Written Statement of Jack T. Ciesielski

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Subcommittee on Financial Management, the Budget and International Security

April 20, 2004

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I am Jack Ciesielski, president of R. G. Associates. It is my pleasure to be participating in this hearing. The following is my written statement, which respectfully request to be entered into the public record.

First, allow me to present a brief description of my business and how it relates to this hearing. My firm, R.G. Associates, Inc. is primarily an independent investment research firm, and is dedicated to the analysis of corporate accounting issues. We have a small asset management business, but our main focus is the publication of a research service entitled The Analyst's Accounting Observer, which analyzes and explains accounting trends to both buy-side and sell-side analysts. Frequently, Observer reports are devoted to new or pending pronouncements of the Financial Accounting Standards Board. Our client base of approximately 70 firms is diverse: readers of our research range from some of the world's largest mutual fund families and well-established brokerage firms and ratings agencies, all the way down to money management firms with only a handful of employees and assets under management. In short, our client base is a unique cross-sectional view of many different kinds of financial statement users.

I've been writing the Observer for over 12 years, and as I've composed reports about new FASB standards, I've had plenty of interaction with the Board and its staff. I've participated in the Board's hearings and roundtables on proposed standards, and as a member of the Financial Accounting Standards Advisory Council and Emerging Issues Task Force, I've had ample opportunity to observe the deliberations and the due process that goes into the development of the FASB's standards. I've had the chance to see how the standard setting process benefits from the inputs provided by accounting firms and financial statement preparers - from people who are close

to the issues being considered by the Board, and whose experience with those issues helps the Board develop more durable standards. In my view, the FASB's system of listening, learning, and then improving their proposals works very well as it exists.

With that, I'd like to turn my attention to the purpose of this hearing. On the surface, this hearing is all about an accounting standard dealing with stock options given to employees, but there is a much larger issue that merits our attention. That issue is the independence of the FASB. For if there were not attempts by some parties to legislate action that robs the FASB of its independence, we wouldn't be having this hearing.

The FASB plays a unique and indispensable function in our country's capital market system - as is the role of any standard setter. Progress in society would be impossible if there were not uniform standards for many of the things we take for granted: for instance, something as simple as the design of electrical outlets. That's what makes the FASB's role critical: by being the independent arbiter of principles at the foundation of financial reporting, investors benefit from financial information that is more comparable and robust than would exist if every preparer had their own way of presenting information.

In my years of observing the standard setting process, I've seen the Board develop improved accounting standards with an unmatched level of openness and fairness. Their standards will not make everyone happy - in addressing the complicated issues they're charged with, it's impossible to satisfy all parties involved. The reason we're here is because some of the FASB's constituents are so unhappy with their attempts to reform the accounting for option compensation that they've pulled Congress into the process. They're seeking a legislative answer to an accounting rule they

oppose, and in doing so, usurping the FASB's authority to set standards. I believe that the FASB's ability to develop impartial standards resulting in robust information for investors to use would be seriously hampered if legislative intervention becomes the norm for disagreeing with their pronouncements, and a blueprint for such behavior was created the last time the Board attempted to remedy option compensation accounting ten years ago. While it may benefit a few of the Board's constituents to preserve the present broken accounting model, in the long run our capital markets would likely suffer - and result in capital being misallocated in the economy.

I'd like to focus the remainder of my remarks more specifically on the accounting issue under consideration, arguably the most contentious project ever taken up by the FASB. Despite the claims of vocal opponents, I do not view the FASB's proposal for equity-based compensation accounting as somehow "dangerous" or reckless. In my judgment, the Board has listened fairly to the views of its constituents and learned much as this project has wended its way from an "invitation to comment" document in 2003 to the exposure draft of a standard at the end of March.

I believe that the issuance of a final standard requiring the recognition of stock option compensation would significantly benefit the users of financial statements. I believe the argument that options cannot be valued, and therefore should reflect no compensation expense when given to employees, is without merit. Companies use option pricing models such as the Black-Scholes model to value illiquid options and warrants they hold in their corporate portfolios; they use them to value options on their stock given as consideration in making acquisitions. Yet they will claim that the same models cannot be used to value options given to employees as compensation. It seems that the only acceptable value such options can have is zero. (See Exhibits A and B).

