

Small
Business
SURVIVAL
Committee

Prepared Statement of Karen Kerrigan
Chairman
Small Business Survival Committee

On

The Stock Option Accounting Reform Act, H.R. 3574

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored
Enterprises
of the

U.S. House Committee on Financial Services
Richard H. Baker, Chairman
Ranking Member, Paul E. Kanjorski

March 3, 2004

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, thank you for the opportunity to testify this morning on behalf of H.R. 3574, the Stock Option Accounting Reform Act.

I am Karen Kerrigan, Chair of the Small Business Survival Committee (SBSC), a nonpartisan small business advocacy organization headquartered in the nation's capitol. SBSC works to advance legislation and policies that help to create a favorable and productive environment for small business growth, job creation and entrepreneurship.

H.R. 3574, the Stock Option Accounting Reform Act, is the kind of legislation that will help to maintain and enhance a dynamic environment for small business competitiveness and economic growth. SBSC applauds your leadership, Chairman Baker, as well as the leadership and support of the many bill co-sponsors on the Subcommittee. We urge the House to pass this important legislation as quickly as possible.

H.R. 3574 is an appropriate response to what seems to be general indifference at the Financial Accounting Standards Board (FASB) with respect to the business community's concerns about mandatory stock option expensing. The Board is about to unveil a stock option expensing rule that would be particularly complex and costly for small businesses. SBSC opposes the proposed rule.

In our judgment, it would not lead to the sort of financial transparency expected by shareholders, small businesses and their workforce, nor our elected leaders and regulators. Instead, broad-based employee stock option plans would suffer, leaving small firms at a competitive disadvantage to larger and more mature entities whose resources allow them to recruit and attract the best and the brightest. This would be a shame as small businesses are a key source of innovation and job creation in the United States.

According to the Small Business Administration (SBA), small businesses produce 55% of innovations. They obtain more patents per sales dollar than large businesses. They employ 38 percent of high-tech workers. A healthy and dynamic entrepreneurial sector is critical to robust job creation, maintaining economic growth and our edge in the global marketplace. Incentives and tools that help small firms add to their innovative capacity, like stock options, are integral to their success and our general economic well being.

Indeed, through the leadership of the small business and entrepreneurial sector, and more specifically the tech sector, the concept of employee ownership and participation has enriched our economy and our workforce in a variety of ways. The spread of “partnership capitalism” – as Joseph Blasi, Douglas Kruse and Aaron Bernstein refer to the concept in their

book, In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them -- is a good thing, as it boosts employee productivity, profits and stock returns.

The mandatory stock option expensing rule proposed by FASB, by contrast, is archaic and out-of-step. It would vastly curtail the capability of small firms to offer stock options as an employee recruitment, retention and incentive tool. Employee wealth diffusion would endure a major setback as stock options would again be concentrated in the hands of a few.

As noted above, smaller firms in particular have been able to attract and keep highly skilled employees because of their ability to offer stock options to their workforce. It makes little sense to erect barriers and rules that eviscerate these programs as stock options have allowed millions of America's workers to hold ownership in the companies where they work.

While FASB's intention to increase financial reporting and transparency is a worthy goal, we are baffled that they would continue down the mandatory expensing of stock options path to achieve it. I am not an accountant, yet the proposal does not seem to make accounting sense.

First, there is no true consensus on the identification of a model to place an accurate and reliable number on the so-called "cost" of employee stock

options. Indeed, all indications are that the FASB is going to rely on either the Black-Scholes method or the binomial method – both of which many experts agree produce bad numbers. In sum, no method currently exists to value employee stock options accurately and reliably. As a result, the mandatory expensing of employee stock options will not make financial statements more accurate, reliable and transparent.

A recent decision by FASB to reject “field testing” of various valuation models is unfortunate, but not surprising. Though I have not attended any of their Board Meetings, my general observation is that the Board is engaged in a race to get this issue “done.” From our perspective, it made sense for FASB to take the time to run valuation tests on a wide sample of companies. FASB says it spoke with 18 companies about the costs associated with implementing the proposed standard, but this is hardly representative of the size and diversity of approximately 14,000 public companies.

Second, the “cost” of stock options appears to be quite clear. Economist Alan Reynolds noted this in a 2002 report for the Institute for Policy Innovation. When an option is exercised, Reynolds noted, “the company will often purchase the required stock on the open market – a stock ‘buyback.’ Using earnings to buy back shares keeps the number of outstanding shares unchanged, but it obviously *does* result in lower reported earnings. The only alternative is to issue more shares—

‘dilution’—which also clearly reduces earnings *per share*. Does the cost of buybacks or dilution show up in company earnings? Of course it does.”

