Prepared Statement of Arthur W. Coviello
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before the

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

of the

House Committee on Financial Services

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Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for inviting me to testify this morning on HR 3574.

My name is Art Coviello and I am President and CEO of RSA Security, a public company headquartered in Bedford, Massachusetts, with 2003 revenues of $259.9 million. As president and CEO, I am responsible for the operations and growth of the company, directing the company's vision, strategy, acquisitions and investments. I am a Certified Public Accountant (CPA) by background.

I am here to tell you that RSA Security supports HR 3574, the Stock Option Accounting Reform Act. Thank you, Chairman Baker, and thank you, Congresswoman Eshoo, for your outstanding leadership on this vital issue.

Executive Summary

What do issues of accounting, valuation, corporate governance, partnership capitalism, competitiveness, economic growth, and job security all have in common? They will all be affected by the Financial Accounting Standards Board's (FASB) proposal to expense stock options, particularly broad-based employee stock option plans. FASB deals with one, or at most two, of these issues – accounting and valuation. By the Board's own admission, the other issues are not relevant to its deliberations. But they are incredibly relevant to my responsibilities as president and CEO of RSA Security and, I believe, to your deliberations here in Congress.

Let's start with the accounting issue. In an ideal world, would we prefer no expensing at all? Absolutely -- because expensing all employee stock options is fundamentally bad accounting. But none of us live in that ideal world. We do live

in a world where the Financial Accounting Standards Board (FASB) has every intention to adopt, as soon as possible, a new accounting standard that will require the expensing of all employee stock options based on demonstrably inaccurate and unreliable valuation methods. Let me repeat that – FASB's new standard will require the use of **demonstrably inaccurate and unreliable valuation methods.**

That is where HR 3574 comes into play. HR 3574 is necessary – indeed, its passage is essential -- *because without it:*

- Good accounting will suffer irreparable harm.

- Investors, especially individual investors, will be confused, and all investors' confidence will be damaged.

- Broad-based stock option plans will likely become a thing of the past, because public companies cannot allow their investors to be confused.

- Employment growth, economic growth and US competitiveness will all take a significant step backwards.

HR 3574 is a thoughtful, sensible and pragmatic approach. The solutions it contains are far, far better than the new accounting standard that the Financial Accounting Standards Board (FASB) intends to adopt in the very near future.

Some Background on RSA Security

With over 14,000 customers around the globe, RSA Security (www.rsasecurity.com) provides interoperable solutions for establishing online identities, access rights and privileges for people, applications and devices. Our encryption technology based on the RSA algorithm is the foundation for privacy and confidentiality on the Internet. Because it is embedded in vitually all software and hardware shipped, it is arguably the most ubiquitious technology ever.

Our customers span a wide range of industries, with extensive presence in the financial services, healthcare, pharmaceuticals, biotech, aerospace, telecommunications, manufacturing, utilities and consumer arenas – and, yes, the government market as well. More than 13 million users across thousands of organizations – including more than half of the Fortune 100 – use RSA SecurID authentication products to replace unsafe passwords, protecting users' identities and access to critical data and resources.

RSA Security's Commitment to a Broad-Based Stock Option Plan

RSA Security has just over 1,000 employees worldwide. We believe that every employee should share in the success of the company. Every person who joins the company receives stock options. More than 80% of our employees have received stock options during the past four years. In addition, for the past four years, we project that approximately three-quarters of the options granted were distributed to employees below the officer and director level. We are proud of our commitment to a broad-based employee stock option plan. By giving employees at all levels a chance through equity ownership to share in RSA Security's financial success, our broad-based stock option plan increases productivity and shareholder value.

Why am I so passionate about employee stock options? Because --

- They are a vital tool for public companies to attract and retain skilled workers.

- They motivate employees to strive for excellence.

- They inspire creativity, loyalty, entrepreneurship and hard work.

Stock options are granted to create incentive for future performance. They allow start-up companies that are short on cash to hire talented employees and to preserve scarce capital funds for research and development. Stockholders benefit from companies with broad-based plans because they expect to receive a financial return that is greater than the potential cost they will bear by sharing ownership with employees.

In the remainder of my testimony, I would like to touch upon four central points:

- *First*, the real cost of stock options is potential dilution of existing shareholders' equity interests.

- *Second*, existing option pricing models, including the Black-Scholes model and binomial models, produce inaccurate and misleading information.

- *Third,* FASB's refusal to conduct comprehensive field testing of multiple valuation methods is indefensible and incomprehensible. Why do these guardians of accounting persist in not taking into account an entire industry – high-technology – as they have with oil and gas?

- *Fourth,* FASB's decision to require the expensing of all employee stock options will destroy broad-based stock option plans and the productivity, innovation, jobs and economic growth they generate.

The Real Cost of Stock Options is Potential Dilution of Existing Shareholders' Equity Interests

The issuance of stock options does not result in a corporate level cost that impacts net income. When an option is issued, there is no outflow or consumption of corporate assets and no decline in the value of corporate assets. Nor is there the creation of a liability representing actual or expected cash outflows. In fact, to the extent options are ultimately exercised, corporate assets are *increased* by the amount of cash that the employee must pay to exercise the option. That is why the original creators' of the standards reflected the dilutive effects of stock options in a thoughtful way in the calcluation of earnings per share. What has changed?

