Opening Statement

Chairman Michael G. Oxley
Financial Services Committee

The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

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Good morning. Today, for the third time this Congress, we will discuss stock option accounting. The number of hearings this Subcommittee has held demonstrates how important this issue is. I applaud Chairman Baker for his good work on this subject. In light of the Financial Accounting Standards Board's recent proposal, it is particularly important now.

The question of whether stock options should be expensed has been debated for many years.

Some, like the former Chief Accountant of the Securities and Exchange Commission, Walter Schuetze and numerous experts in accounting, believe that the FASB's position that the issuance of employee stock options creates an expense is simply improper accounting.

Mr. Schuetze observes that the issuance of a stock option to an employee does not change the market capitalization of the corporation, as measured by the market value of the outstanding shares and the value of the outstanding option. Thus, there is no expense. If there had been a true expense, which he defines as the "using up" of an owned asset or the decline in the value of an owned asset, then the market value of the outstanding shares and option should have declined, but that is not the case.

Others, like FASB, as evidenced by its recently released proposal, take the contrary view, arguing that employee stock options do constitute a corporate expense. FASB's position is that all employee stock options have value – which employees purchase with the services they provide. Because they have value, FASB asserts, when stock options are given to employees they give rise to compensation costs that are properly included in measuring an enterprise's net income.

Some point out that the grant of an employee stock option is an opportunity cost to the issuer. They argue that if a company were to grant stock, rather than options, to employees, the company's cost for this transaction would be the cash it otherwise would have received if it had sold the shares at the current market price to investors. But this situation is not analogous to that of the issuance of employee stock options.

Not only are employee stock options issued exclusively to employees of the issuer, but each employee stock option is written for a specific individual. Thus, there is, by definition, no market into which these options can be sold.

Another significant problem is the accurate valuation of stock options. While there is a diversity of opinion on the merits of requiring the expensing of employee stock options, there is uniform agreement on at least one aspect of this debate: it is extremely difficult to value those options. This gives rise to concerns that strike at the heart of financial statements: what use are they if not for purposes of comparing one company's statement against another's?

The FASB itself recognizes that there is no options-pricing model that gives an accurate assessment of the value of options across all enterprises. The Black-Scholes model has been shown to have significant deficiencies for purposes of valuing employee stock options. The Binomial method has similar problems. FASB's solution is to provide no guidance as to what method a company must use to calculate value.

The lack of a uniform, reliable valuation method creates problems of comparability among companies, accuracy of the financial statements themselves, and, as one of our witnesses today suggests, even opens up the possibility of manipulation of earnings by management. These are concerns that merit further consideration.

But, as Craig Barrett, the CEO of Intel, has observed, whether or not stock options should be expensed is not just an accounting issue. It is also an economic issue. And that is the focus of today's hearing.

Preserving the independence of the Financial Accounting Standards Board is a consideration. That's an issue of process and jurisdiction, and certainly the members of this panel have a great respect for FASB's expertise. However, some issues go beyond that of accounting and enter the mainstream of economic policy. If it is true that the adoption of FASB's employee stock option expensing rule would cause significant and serious damage to job creation, then it becomes an economic policy issue and one that Congress should certainly review.

Dozens of chief executives have publicly stated that their firms will reduce or eliminate options if the FASB proposal is enacted in order to avoid the negative impact that expensing will have on earnings per share (and, in turn, the company's share price). If this is the case, then shareholders and our economy as a whole will sacrifice some measure of economic growth.

The venture capital community has been quite outspoken on this issue. One of our witnesses today discusses the great extent to which venture-backed companies rely on stock options to attract and retain talent. He also points out that in over 70 percent of venture-backed companies, stock options were awarded to all employees, not just the top executives. These companies are a significant component of our economy. He cites statistics illustrating that venture-backed companies directly or indirectly accounted for 27 million jobs in 2000, and had sales constituting about 11 percent of the GDP.

These are compelling figures. If the FASB proposal will undermine job creation and economic growth, then it calls for closer scrutiny by Congress.

The Congressional Budget Office study concluded that expensing employee stock options will not have a significant effect on the economy. The study argues that the information has already been disclosed in footnoted financial statements and thus is reflected in the stock price. We will examine today whether this analysis is correct.

While there are many informed experts on both sides of this issue, there are some aspects of this debate on which there is agreement. First, expensing employee stock options is not a silver bullet for achieving better corporate governance. And second, the importance of transparent, accurate financial statements cannot be overstated.

I look forward to hearing from our esteemed panel of experts today as we consider the far-reaching implications of FASB's proposal.

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