Some of the opponents of the FASB's proposals claim that option compensation information should be relegated to a footnote as it is currently displayed. I disagree. The current presentation is a substitution of disclosure in place of proper accounting. It resulted from a Board that was badly compromised in 1994 due to the political actions that interfered with its independence. The information reported in the footnotes since 1996 were real transactions that occurred with employees, and financial statements are supposed to contain the transactions that occurred in a firm for a given period. By our count for the S&P 500, net earnings were overstated by more than $175 billion from 1995 to 2002. (See Exhibit C.) That's information about transactions which was presented only once a year to investors, rather than as it occurred each quarter - and it directly related to the resources under the firm's disposal, which management is supposed to employ for the benefit of its shareholders. That's one of the tenets of capitalism, and one that has been ignored when it comes to reporting equity-based compensation.

Opponents of the FASB proposal often claim that stock prices will fall if options compensation is recognized in earnings. I cannot think of a more patronizing argument. Markets are supposed to allow capital to flow to wherever it can earn the best return; information about how capital is being managed allows capital providers to make investment decisions. If stock prices fall because capital is not being allocated properly in certain firms, then markets are allowing capitalism to function as it should. For decades, accounting standards have done a poor job in depicting how capital is being used when it comes to equity-based compensation - and consequently, we have seen how capital has sometimes been misallocated.

The interference surrounding the FASB's equity-based compensation project is very much like a decade ago when the Board proposed that health care benefits promised to employees be

accrued on balance sheets as a liability. At the time, only rudimentary information about the payments for such obligations appeared in the back pages of financial reports. Many feared that the new accounting standard would virtually bankrupt many concerns. As it turns out, the new accounting didn't bankrupt anyone - as if accounting standards have the power to add or detract from wealth. All that accounting standards can do is provide measurement, and that is where their power lies. Simply put, we manage what we measure. Once their health care liabilities were measured, American firms began managing them. I think that most would agree that the world didn't come to an end when accountants measured these liabilities - or when managers actually paid attention to the consequences of promises they had made to employees. As a nation, I think we're better off for having faced the issue - and proper accounting, not "out of sight, out of mind" disclosures - helped us face the issue.

Earlier in my comments, I mentioned that I encounter a large variety of financial statement users in writing The Analyst's Accounting Observer. There's one question about the FASB project I encounter more often than any other in my conversations with analysts of all stripes, and it isn't "Can we stop this from happening?" The question I hear most often is "When will this go into effect? We want to start adjusting our models." Investors and analysts are ready now for such information and would like to roll back the uncertainty that surrounds the way it will affect them as they do their jobs. That uncertainty will diminish once the FASB completes its project.

In closing, I would like to reiterate my support for an independent FASB to bring this project to a timely conclusion with the accounting they have proposed.

Thank you, Mr. Chairman. I would be happy to respond to any questions you may have.

Exhibit A. Financial Statement Excerpts: Firms Use of Black-Scholes Option Pricing Models to Value Options Held or Issued (other than in compensation situations)

Intel 2003 10-K (page 57)

Fair Values of Financial Instruments

Fair values of cash equivalents approximate cost due to the short period of time to maturity. Fair values of short-term investments, trading assets, long-term investments, marketable strategic equity securities, certain non-marketable investments, short-term debt, long-term debt, swaps, currency forward contracts, equity options and warrants are based on quoted market prices or pricing models using current market rates. Debt securities are generally valued using discounted cash flows in a yield-curve model based on LIBOR. *Equity options and warrants are priced using a Black-Scholes option pricing model.* For the company's portfolio of non-marketable equity securities, management believes that the carrying value of the portfolio approximates the fair value at December 27, 2003 and December 28, 2002. This estimate takes into account the decline of the equity and venture capital markets over the last few years, the impairment analyses performed and the impairments recorded during 2003 and 2002. All of the estimated fair values are management's estimates; however, when there is no readily available market, the estimated fair values may not necessarily represent the amounts that could be realized in a current transaction, and these fair values could change significantly.