In a seminal work on employee stock options published a little over a year ago, Rutgers University Professors Joseph Blasi and Douglas Kruse and *Business Week* Senior Editor Aaron Bernstein prove, through clear empirical evidence, that, contrary to the claims made by mandatory expensing advocates, employee stock options for everyone except perhaps the highest level executives (something explicitly recognized by HR 3574) are not compensation from an economic standpoint.

According to Professors Blasi and Kruse, "[t]here are only three significant studies of stock options plans that include most or all employees."[1] Indeed, all of these studies are quite recent. Drs. Blasi and Kruse, together with James Sesil of Rutgers University and Maya Kroumova of the New York Institute of Technology, published a study in 2000 that examined 490 companies, in a variety of industries that granted stock options to most or all of their employees. These companies had average sales of $3 billion and had an average of 14,000 workers. That same group conducted a follow-up study of 229 "knowledge industry" companies out of the original sample in 2002. The third study was conducted in 2001 by three professors at the University of Pennsylvania's Wharton School of Business. This study looked at 217 high-tech firms with a median market capitalization of $1.6 billion in 1999.

Based on these studies, Professors Blasi and Kruse conclude:

> From the standpoint of employees, partnership capitalism offers the prospect of significant capital gains. There is a widespread notion in the United States today that employee stock options are just another form of compensation, like salaries and benefits. Many experts made this point repeatedly during the national debate on stock options that arose after the failure of Enron in early 2002.

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[1] *In the Company of Owners*: *The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at 170.

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> We believe this view fundamentally misunderstands the nature of employee ownership in general and stock options in particular, at least regarding average employees. <u>**Far from being compensation for labor performed, options are instead a form of capital income.**</u> They represent risk sharing based on joint property ownership. Options turn employees into economic partners in the enterprise. As such, they stand to share in the stock appreciation that they help to bring about. Essentially, options offers employees a way to become shareholders by spending their human capital instead of their cash. They're still employees and they still get paid their regular wages and benefits. But options provide an additional dimension to their employment relationship, allowing workers to participate in both the risks and the rewards of property ownership.

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> <u>**There's substantial economic evidence that options bring workers capital rather than labor income….[T]he earnings workers get from options comes on top of their regular market wage**</u>. It's true that some high-tech firms, the ones that engage in wage substitution, do effectively require workers to pony up their own money to become property owners. These firms basically get employees to buy their options with a part of their salary. But this isn't a necessary feature of employee options, or a usual one.

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> Several studies demonstrate this. For example, the point came though clearly in the study of the 490 non-Internet firms with broad-based option plans. On average, they paid their employees about 8 percent more than all other public companies between 1985 and 1987, when most of them set up their option plans. A decade later, they still paid about 8 percent more, excluding the money workers got from options. <u>**In other words, these employees got option income on top of the same pay hikes everyone else in the United States had received over the decade**</u>." [2]

Thus, substantial empirical economic evidence now exists to support the conclusion that employee stock options are not necessarily a form of compensation.

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[2] *In the Company of Owners:* at 214-15 (emphasis added).

Based on this and other evidence, Blasi recently stated: “It would be a sorry conclusion . . . if the result of two years of horrible scandals in American corporations and an unprecedented public demand for corporate reform is that the accountants persuade us to eliminate broad-based ownership for technology companies and other companies…” [3]

Existing Option Pricing Models Generate Inaccurate And Misleading Information

The FASB appears to presume that existing option pricing models can reliably measure the value of something they were never intended to value. That presumption is fatally flawed.

Current option pricing models – such as the Black-Scholes model or a binomial method – were designed to value short term, freely-tradable stock options. They were not designed to value employee stock options. Many of the unique aspects of employee stock options cannot be reliably addressed by option pricing models designed specifically for other use.

For example, existing models do not properly account for the fact that employee options generally have a long life, vest over time, are not freely tradable, are subject to forfeiture, and may be subject to external and internal company policy with respect to timing of exercise (such as insider trading restrictions).

Moreover, the required estimate of stock volatility, which generally has one of the largest impacts on the valuation model, requires the company to predict the future – and it is inevitable that any estimate will be wildly wrong far more often than it will be even close to right. While existing option pricing models work well to value what they were intended to value – freely tradable, exchange-based options – simply put, they cannot reliably or meaningfully measure the value of employee stock options – or, by definition, be used to estimate any corporate level expense associated with their issuance. Indeed, current option pricing models require a prediction of employee behavior, thereby making the models even more unreliable in the context of employee stock options.

The FASB will apparently push companies toward using either the Black-Scholes model or a binomial method. Since there is greater familiarity at this point with the problems with Black-Scholes, let me spend a moment on what is known as a binomial model.

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[3] Schwanhausser, “Stock Options Benefited Workers,” *The San Jose Mercury News*, January 9, 2003.

Binomial models require the use of "binomial trees." These are equivalent to a series of decision trees that are used to predict possible future events. Thus, binomial models permit the modeling of behavior over time, thereby allowing the inputs used in the model to change during the life of the option. Black-Scholes, on the other hand, uses a specific and constant number throughout the life of the options. For example, under Black-Scholes, once an assumption is made about volatility, that assumed number remains constant over the term of the option. Under a binomial model, multiple assumptions could be made about volatility, so that the volatility estimate could change over the term of the option. Unfortunately, the volatility estimate, whether it changes or not, is still a guess. A binomial model, while more complicated than Black-Scholes, still suffers from the same problems.

