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LET FASB DO THE RIGHT THING

COMPANIES SHOULD RECOGNIZE THE COST OF STOCK OPTIONS ON THEIR FINANCIAL STATEMENTS

Dear Colleague,

I'd like to call your attention to a recent Congressional Budget Office report, *Accounting for Employee Stock Options.* As you may know, the Financial Accounting Standards Board (FASB) released a draft report on March 31, 2004, proposing that companies recognize the cost of employee stock options on their financial statements. FASB is a private-sector organization of accounting experts that sets standards for financial accounting and reporting. The U.S. Securities and Exchange Commission, which requires all publicly-owned companies to file annual financial statements and other reports, generally accepts the standards set by FASB.

The CBO report affirms FASB's position requiring companies to count the value of employee stock options as an expense, and refutes the arguments made in defense of not expensing stock options. The anti-expensing lobby has put up a spirited defense based on misconception and misdirection. We've attached a summary of CBO's point by point rebuttal of their main arguments.

In 1993, Congress stepped in and pressured FASB into revising a similar proposal to expense stock options. Some in Congress would again limit FASB's rule making abilities. I strongly urge members not to support legislation that would prevent FASB from implementing its new rule. It was a mistake in 1993; it would be a mistake now, and a continuing disservice to investors.

Please take the time to review the attached summary of the CBO report on employee stock options. The full CBO report is available at www.cbo.gov. If you have questions about the report, please talk to me or have your staff contact JEC deputy director Frank Sammartino at <Frank_Sammartino@jec.senate.gov> or call him at 4-0372.

Sincerely,

Pete Stark
Senior Democrat

The Congressional Budget Office Answers
Some Common Fictions about Employee Stock Options

Fiction: Stock options have no cost to companies and thus should not be subtracted from earnings on income statements.

CBO: *"If firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' reported net income will be overstated."*

The argument that options are not a cost to firms because no cash has changed hands is hardly creditable. Many transactions do not involve cash. Grants of stock and increases in future pension benefits are examples of the many non-cash transactions that are counted as expenses. Moreover, stock option grants are transactions with real costs to companies. Firms could just as easily sell options to private investors. Managers and employees accept stock options in lieu of cash compensation precisely because the options have economic value.

The fiction that stock options are costless has led to the indiscriminate granting of options to top executives and other senior employees. Expensing options grants would impose the same bottom line discipline on stock options as on any other form of compensation.

Fiction: Stock options are impossible to value.

CBO: *"Although complicated to calculate, the fair value of employee stock options may be estimated as reliably as many other expenses."*

Firms engage in far more complicated computations in trying to project the value of depreciation and future pension liabilities. Should firms no longer consider the cost of future pension liabilities as an expense because it is difficult to estimate precisely? Calculating the value of options is not an impossible task. Banks and insurance companies routinely value options traded in private markets. Moreover, firms already calculate the value of employee stock options and report those estimates in footnotes to their income statement.

Fiction: Expensing will depress the earnings of start-up companies, make it difficult for high-tech companies to raise capital, and hurt the economy.

CBO: *"Recognizing the fair value of employee stock options is unlikely to have significant effect on the economy (because the information has already been disclosed); however, it could make fair value information more transparent to less-sophisticated investors."*

Economic studies show that there is no effect on the stock value of firms that voluntary switch to expensing of employee stock options. There is also no evidence to support the notion that start-up companies and high-tech firms need to misrepresent themselves in order to raise capital. Capital markets are highly sophisticated and already factor in stock option expense in their valuations. This is particularly true for venture capitalists who supply funding for start-ups.

Opponents counter that if the costs of employee stock options are already known, why force companies to include them in income statements? Currently, firms must disclose information about the value of stock options in the notes to their income statements. The current information, however, is both obscure and incomplete. Besides, if disclosure in footnotes is the right way to present costs, then why not treat all costs this way? Small investors are the ones that are hurt by the failure to accurately represent a company's true financial condition on its income statements.

The real issue is openness and transparency. As Chicago Graduate School of Business accounting professor Doug Hanna has said:

"The logic appears to be that if management has to tell shareholders how much they are paying themselves, then they will have to reduce these payments. This is ridiculous as a defense. If they are being paid fairly, then shareholders will want to continue the practice to keep their valuable management team. If management is being overpaid, then the payments may well have to be reduced, and I suspect this is what the lobbyists are working hard to prevent."