H.R. 3574 is a prudent solution, which comes at an ideal time. The proposed legislation incorporates sound and targeted reforms with a reasonable requirement that a study be conducted to understand the economic impact of the mandatory expensing of all employee stock options. The latter is very important as policymakers must make every effort to review whether proposed policies and initiatives weaken or strengthen U.S. job creating capacity and competitiveness.

FASB readily concedes that it does not consider the economic consequences of their decisions. I believe a comprehensive study will indeed confirm, and most definitely advance, what we already know about the wide-ranging benefits of employee stock option plans.

SBSC certainly appreciates the lengths to which the legislation goes to protect small businesses and start-up companies. The exemption for companies with less than \$25 million in revenues and the protection for companies three years after their initial public offering strike a reasonable balance. In essence, H.R. 3574 will help preserve broad-based stock option plans and the ability of small firms to offer these plans.

FASB contends that its “independence” shields it from Congressional action, yet the economic consequences of the proposed rule are far too

great for Congress to stand by and observe. SBSC is hopeful that this instance serves as an opportunity for FASB to review its standards setting process. Already, FASB has reached out to the small business community, and the Small Business Survival Committee (SBSC) specifically, with an announcement that they are developing a Small Business Advisory Board to act as a resource for future proposals. SBSC cheerfully submitted our recommendation of an individual, as requested, to serve on this new FASB entity.

In closing, I reiterate SBSC's strong support for H.R. 3574, The Stock Option Accounting Reform Act. We encourage Congress to act quickly on the legislation. With the economy getting back on a strong path, Congress would be taking a prudent step in shielding America's workforce and small businesses from a proposed action that would undermine economic growth.

Thank you again for your leadership Chairman Baker, and for providing SBSC with the opportunity to testify today. I look forward to your questions.

Karen Kerrigan BIO

Ms. Kerrigan founded the Small Business Survival Committee (SBSC) in 1994, a prominent and respected small business advocacy organization with more than 70,000 members nationwide (www.sbsc.org). She now serves as the group's Chairman.

Karen Kerrigan is also President and CEO of Women Entrepreneurs Inc. (WE Inc.), a nonprofit business association helping women business owners succeed through educational programs, networking and advocacy. In 2003, she was appointed to serve on the National Women's Business Council (www.nwbc.gov). Kerrigan also serves on the Taxpayers Advocacy Panel, a federally appointed panel made up of 100 citizens who work to improve the Internal Revenue Service by listening to taxpayers and making recommendations based on taxpayer ideas and feedback.

As a well-known small business advocate, Kerrigan has developed important relationships with key individuals in media, government and the private sector that have led to substantive reforms and initiatives to help America's entrepreneurial sector. Kerrigan testifies often before Congress on issues that impact America's entrepreneurial sector. She has appeared before various U.S. Congressional Committees including House Ways and Means, Education and the Workforce, Small Business, Government Reform and the Senate Commerce, Small Business and Judiciary Committees, as well as commissions at the federal and state level.

Ms. Kerrigan meets regularly with delegations from around the world that wish to learn about public policy recommendations that would enhance and sustain entrepreneurial activity. She recently visited Jerusalem in December 2003, where she met with women business leaders and owners to help them establish an organizational and advocacy presence in the region. While there, she also participated in a video conference with nearly 100 Syrian women business leaders assembled in Damascus.

Her commentary, analysis and written work have appeared in *Investor's Business Daily*, *The Wall Street Journal*, *The Washington Times*, *The Houston Chronicle*, *San Jose Mercury News*, *The Union Leader*, *The New York Post*, and scores of other prominent newspapers and magazines throughout the country. Since 1995, she has written a regular column for the *American City Business Journals* - an influential network of weekly business newspapers in 40 major markets. She has appeared on various television programs and networks such as ABC's Nightline, The McLaughlin Group, CNN, CNN-fn, CNBC, C-SPAN, MSNBC, Fox News Television, various PBS shows and independent cable news programs. She has been a guest on hundreds of radio talk shows and has served as a guest host for both TV and radio as well.

Fortune Small Business named Ms. Kerrigan to its *Power 30* list of key advocates in Washington, D.C. in its September 2000 publication. In 1995, *National Journal* named Ms. Kerrigan to its short list of "K Street" activists less than 40 years of age (which she is no more) most likely to have an impact on Capitol Hill. *Campaigns and Elections Magazine* named her as one of its "Rising Stars in Politics" in its April 1996 issue. She serves on the board of BIPAC and chairs the Coalition for Patient Choice and the HSA Coalition, formerly the Archer MSA Coalition.

Ms. Kerrigan is a native of New York, and holds a BA degree in Political Science from the State University of New York College at Cortland. She resides in Oakton, VA.