According to binomial theory, the more decision trees that are used, the more precise the answer. *The problem is that the more trees that are used, the closer the binomial estimate becomes to the Black-Scholes estimate*. As a result, although the answer derived from a binomial model at any given time will likely differ from the answer derived under Black-Scholes, it will not be a "better" number – it will just be different. And if you follow binomial theory and use a significant number of binomial trees, you are back to the Black-Scholes number that is widely discredited.

The inadequacies of those methods were recently described by SEC Commissioner Paul Atkins in this way:

> "The only positive comment I have heard about Black-Scholes is that everyone seems to understand how to implement vs. the binomial method – but let me be the first to admit that I don't understand the intricacies of the binomial method, and much less some of the ins and outs of Black-Scholes. It's complicated, and as far as the binomial method goes, it has lots of data points. It will take a lot of efforts and expense by companies to implement and it ultimately produces results that are strikingly similar to Black-Scholes. ***Accounting professionals and FASB readily acknowledge that both of these methods are not perfect and frankly are far from it***." [4]

The bottom line on valuation is this. It is not an improvement in financial reporting to "***substitute an arbitrary value when the actual value cannot be ascertained. Doing so impairs the credibility and trustworthiness of the***

[4] Remarks of SEC Commissioner Paul Atkins, AEI Conference, January 8, 2004; emphasis added.

financial statement, and certainly does not meet the accounting test of reliability—i.e., 'faithfully representing what it purports to represent.'" [5]

Attached to my statement is a sample of comments by accounting, financial and other experts alike that clearly demonstrate the consensus view: Black-Scholes or binomial models cannot and should not be used to value employee stock options. I would respectfully request that this attachment be made a part of the subcommittee's record.

FASB's Refusal to Conduct Field Testing of Multiple Valuation Methods is Indefensible

RSA Security is a member of the International Employee Stock Options Coalition. On January 22, 2004, the Coalition submitted a letter to the FASB urging the FASB to conduct comprehensive field testing of multiple models for valuing employee stock options before proceeding any further with its pending project on stock options. Given the widespread recognition that an accurate and reliable method for valuing employee stock options does not exist, the Coalition reasonsed that that investors, issuers and all stakeholders in the financial reporting system would be well-served by such testing. A copy of the Coalition's letter is attached to my testimony, and I respectfully request that it be made a part of the record.

A number of the coalition's members expressed an eagerness to participate in field testing, and to do so quickly. Indeed, there is FASB precedent for such testing, and at least one prominent organization has urged that FASB conduct field testing with respect to standard-setting generally. Coalition companies told the FASB that they were ready to assist the FASB expeditiously, in any and all ways, in the development, implementation and analysis of the field tests.

In my view, significant field testing of multiple valuation proposals with the open participation of broad industry groups, including technology companies, auditing firms and valuation consultants, would serve investors well and could help mitigate the growing controversy surrounding valuation. The Coalition suggested to the FASB that at least 100 companies across numerous industry segments, as well as the Big 4 accounting firms and several valuation consultants, test multiple methods.

To date, most companies have applied the Black-Scholes method only in their footnote disclosures. As noted, it now appears that FASB will recommend not only the Black-Scholes method but also a binomial or similar method. There

[5] (Kevin Hassett and Peter Wallison, The Economic and Legal Consequences of Requiring the Expensing of Employee Stock Options Without Specifying the Valuation Method, AEI Conference, January 8, 2004, at 8; emphasis added)

is no body of knowledge from footnote disclosures on these other methods, however, in terms of the assumptions companies would make and other key factors. Surely field testing makes sense under these circumstances in order to safeguard the integrity of financial statements.

Inexplicably, FASB made clear at a recent Board meeting that no such field testing will occur. I see no valid policy reason not to conduct such testing – indeed, such testing seems to me to be most appropriate under the circumstances surrounding FASB's stock options project. Whether one supports expensing or opposes expensing, it is undeniable that the valuation issue is complex, contentious and controversial. Why not take the time to get this right?

Mandatory Expensing Of All Employee Stock Options Will Eliminate Broad-Based Plans

HR 3574 would go a long way toward preserving broad-based stock option plans. Why is this so important? Because as Blasi, Kruse and Bernstein conclude in their recent book:

> …investors and employees alike would gain if companies turned employees into corporate partners by granting stock options to most of the workforce. Most U.S. corporations would be better run, and in the long run more profitable, if America pursued this approach. We say this because unlike the case with executive options, there's compelling evidence that broad-based employee ownership does in fact produce more value for shareholders.[6]

We view the continued availability of broad-based employee stock option plans as essential to the U.S. economy. Any action that would chill or eliminate the use of broad-based employee stock option plans should be avoided, and we believe that any movement toward a mandatory expensing standard will most certainly result in the elimination of broad-based employee stock option plans.

Broad-Based Stock Option Plans are Vital to Enhancing Productivity and Growing the Economy

Professors Blasi and Kruse looked comprehensively at employee ownership programs over the past 25 years. They call employee ownership "partnership capitalism." They concluded that investors came out ahead if their company adopted key elements of partnership capitalism. Just listen to some of their key findings:

[6] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at xi.

- On average, shareholder returns were boosted by 2%.
- Productivity improved 4%.
- Return on equity increased 14%.
- Return on assets increased 12%.
- Profit margins increased 11%. [7]

And there's more. A study published in 2000 of 490 public companies that offered stock options to most or all of their employees found that, compared to public companies without broad-based option plans, the broad-based option companies' average productivity grew 6% faster from the mid-80's to the mid-90's than companies with no employee option plans. Their return on assets also increased 16% more than all public companies, and their average annual stock returns improved by 23% versus 18% for all non-option public companies. [8]

These are some of the concrete, tangible benefits of the partnership capitalism that HR 3574 is committed to preserving and protecting.

