolemy, Copernicus, Brahe or Galileo, and you don’t have to be Johannes Kepler to say they just have this thing wrong.

I believe that this committee should focus on two keys points: (1) employee stock options do not ever impose a cost or expense on companies, so proposals that try to explain how that is the case and scores that cost must be flawed from the get-go; and (2) employee stock options do have the potential of imposing a “cost” on shareholders, primarily through the effect of dilution. Therefore, if the committee wants to do something to benefit shareholders, which I certainly support, you should look at improving the process of informing shareholders with accurate information regarding stock options and their potential impact on share value, as H.R. 1372 seeks to accomplish.