THE TESTIMONY OF

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

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I appreciate this opportunity to appear before this Subcommittee. My specific purpose today is to offer my views as to H.R. 1372; legislation that would instruct the Securities & Exchange Commission to not accept any new accounting standard relating to the treatment of stock options for three years.

First, I would like to allude briefly to the broader issue to which H.R. 1372 is a reaction. It is the fact that a number of problems have created a crisis for the accounting profession and are putting such enormous pressure on it that some doubt it can survive in its present form: that is, as four major firms.

What problems?

- The failure of the profession on so many occasions to stop clients from falsifying their reported accounts;
- The failure, as stated recently by the Economist, to "keep up with the tricks that were devised to help companies inflate their profits";
- The fact that accountants are becoming or have become rule checkers, applying the myriad of FASB pronouncements and clarifications rather than using their judgment as to what is a fair presentation of financial statements;
- The fact that far too many CEOs regard the annual audit as a commodity required by government rather than an exercise that has intrinsic value; and

- The belief by many, also noted by the Economist, that this crisis has created an "opportunity to [fundamentally] change the shape and content of accounts": to move inexorably to the use of "market values" rather than "historic costs" to gauge profits and losses.

The question of whether options should be accounted for is in large part a reaction to these circumstances. The answer to me seems clear: ***They should be accounted for:***

- Options have become a material factor in how a company compensates its employees;
- Options, when exercised, can significantly affect stock prices.
- That options are not now accounted for has distorted the compensation policies of too many companies. A grant of stock or cash compensation reduces reported earnings, while options do not. As a result CEOs are encouraged to grant far more options than might otherwise be granted;
- Also, it has become apparent to me over the past 34 years that many CEOs do not understand the real cost that option grants have for their companies. Because the grants do not affect the bottom line when granted, these CEOs treat options as "freebies" that can be given without cost.

So why is there such a fuss about the issue?

The fierce opposition to proposals to require the accounting of options comes from a very large number of CEOs. They believe, probably justifiably, that their stock prices can be severely hurt if the "cost of options" is used to reduce earning per share.

This view is that analysts and investors who previously thought well of their companies will punish stock prices if management, ***using information already in publicly filed papers***, applies a Black-Scholes type formula to that information and uses the resulting number to reduce reported earnings per share.

If this were not such a serious issue, it would be comic opera. Analysts are able to take a company's public information, use Black-Scholes, and find a number that can be a charge to earnings. Why would an analyst have any different view of a company just because the company does the same math?

The problem exists because the accounting profession and the analyst community have not been doing that kind of work. They have not been making the kind of judgments about the earnings, and the assets of corporations that would, long ago, have made the effect of stock options understood by both management and investors.

I do not mean that comment as a criticism of accountants. They have not been asked to make such judgments and they are not paid to do so. It is no wonder that they have neither the inclination nor, far too often, the capacity to do so.

So, we can sympathize with CEOs who argue that they should not be required "to shoot themselves" by using a Black-Scholes type formula. They also claim, with some justification, that a Black-Scholes number will not be a precise gauge of cost and certainly will not be understood by the average investor.

So why do the members of FASB and the IASB insist that the cost of options be calculated by management and put into earnings per share? And why do so many organizations and spokesmen, and I include myself, constantly call for option accounting?

Why, in short, is not H.R. 1372 a perfect answer? It would call for three years of education, with some new disclosure. This cooling off period could make it easier to account for options later and perhaps make more people understand the issue.

It may seem attractive to put off this fight once again, but it is not going away. H.R. 1372 is an understandable effort, but the studies contemplated by H.R. 1372 are no answer to the problem. They are only a reason for another delay.

Only when companies, accountants and analysts begin to wrestle with the various approaches to option valuation and start to explain their formulas to the investing world, will the investing world understand how the grant of options affects stock values.

H.R. 1372 if passed would have, in my view a most serious side effect. The costing of options is not the only accounting problem facing corporate America, nor is it the most serious. I have attached to my statement the Economist article of April 24, 2003 that I referred to earlier. Along with stock options the article identifies five other areas that cry out for reform, and describes the wide-ranging efforts underway here and in Europe to make the audit, and the accounting profession far more effective.

At the outset of my remarks I listed the circumstances that have created a crisis in accounting. That the audit has become a commodity in which few CEOs see intrinsic value and that auditors are too often just rule checkers who avoid exercising judgment are problems that urgently need the attention of the new structures created by the Sarbanes/Oxley Act.

The profession is being pushed to move toward a more principle based system and away from reliance on specific rules. And, as noted earlier, there is a growing use of "market values" rather than "historic costs" to present a companies financial position. The Economist notes these two trends and acknowledges that:

> "Profits may come to be stated as a range of figures, each of them arrived at by using different accounting assumptions."

> "This" continues the article "may sound worryingly uncertain, but it might be better than trying to rely on a ***brittle illusion of accounting exactitude***, which is liable to collapse during times of economic strain."

My point is that the accounting profession is in a period of profound change based largely on a growing realization that we have for far too long relied upon the ***brittle illusion of accounting exactitude.*** To some extent the string of accounting failures that we have had in the past few years are a result of that reliance.

My strong suggestion is that Congress allow the transformation to continue with the role of self-regulation intact but with far stronger oversight with the new Public Company Accounting Oversight Board and a newly staffed SEC with far more resources to do its job. An effort now by Congress to stop this fledgling effort to value options would seriously interfere with the development of the accounting profession that we so badly need.

I have no love for the Black-Scholes formula. It was not conceived to value options to determine earnings per share. I sincerely hope that it is not made the required way to value options.

More important, I very much hope that FASB and the SEC will allow flexibility in the costing of options. Let different companies use different formulas. The fact that there will be no precise formula or number should be a vivid illustration of the fact that much of the information in profit and loss statements is equally imprecise.

Robert Frost, the poet, knew this as early as 1905 when he wrote.

Never ask of money spent
Where the spender thinks it went
No one was ever meant
To remember or invent
What he did with every cent.

What Robert Frost understood almost 100 years ago is beginning to be understood by us today. I fear that H.R. 1372 would impede the development of that understanding.