Conclusion

Mandatory expensing of all employee stock options represents a solution in search of a problem. As SEC Commissioner Paul Atkins said at a conference less than two months ago:

> "What is the problem that people are trying to solve? And does the FASB direction fix the problem? ***I'm not sure that the presented fix doesn't create more problems***." [9]

Commissioner Atkins went on to say:

> "I…fear that this change is coming about not simply to improve accountability or to provide more reliable financial information to investors. ***My fear is that this change is coming about as part of a basic horse trade in order to facilitate international convergence with other***

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[7] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at 153-157.

[8] *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003).

[9] Atkins remarks.

> ***accounting standards.*** Convergence of accounting standards is of course a laudable goal, and I think my colleagues at the commission have said the same – that it's something to strive for. ***But in an effort to reach this goal we cannot sacrifice the integrity and reliability of financial statements***." [10]

In my judgment, the mandatory expensing of all employee stock options is without any clear or generally accepted accounting rationale. It is a perverse investor guarantee – it will ensure that investors receive, on a regular basis, inaccurate financial information that is highly subjective and easily manipulated -- Information that will need to be poised and explained. Furthermore, mandatory expening of all employee stock options will destroy broad-based plans as we know them and the productivity, innovation and economic growth they generate. "Partnership capitalism" in the form of broad-based stock option plans should be nurtured, not neutered.

I urge the adoption of HR 3574.

Thank you for the opportunity to testify today, and I look forward to answering the subcommittee's questions.

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[10] Atkins' Remarks; emphasis added. Two highly respected economists have reached the same conclusion:

> "[T]he establishment of new accounting rules for expensing options would likely do more harm than good." (Charles W. Calomiris and R. Glenn Hubbard, Options Pricing and Accounting Practice, Preliminary Paper Presented at AEI Conference, January 8, 2004, at 2).

There is Widespread Opposition to Expensing All Employee Stock Options

Quote Sheet
July 2003-January 2004

"[SEC Commissioner Paul] Atkins, the first SEC member to align himself openly with critics of mandatory expensing, said he was not trying to tell the Financial Accounting Standards Board what to do and was only expressing his own opinion, not that of the entire SEC. But at a conference on stock options expensing, he said he feared the Connecticut-based FASB was moving towards requiring options expensing for political reasons, not accounting ones."

"SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.

"Putting a fair value on something as complicated as long term stock options is almost an impossible task."

Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.

"I'm not sure that the presented fix doesn't create more problems than it actually solves."

Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "SEC Commissioner Queries Stock Options Expensing," Reuters, January 8, 2004.

"[AEI Visiting Scholar and Columbia University Finance and Economics Professor Charles] Calomiris also said that mandating stock option expensing will not help investors value a company, and may cause confusion, or "noise," for some unsophisticated investors."

Phil McCarty, "FASB Option Expensing Proposal Draws Critics At AEI Panel," Dow Jones, January 8, 2004.

"Peter Wallison, a resident fellow at AEI and a co-director of the public policy research group's program on financial market deregulation, asked if it makes sense to require the expensing of stock options when no one knows how to value the options. While he admits the options do have some value, Wallison concluded that FASB should defer requiring expensing of stock options "until a workable model is found."

Phil McCarty, "FASB Option Expensing Proposal Draws Critics At AEI Panel," Dow Jones, January 8, 2004.

"FASB 'should not be concerned with corporate governance issues,' Atkins said, nor should they 'be in the business of dictating what kind of compensation' a company offers its employees. He also fears that the accounting change 'is part of a horse trade to facilitate convergence' with international accounting standards."

> *Teri Rucker, "SEC Commissioner Sees Problems With Stock-Options Plan," National Journal's Technology Daily, January 8, 2004.*

"I have yet to meet anybody who suggests that Black-Scholes is a good or even fairly good indicator of the value of long-term compensation options--especially those in broad-based stock option plans,"

> *Paul Atkins, U.S. Securities and Exchange Commissioner, quoted in "Atkins Expresses Concern Over Mandating Stock Option Expensing, Cites Valuation Issue," BNA, January 12, 2004.*

"Opponents of mandatory expensing of stock options -- contracts to buy or sell shares of stock at a set price in the future -- say they give employees a stake in making a company a success. Mandatory expensing will make firms stop giving them out, said Jeffrey Peck, a lobbyist for a coalition opposing FASB rules."

> *Kathleen Day, "Senators Resist Blocking FASB; Accounting Board Close to Ruling on Expensing Stock Options," The Washington Post, January 9, 2004.*

"Atkins also expressed concern that FASB was trying to make U.S. accounting standards converge with international standards that are also moving toward mandatory options expensing. While convergence is a laudable goal, he reportedly added, 'in an effort to reach this goal we cannot sacrifice the integrity and reliability of our financial statements.'"

> *Stephen Taub, "SEC Commissioner Opposes Expensing Options," CFO.com, January 12, 2004.*

"Later, in a face-to-face conversation, she pressed Dean to agree that corporations should treat stock options as expenses on their books, and once again he differed with her, explaining that he had learned that options were vital for start-up ventures in such places as Silicon Valley."

