CBO TESTIMONY

Statement of
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Director

Accounting for Employee Stock Options

before the
Committee on Small Business and Entrepreneurship
United States Senate

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Madam Chair, Senator Kerry, and Members of the Committee, thank you for the opportunity to present the findings of a Congressional Budget Office (CBO) report on accounting for employee stock options.[1] The purpose of the report was to examine the way in which the recognition of the cost of such options—as in the Financial Accounting Standards Board's proposal to require the expensing of compensatory stock options for publicly traded firms[2]—would improve the measurement of net income. In my remarks today, I wish to make three points:

- Granting stock options to employees results in a cost to the firm that is equivalent to cash and other noncash compensation. Like the cost of other compensation, the fair value of options is an expense to the granting firm.

- Valuing employee stock options is more difficult than valuing cash compensation, but the difficulty does not appear to preclude the recognition of their fair value, especially when compared with the intricacy of some other calculations of compensation expenses.

- Recognizing the expense of employee stock options would not change the economic fundamentals of any business, large or small. Thus, any economic effect of this accounting change would derive from altering investors' perceptions of the expenses and net income of some firms. To the extent that recognized net income is closer to its underlying economic value, more accurate perceptions would be broadly beneficial.

Compensating Employees with Options Is Costly to the Firm

Granting options or other benefits in lieu of cash compensation is an exchange of value for labor services. A fundamental objective of financial accounting is to tally operating flows of resources into and out of the reporting entity in order to measure the net gain or loss from operations during the specified period. Including the fair value or cash equivalent of compensatory options and recognizing that value as an outflow of resources when the corresponding labor services are provided—the vesting period—brings accounting practice closer to economic reporting of total expenses and net income.

Several aspects of that observation merit discussion. First, CBO's analysis is entirely consistent with the notion that stock options are valuable to employees. Indeed, if not, employees would not accept options instead of other compensation.

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1. Congressional Budget Office, *Accounting for Employee Stock Options* (April 2004).

2. Financial Accounting Standards Board, *Proposed Statement of Financial Accounting Standards: Share-Based Payment* (No. 1102-100, an amendment of FASB Statements in No. 123 and 95), March 31, 2004, available at www.fasb.org/draft/ed_intropg_share-based_payment.shtml.

Second, it may be the case that the value of options differs among employees or shifts over time. The focus of accounting for expenses and net income, however, is on the cost of compensation to the firm at the time that the labor services are provided. Expensing over the vesting period the fair value of stock options when they were granted reports that cost for the firm. As detailed in the CBO report, subsequent changes in valuation represent a shift of resources among firms' stakeholders but not a change in the cost of labor compensation.

Finally, stock options can be cost-effective in attracting and retaining a skilled workforce. Any beneficial incentive or productivity effects will be reflected in earnings, as reported in net income. A fair display of cost-effectiveness will be achieved by also showing the cost of labor services. The demonstrated effectiveness of options as an incentive-based compensation tool makes it desirable that proposals to recognize the value of options do not prohibit their use by any company.

Valuing Options Can Be More Difficult Than Valuing Some Other Forms of Compensation

Compared with pay and purchased fringe benefits such as employee health insurance, employee stock options are more difficult to value because their price is usually not observed directly. In addition, features such as vesting periods, forfeiture provisions, and restrictions on transferability make valuation more complicated than for options without those features. However, advances in financial analysis now permit reasonable valuation of a wide variety of such warrants, as attested by their presence in many investment portfolios—including that of the federal government.

Some perspective on the difficulty of valuing options may be provided by comparison with another form of employee compensation: health benefits for retirees. To value those costs, the firm must project numerous uncertain future conditions, including employees' tenure, retirees' marital status, trends in health and mortality, changes in medical technology, and the cost and utilization of medical services years hence. That is, the valuation exercise is forward-looking and incorporates uncertain and volatile prices. Current valuation methodologies for employee stock options address an analogous situation, with the advantage that robust options-pricing models are now in the standard toolbox of MBAs. In short, the challenge does not appear to be unique or fraught with such practical difficulty that one would prefer a value of zero, which is currently permitted. Moreover, as the demand for such valuations increases, one should anticipate further analytical advances and a growing supply of service providers.

Recognizing the Fair Value of Options Would Not Change the Economic Fundamentals for Any Business

Cash flows available to conduct operations will not be affected by the form of accounting disclosure in financial statements. Customers, product markets, and competition will be unchanged. Small and large businesses will face the same labor market conditions, and they will have the same tools available to attract highly productive labor. In fact, the underlying financial facts will be precisely the same for all businesses after any new accounting standard is adopted.

Thus, the channel for any possible real economic effect would be a change in investors' valuation of businesses. For savvy investors and most firms, expensing would provide no new information and, therefore, no change in value. That situation exists because the current standard requires firms to calculate and disclose, in audited notes, the fair value of the options granted and the effect that recognizing them as an expense would have on reported net income. For those investors willing to refer to that disclosure, information required by the proposed standard is already available. Expensing would only make that information more easily accessible and broadly available. Nonetheless, it has been argued that there will be a significant decline in the prices of stocks as a result of expensing. The experience of companies that have already begun to expense options in the United States, Canada, and the European Union argues against any significant overall effect.

Another concern has focused primarily on businesses too small to be tracked by market analysts. The belief that expensing employee stock options will reduce their stock prices has prompted some businesses to declare that they will stop granting options rather than recognize the expense, regardless of the benefit of the options to the firms or to their employees. The economic importance of entrepreneurial firms and the informed nature of these reports suggest that they be taken seriously. Perhaps investors in some firms would be surprised to discover the effect of options on earnings. Such businesses would suffer a decline in stock prices and an increase in the cost of equity capital, with potentially sizable near-term losses for managers and employees. But in the same way that some businesses might have been relatively overvalued as a result of understated compensation costs, other firms have been relatively undervalued. The latter would enjoy an increase in stock prices as a result of the accounting change, permitting near-term expansion of markets and employment. Therefore, the effect overall would be smaller than for any single firm.

Such dynamics reflect the fact that improved information and valuation would tend to divert new investment from firms with less productive opportunities toward others with more productive ones. That is, a potential economic benefit for

the economy as a whole from the proposed accounting standard would be to increase the flow of capital to those businesses that could use it more productively, as indicated by their higher net income.

This completes my statement, Madam Chair, but if I may, I would like to submit the CBO report on this topic for possible inclusion in the record.