STATEMENT FOR THE RECORD OF RICHARD L. TRUMKA
SECRETARY-TREASURER
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
Before the
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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On behalf of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and our affiliated unions' 13 millions members, I appreciate the opportunity to comment on H.R. 3574, "The Stock Option Accounting Reform Act," which would block the Financial Accounting Standards Board (FASB) from issuing a new standard requiring mandatory expensing of stock options until completion of an "economic impact" study.

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.

In coming weeks, FASB is expected to issue a proposed standard on equity-based compensation that would require companies to charge stock option costs against earnings beginning in 2005. The AFL-CIO strongly supports FASB in its efforts to close an accounting loophole that has allowed corporations to understate the true cost of compensation to senior executives and other management employees.

In an attempt to position H.R. 3574 as a compromise bill, its authors would require companies to expense options granted to their top five executives. However, H.R. 3574 would also require companies using an option pricing model like Black-Scholes to assume that the underlying stock price has zero volatility. This "minimum value" approach results in unrealistically low cost estimates because much of the value of stock options derives from the volatility of stock prices. The minimum value approach is rarely used except where historical volatility data is unavailable -- for options on untraded stocks, for example -- and its adoption here suggests that the objective of H.R. 3574 is to keep CEOs knee-deep in stock options without having to report the real cost to shareholders.

Moreover, as Mark Rubinstein demonstrates in the *Journal of Derivatives*, the minimum value approach can easily be manipulated to drive the reported value to zero or near zero ("On the Accounting Valuation of Employee Stock Options," Fall 1995). This is done by raising the exercise price and multiplying the number of options in order to maintain the real value of the grant while lowering its reported "minimum value."

However, even if the cost of option grants to senior executives were calculated using a fair value approach, we reject any compromise that results in some options being counted as an expense and others not. We agree with FASB Chairman Robert Herz, who last year testified before the Senate that "financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermines the credibility and value of that information and the proper functioning of the capital markets by impairing investors' capital allocation decisions."[1]

What we oppose is giving one particular form of compensation – in this case, stock options – preferential accounting treatment over other more important employee benefits such as wages, pensions or health care. If the corporate opponents of stock option expensing truly want to help America's working families, they should instead focus their efforts on encouraging the expansion of retirement plans and health care coverage.

Despite attempts to portray stock options as a broad-based benefit, few ordinary workers receive stock options. At the height of the stock market boom in 1999, only 0.7 percent of private sector workers earning less than $35,000 received stock options, compared with 12.9 percent of workers earning $75,000 and above.[2] Even in Silicon Valley, where options are sometimes granted to a cross-section of employees, households with stock options have a median income of $122,000.[3]

Stock options have widened the pay gap between executives and ordinary workers. In 1980, prior to the widespread use of stock options in executive compensation, CEO pay stood at approximately 42 times the average worker. Two decades later, CEO pay reached 531 times the average worker's pay. The majority of this increase was due to stock options, which have become the biggest component of today's CEO pay packages.

We do not believe that mandatory expensing "threatens small businesses and imperils the fragile economic recovery," as the American Enterprise Institute's James K. Glassman claimed in his Senate testimony last year. Compared to large corporations, few small businesses grant their employees stock options. Bureau of Labor Statics data shows that only 2.1 percent of companies with 100 employees or less granted stock options, compared with 10.1 percent of companies with over 100 employees. We believe this data shows that stock option expensing will have little if any impact on America's small business, and that H.R. 3574's small business exemption is simply a public relations ploy.

Mandatory expensing enjoys almost unanimous support among institutional investors and governance advocates, including the Conference Board Commission on

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[1] Statement of Robert H. Herz, Chairman, Financial Accounting Standards Board, for the Roundtable on "Preserving Partnership Capitalism Through Stock Options for America's Workforce," United States Senate, May 8, 2003.
[2] Bureau of Labor Statistics, "Pilot Survey on the Incidence of Stock Options in Private Industry in 1999," press release October 11, 2000.
[3] 2002 Gallup Poll of Media Use and Consumer Behavior for the San Francisco market, cited in Mark Schwanhausser and Jeanne Cardenas, "Stock Options Slow After Dot-Com Bust," *San Jose Mercury News*, December 13, 2002.

Public Trust and Private Enterprise, the Council of Institutional Investors, Institutional Shareholder Services, and the Teachers Insurance and Annuity Association - College Retirement Equities Fund. Warren Buffett, Securities and Exchange Commission Chairman William H. Donaldson, Public Company Accounting Oversight Board Chairman William McDonough, Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul Volcker, and Nobel Prize-winning economists Robert C. Merton and Joseph E. Stiglitz are also in favor of mandatory expensing.

The support of institutional investors and other disinterested observers belies the concerns of Intel Chairman Andrew Grove, who claimed in a letter to shareholders that mandatory expensing "could cause real economic harm to Intel, our stockholders, and our economy." Speaking on behalf of union pension funds and other Intel investors, Grove's regard for our well-being seems misplaced.

Investors have demonstrated their support by voting in favor of expensing at annual meetings of shareholders. Last year, worker fund proposals on expensing options won majority votes at 30 companies, and many companies where our funds filed proposals have joined the growing ranks of major corporations such as Microsoft that have voluntarily begun expensing stock options. According to Bear Stearns, 483 companies have announced their intention to voluntarily expense stock options, including 113 members of the S&P 500, representing 41 percent of the index's market capitalization.

In our view, the stock option accounting loophole not only has caused a misallocation of capital in favor of companies that understate their compensation costs, but also has resulted in the over-reliance on stock options at the expense of other forms of executive compensation that better align management interests with the interests of shareholders. Many companies, for example, have told us that they are reluctant to use performance-based stock options that are indexed to their competitors because indexed stock options must be expensed under the current accounting rules.

Unlike actual share ownership, stock option grants to executives create perverse incentives that are not in the best interests of long-term shareholders:

- stock options can encourage executives to take excessive business risks by promising executives all the benefit of share price increases with none of the risk of share price declines;

- stock options can reward short-term decision-making because many executive stock options can be exercised just one year after the grant date;

- executives can profit from share price volatility (a measure of shareholder risk) by timing when they exercise their stock options;

- because option holders are not entitled to dividends, dividend yields have fallen to historic lows, and many companies have instead used this cash for stock buybacks to prevent dilution from executives' stock option exercises; and

- stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

The goal of accounting is to facilitate comparisons between companies -- a goal not being met under the current system when some companies expense options and others do not. If stock options are not expensed, a company that pays its employees in stock options has lower compensation costs and therefore artificially higher earnings. As former Enron CEO Jeffrey Skilling explained in his Congressional testimony, "you issue stock options to reduce compensation expense and, therefore, increase your profitability."

This is not the first time FASB has attempted to require appropriate expensing of stock options. In the mid-1990's, just as the great orgy of executive option grants was beginning, FASB attempted to require option expensing, and was pressured by Congress into abandoning the position it had adopted on the merits. We believe that this thwarting of FASB's role as an independent body was a key initiator of the chain of events that led to the corporate scandals of the last several years.

FASB's decision to require stock option expensing in 2005 will strengthen investor confidence in the financial statements of large and small businesses, thus lowering their cost of capital. The efficient allocation of capital to the most economically valuable business activities depends on consistent accounting rules. For this reason, we believe all businesses should expense stock options, so that stock options do not artificially boost any company's profit reports. Congress should let FASB do its job.

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