> *David S. Broder, "The Politics Of 'Holy Moly' In Iowa [Column]," The Washington Post, January 11, 2004.*

“First, it has become clear that stock option expensing will not accomplish its intended goal of better accounting or corporate governance. More and more, experts are starting to agree that expensing under current models does not create greater accounting accuracy, transparency, or reliability. Second, the fact that there will be negative effects on jobs, competition, and productivity -- factors not initially considered -- is now at the forefront of the minds of most Americans. And third, we're seeing more government, business, and economic leaders, and shareholders begin to realize that the decision to expense cannot be made in isolation. It is part of a much larger equation with very serious downside potential if improperly implemented.”

> *John Chambers, CEO, Cisco Systems Inc., quoted in “Stock Options Inspire Innovation,” Business Week, December 22, 2003.*

“Not all companies are resigned. A powerful Silicon Valley contingent that stands to take the biggest hit to earnings if expensing becomes a reality -- including Intel (INTC) Corp. and Sun Microsystems (SUNW) Inc. -- is stepping up lobbying against expensing, saying it will stifle innovation and threaten the survival of young companies. ‘The economic harm of stock-option expensing cannot be overstated,’ Intel CEO Craig R. Barrett told a House subcommittee in June. ‘At stake is the future strength and vitality of the American economy.’”

> *Louis Lavelle, “Expensing is Forcing Companies to Rethink Employee Pay Perks,” Business Week, December 1, 2003.*

“What the change in the way options are handled would most likely do is to keep corporations from granting options to employees further down the corporate ladder. That would be a colossal problem for smaller corporations and for start-ups that, short on cash, use options to entice talented workers into the fold.”

> *Editorial, “New Stock Options Rules Just Worthless Change,” The Republican, November 20, 2003.*

“[Expensing stock options is] the wrong answer to the right question, and the Financial Accounting Standards Board has got to know that.”

> *Editorial, “New Stock Options Rules Just Worthless Change,” The Republican, November 20, 2003.*

“’Without the ability for small businesses to attract ... talented employees (with stock options), start-up businesses will be hurt, and our efforts to diversify our economy in Nevada will be hurt,’ said Ensign, who is chairman of the Senate Republican High Tech Task Force.”

Senator John Ensign, as quoted by Tony Batt, "Stock Options Not An Expense Under Legislation Supported by Nevada Senators," Las Vegas Review-Journal/Knight Ridder, November 20, 2003.

"'I have to say in this case FASB's green eyeshades have turned into blinders,' Boxer said."

Senator Barbara Boxer, as quoted by Tony Batt, "Stock Options Not An Expense Under Legislation Supported by Nevada Senators," Las Vegas Review-Journal/Knight Ridder, November 20, 2003.

"[Senator] Enzi added, 'It was evident that FASB is not listening to small businesses and not taking their concerns seriously.' Small business groups complain any mandatory stock option expensing will be too expensive and result in them not granting options to workers."

Rob Wells, "U.S. Stock Option Expense Bill Has Bipartisan Backing," Dow Jones International News, November 19, 2003.

"A bipartisan Senate bill that would require companies to expense the stock options awarded to their top five executives, but not those granted to rank-and-file workers, represents a welcome contribution to the rancorous accounting debate on stock options."

Editorial, "Spotlight on Exec Options; Senate Bill's Intent is Sound: Curb Executive Compensation," San Jose Mercury News, November 19, 2003.

"Employee stock options are yielding jackpots again, re- energizing high-tech workers who have been able to cash in on the recent run-up in their employers' stocks. The revival is vindicating stock options as an employee incentive tool…"

Michael Liedtke, "Bouncing Back; Employees Find Stock Options Becoming Attractive Incentive," Associated Press, November 14, 2003.

"In particular, many computer, software and semiconductor makers say FASB's proposed rule would force them to cut profits and abandon the use of options. 'The adoption of this proposal may place U.S. small business at a competitive disadvantage with overseas companies that will not be bound by the standards,' Enzi said."

Donna Block, "Enzi: FASB Must Protect Startups," Daily Deal, November 14, 2003.

"Financial Accounting Standards Board Chairman Robert Herz assured a Congressional panel Wednesday that the rulemaking board will consider the effect that requiring stock-option expensing will have on small businesses."

Phil McCarty, "FASB Will Consider Small Cos In Stock-Option Standard," Dow Jones Newswires, November 13, 2003.

“’I'm hoping small businesses don't have to wage an 11th-hour campaign to get FASB to listen,’ Sen. Mike Enzi (R-Wyo.) told Robert H. Herz, chairman of the Financial Accounting Standards Board. ‘It seems you spend five times as much time speaking as you do listening. The listening is the part small businesses need more of.’”

> *Steven Gray, “Senator Urges Caution On Accounting Reform; Hearing Focuses on Fears of Small Firms,” The Washington Post, November 13, 2003.*

“’I've heard from Intel ... and there's a good case,’ Snow said. ‘There can't be much argument that options, properly used, are an important component of what drives enterprise and what helps retain employees and motivate them.’”

> *Treasury Secretary John Snow, “U.S. Treasury's Snow - stock options key US pay tool,” Reuters News, November 12, 2003.*

“But mandatory expensing of options would kill most broad-based plans. The companies that sponsor them would simply be unable to withstand the hit to earnings-and to stock prices. And neither is warranted because stock options might never be exercised and can't be accurately valued.”

> *Marc J. Lane, “Why Options Expensing Rule Would be a Costly Mistake,” Crain’s Chicago Business, November 10, 2003.*

“Jeff Peck, a lobbyist for the Coalition to Preserve and Protect Stock Options, praised the Enzi proposal ‘as a marriage of accounting principles and political reality.’ A ‘regulatory basis’ exists for crafting different rules for top executives, he said, noting that executives have different Securities and Exchange Commission reporting requirements from others in the company.”

> *Teri Rucker and William New, “Compromise Plan For Stock Options Garners Interest On Hill,” National Journal’s Congress Daily, October 31, 2003.*

“[Dell Inc. CEO Michael Dell] also said the move [to expense options] will make it harder for growing companies to attract entrepreneurial employees ‘who are willing to take significant risks’ by trading upfront compensation for the potential of stock-market gains, and he added that it could hurt job-creation.”

> *Bob Sechler, “DELL CEO: Stock-Option Expensing May Hurt Job Creation,” Dow Jones Newswires, October 30, 2003.*

“But Joseph Blasi, a Rutgers University professor, warns that cutting back options for rank-and-file workers while insulating top managers and executives ‘amounts to an economic atrocity against normal working people.’ He hopes more companies like Intel and Cisco Systems will try to win over shareholder support for broad-based plans rather than back down without a fight.”

> *Mark Schwanhausser, “Tech firms cut back on options, survey says: Companies Tighten Eligibility, Plans,” San Jose Mercury News, October 20, 2003.*

“Driven by heated political rhetoric and hysterical press coverage, a myth has arisen that the decline in equity prices of the late 1990s was caused by option-happy corporate executives. Unfortunately for myth-mongers, the story has been soundly rejected by financial scholars. While options are difficult to value precisely, numerous recent academic studies have been unable to find any evidence that the market misprices firms that rely on them more heavily. There is no crisis.”

> *Kevin Hassett, “A Level Paying Field [Op-Ed],” The Wall Street Journal, October 20, 2003.*

“A year ago, the Mercury News' editorial board called for the expensing of options, based, in part, on the assumption that an accurate valuation method could be found. That turns out to be a work in progress. Further, it's clearer now that the abuses uncovered in recent years won't be solved by expensing. Finally, the industry's economic policy argument must be fully studied.”

> *Editorial, “The Best Option,” San Jose Mercury News, September 29, 2003.*

“Stock options are not inherently flawed…and are actually a very good device, if properly structured.”

> *Robert J. Stuckler, Vedder, Price, Kaufman & Kammholz , as quoted by Ameet Sachdev, “Lawyers Help Executives Win Big Bucks from Major Corporations,” Chicago Tribune, September 14, 2003.*

“The trouble is that while a change in the rules may, within the context of a "flawed" conceptual framework, appear coherent and desirable to IASB technical experts, we would not expect them necessarily to be quite so aware of unintended consequences - such as sudden widespread falls in corporate pre-tax profits, redundancies and the closure of some all-employee share schemes - as I fear will occur in the wake of the IASB's imminent standard on accounting for share-based payment (the profit and loss account expensing of stock options).”

> *Malcolm Hurlston, Chairman, Employee Share Ownership Centre, “Standards Board Must Be Checked,” Financial Times, September 12, 2003.*

“You can't get through all the way to expensing unless you find a credible, acceptable way to value stock options, and that hasn't yet been put forward.”

> *Jeff Peck, International Employee Stock Options Coalition, quoted in “Markets; Accounting Board Delays Changes in Options Rules,” Los Angeles Times, September 11, 2003.*

“Following his speech, Dean answered questions from the media in which he said he would not favor expensing stock options if at least 65 percent of the options were distributed widely throughout a company.”

> *Dana Hull, “Dean Pans Bush in S.J. Speech,” San Jose Mercury News, September 8, 2003.*

“The problem with expensing options is that it's like expensing a guess.”

> *Sonia Arrison, Director of Technology Studies, The Pacific Research Institute, “Government's Hand in Our Investments [Op-Ed],” San Francisco Chronicle, September 2, 2003.*

“I think that people are beginning to take a step back and look at the bigger picture much more accurately…I'd personally be…surprised if they don't find a middle ground.”

> *John Chambers, CEO, Cisco Systems Inc., quoted in “Compromise Possible In Debate Over Expensing Options,” San Jose Mercury News, August 12, 2003.*

“Of course, options aren't the perfect compensation solution for every company. Whether to issue them is a business decision — like a decision to build a new plant or expand a sales force or launch an ad campaign. It is, therefore, a decision best left up to businesses themselves, not bureaucrats. If Congress fails to stop the accounting board, it will be sacrificing the country's economy to satisfy the green-eyeshade types.”

> *James Glassman, Resident Fellow, The American Enterprise Institute, “Stock Options Showdown Will Affect Future of U.S. Economy [Op-Ed],” USA Today, July 31, 2003.*

“Remember, though, that one size doesn't fit all in this case. Just because Microsoft has shifted to using restricted stock doesn't mean that everyone else should follow. Companies have many choices when they set up compensation plans -- bonuses tied to personal or corporate performance, stock options, restricted stock -- and they should use a mix of all of these methods as needed.”

> *Editorial, “Microsoft's Bold New Pay Plan,” Business Week, July 21, 2003.*

“Although stock and options obviously have value, calculating that value involves the kind of guesswork that only undermines the credibility of a company's income statement.”

> *Steven Pearlstein, “Corporate Reform Could Go Too Far [Column],” The Washington Post, July 18, 2003.*

“In other words, stock options aren't evil...management's willingness to accept stock options sends a signal. It tells shareholders that management thinks the company's stock will go up.”

> *Paul Kedrosky, “The Desirable Option [Op-Ed],” National Post’s Financial Post, July 12, 2003.*

“We've never thought expensing for options is the silver reform bullet that some believe.”

> *Editorial, “Better Shareholder Options,” The Wall Street Journal, July 10, 2003.*

January 18, 2004

The International Employee Stock Options Coalition

January 22, 2004

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Mr. Herz:

On behalf of millions of U.S. employees and investors, the members of the International Employee Stock Options Coalition (IESOC)[i] urge the Financial Accounting Standards Board (FASB) to conduct comprehensive field testing of multiple models for valuing employee stock options before proceeding any further with its pending project on stock options. Given the widespread recognition that an accurate and reliable method for valuing employee stock options does not exist, we respectfully suggest that investors, issuers and all stakeholders in the financial reporting system would be well-served by such testing.

Many coalition members are eager to participate in field testing, and to do so quickly. Indeed, there is FASB precedent for such testing, and at least one prominent organization has urged that FASB conduct field testing with respect to standard-setting generally. The IESOC stands ready to assist the FASB expeditiously, in any and all ways, in the development, implementation and analysis of the field tests.

Significant field testing of multiple valuation proposals with the open participation of broad industry groups, including technology companies, auditing firms and valuation consultants, would serve investors well and could help mitigate the growing controversy surrounding valuation. We suggest that at least 100 companies across numerous industry segments, as well as the Big 4 accounting firms and several valuation consultants, test multiple methods.

To date, most companies have applied the Black-Scholes method only in their footnote disclosures. It now appears that FASB will recommend not only the Black-Scholes method but also a binomial or similar method. There is no body of knowledge from footnote disclosures on these other methods, however, in terms of the assumptions companies would make and other key factors. Surely field testing makes sense under these circumstances in order to safeguard the integrity of financial statements.

A recent American Enterprise Institute conference underscored the need for field testing. Highly regarded finance, economic and accounting experts, including SEC Commissioner Paul Atkins, Glenn Hubbard, the former Chairman of President George W. Bush's Council of Economic Advisors, and Kevin Hassett, AEI's Director of Economic Policy Studies, identified, among other things, fundamental problems with existing valuation methods. Their comments, a summary of which is attached, provide further evidence that comprehensive field testing is warranted.

Background

The IESOC believes that broad-based employee stock option plans are integral to the formation and growth of high technology, biotechnology and other companies and that the current accounting treatment for stock options should be continued. In our view, stock options do not constitute an expense as no cash payment or outflow of corporate assets is made. The cost of stock options is borne by stockholders through potential dilution, and this expense is already accounted for, and disclosed to investors, in diluted earnings per share.

We agree that there should be greater visibility to stock options and, to that end, many of our member companies have proactively expanded their quarterly and annual stock option disclosures to provide further information to investors.

Latest reports indicate that FASB will require companies to expense all employee stock options pursuant to an existing option pricing model, i.e., the Black-Scholes model, or a binomial or similar model. Experts from numerous fields, expensing advocates and opponents alike, and numerous commentators have raised concerns that these models are highly inaccurate and unreliable when used to value employee stock options, as opposed to freely tradeable options.

The IESOC agrees. The Black-Scholes model, binomial methods, and Monte Carlo modeling all fail the tests of reliability, comparability and consistency. These existing methods simply do not produce credible, transparent, consistent, comparable and unbiased financial information. More specifically, under existing models:

- <u>Consistency and comparability will be at risk</u>. The need to make subjective determinations of the variables used in stock option valuation models will lead to a reduction in existing levels of comparability and consistency in financial reporting across companies and industries.

- <u>To date, accurate valuation of employee stock options has proven to be an impossible task</u>. Valuing stock options granted by high technology and biotechnology companies is particularly complex because estimating certain valuation variables is highly subjective and impacted by factors out of management's control.

- <u>None of the existing valuation models is currently adequate for valuing employee stock options</u>. We believe that the models under consideration by FASB fail to adequately incorporate factors unique to employee stock options and could subsequently compromise the reliability, integrity and comparability of financial reporting, as well as open the door to manipulation.

When one couples issues of volatility, expected holding periods, early exercise, forfeitures, risk free rates of return and trading blackout periods with common issues of the lack of a market, vesting requirements and non-transferability, it becomes crystal clear that there will be significant issues of accuracy and reliability within a company's financial statements as well as consistency and comparability across companies and industries.

While we continue to oppose in the strongest terms the expensing of all employee stock options, we recognize that FASB also continues to press forward. If the Board ultimately proposes mandatory expensing of all options on the face of the income statement, we believe it has an obligation – ***before*** adopting a new accounting standard – to consider multiple valuation methods, test them, and evaluate their accuracy and reliability.

There is FASB Precedent For Field Testing

FASB recently conducted field testing in connection with its project on business combinations (purchase/pooling). The purpose of such field testing was "to determine whether the approach that the Board is pursuing for accounting for goodwill that arises in conjunction with a purchase business combination is operational." [ii] A 1999 memorandum prepared for members of FASB's Financial Accounting Standards Advisory Council discusses the key issue of goodwill amortization, and refers to the results of FASB's field testing. Indeed, field testing "confirmed the Board's concerns about the operationality of the proposed approach, the opportunities for gamesmanship the approach would have provided, and the lack of rigor in impairment testing." [iii] As a result, the Board changed its approach to amortization.

Records also indicate that the FASB conducted field testing in connection with its proposed standards for financial statements of not-for-profit organizations and accounting for contributions in 1994. In addition, FASB conducted field testing in connection with FAS 133 in 1996. [iv]

Field testing is the only prudent way to proceed on the stock options project:

- As before, the Board ought to determine whether its approach on valuation is "operational."
- As before, the Board ought to determine whether its approach on valuation will create "opportunities for gamesmanship."
- And, as before, the Board ought to determine whether its approach is sufficiently rigorous.

Others Have Supported Field Testing Generally

The Association for Investment Management and Research (AIMR) – an expensing advocate – has urged FASB to conduct field testing generally as part of the standard-setting process. In AIMR's words:

> "AIMR's Financial Accounting Policy Committee has on several occasions communicated directly to the FASB in support of field testing in the standards-setting process. ***Field tests can be enormously helpful in identifying implementation problems that neither preparers nor users of financial statements could have anticipated at the conceptual level***." [v]

If there were ever a project for FASB to follow AIMR's recommendation, the stock options project must surely be it.

FASB's "Cost-Benefit" Analysis is Inadequate

In September 2003, press reports indicated that FASB had decided to conduct "road testing" of actual valuation models. These media accounts reported that a number of companies "pledged cooperation in taking part in a 'road test' of the accounting standard before FASB formally issues" a new standard.[vi] Numerous companies volunteered to participate in such testing. It was widely understood that actual models would be tested for accuracy and reliability.

FASB has replaced the kind of field testing we recommend here with a cost-benefit kind of analysis that will not impart any relevant or material information about the accuracy and reliability of valuation methods. FASB has told companies that volunteered to participate in field testing that it will instead ask them to assess the out-of-pocket costs that they will incur as a result of attempting to comply with the new standard. FASB has communicated that it does not intend to actually test valuation models. In FASB's words:

> "In particular, the Board seeks to assess and understand the costs, in qualitative terms, that would be required to design and implement a lattice option-pricing model….***The scope of the Program does not include testing of lattice option pricing models***…." [vii]

The field testing program that we recommend is fundamentally different and considerably broader than FASB's ongoing "cost benefit" analysis. Such a broader program – consistent with what appeared to be FASB's original intent – is necessary for any number of reasons, not the least of which is the substantial controversy surrounding valuation.

Suggested Parameters for Field Testing Multiple Valuation Methods

As noted above, we believe that mandatory expensing of employee stock options using currently available valuation models compromises the core financial accounting objectives of comparability, reliability, trustworthiness and consistency. In our view, field testing should include elements that will produce data enabling reasonable judgments about whether expensing stock options enhances or erodes these core objectives.

In order to judge the impact of expensing on comparability, we recommend that field testing include several different industries and multiple companies within each industry. In addition, companies should be chosen that have markedly different levels of stock option usage. By carefully chosing the participants for field testing, FASB can obtain sufficient data bearing on comparability.

Field testing should also require participants to produce a variety of different estimates of their putative stock options "expense" using different valuation models and different inputs for each model for several prior reporting periods. Such data can be used to judge the year-to-year consistency of using a valuation model to determine the alleged "expense" and its impact on the reliability of financial statements.

Such data could also reveal the degree to which changes in the assumptions and inputs skew the outcomes of the various models. This data would allow FASB to assess the degree of trustworthiness (or untrustworthiness) of available valuation models.

We hope that FASB will consider these suggestions in designing field tests, and we would welcome the opportunity to provide further details on suggested methodology and approach.

Conclusion

Those who want to require the expensing of all employee stock options have the burden of demonstrating that such a new accounting standard would enhance the reliability, comparability and consistency of financial statements. Field testing of multiple valuation models across companies and industries is critical. The views of valuation consultants and auditors also are essential to determine the "workability" of any proposal.

The IESOC calls upon FASB to attempt to address the fatal shortcomings of existing option pricing models or develop a new model before mandating inclusion of materially inaccurate numbers on the face of financial statements. FASB should field test multiple models through footnote disclosure until it can be determined whether they do, in fact, "work." Coalition member companies would be pleased to work constructively with the Board in identifying the models to be tested, developing the methodology, identifying companies and industries, and analyzing the resulting data.

Sincerely,

Rick White

Rick White
President

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[i] The IESOC supports broad-based employee stock option plans. It is comprised of trade associations and companies representing a diverse range of industries, including high technology, biotechnology, manufacturing and service companies, in the U.S. and abroad.
[ii] "Business Combinations," Financial Accounting Standards Advisory Council, October 1998, at 1.
[iii] "Business Combinations," Financial Accounting Standards Advisory Council, January 1999, at 3.
[iv] Testimony of FASB Board Member Leslie Seidman before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce, July 22, 2003, p. 8.
[v] See http://accounting.rutgers.edu/raw/aicpa/dbase/d-18d.htm.
[vi] Steve Burkholder, "Several Members of FASB Advisory Panel Praise Proposed Rules on Stock Options," BNA Tax, Budget and Accounting, September 26, 2003, G-9.
[vii] Memorandum from Mike Tovey to FASB Field Visit Program Participants, November 7, 2003, at 1 (emphasis added).