Apple Computer 2002 10-K (page 79-80)

Acquisition of PowerSchool, Inc.

In May 2001, the Company acquired PowerSchool, Inc. (PowerSchool), a provider of web-based student information systems for K-12 schools and districts that enable schools to record, access, report, and manage their student data and performance in real-time, and gives parents real-time web access to track their children's progress. The consolidated financial statements include the operating results of PowerSchool from the date of acquisition.

The purchase price of approximately $66.1 million consisted of the issuance of approximately 2.4 million shares of the Company's common stock with a fair value of $61.2 million, the issuance of stock options with a fair value of $4.5 million, and $300,000 of direct transaction costs. *The fair value of the common stock options issued was determined using a Black-Scholes option pricing model* with the following assumptions: volatility of 67%, expected life of 4 years, dividend rate of 0%, and risk-free rate of 4.73%.

Total consideration was allocated as follows (in millions):

Net tangible assets acquired	$ 0.2
Deferred stock compensation	12.8
Identifiable intangible assets	2.6
In-process research and development	10.8
Goodwill	39.7

Total consideration	$ 66.1

Critical Path 2003 10-K (page 42)

Acquisitions

Using the Black-Scholes option-pricing model and assuming a term of 7 years and expected volatility of 90%, the initial fair value of all the warrants on the effective date of the agreement approximated $26.4 million, which is included as a component of the purchase price of the acquisition.

Exhibit B. Barron's Editorial

Reprinted from BARRON'S

May 5, 2003

EDITORIAL COMMENTARY

JACK T. CIESIELSKI

Another Options War

The political defense of stock options threatens accounting standards

Mark Twain said that history doesn't repeat itself, but it rhymes. For example, 12 years after the 1991 Gulf War, there's the current Iraqi conflict. History is rhyming faster when it comes to another war of the 1990s. The first stock-options war took place in 1994—the second is going on right now. The first stock- options war left the Financial Accounting Standards Board badly beaten. Having called for compensation expense paid in stock options to be recognized in earnings, the FASB was maneuvered into a compromise requiring companies merely to make annual disclosures of what they should have been reporting in earnings.

The weapon that won the war for Silicon Valley and its allies was political hot-air power rained on the FASB and the Securities and Exchange Commission. Senator Joseph Lieberman, the Connecticut Democrat who now is running for President, proposed to put every movement of the FASB under the thumb of the SEC, fully aware that the SEC is easily influenced by Congress—as no less than former Chairman Arthur Levitt confessed in his recent book.

Lieberman in effect was proposing the federalization of the independent accounting standard-setting process. Compared to a blunder of that magnitude, stock-option accounting was trivial. The SEC and the FASB surrendered.

Smart Bomb

The weapons of air power have been refined in the last nine years; fewer Iraqis died and victory was more complete. In the stock-options war, a new weapon of hot-air combat is also somewhat smarter. The new political weapon is a bill named for Reps. David Dreier and Anna Eshoo, Republican of California and Democrat of California, respectively. It would prohibit the SEC from recognizing as Generally Accepted Accounting Principles any new accounting standards related to the treatment of stock options for at least three years. That's an effective moratorium on anything FASB develops in its current option accounting project.

Like a smart bomb, the bill is a bit more targeted than Lieberman's 1994 blockbuster, but the result is no different: It would put the independent FASB under the purview of the SEC so Congress can force the commission to provide the answers members like for their lobbying constituents.

Doing her part, Senator Barbara Boxer, the California Democrat, is working on the Senate version of the Dreier-Eshoo bill and she promises that her version "will send this whole matter to the SEC for review before the proposed rule goes into place and we are dealing with its unintended negative economic consequences."

It's not the unintended consequences that she and Silicon Valley friends are worried about. It's the fully intended consequences, such as less-inflated earnings reports, better-justified executive compensation and reduced corporate obsession with the vagaries of the stock market.

The eagerness of lawmakers to work with Silicon Valley executives on legislation to control accounting standard-setting is a frightening sight to behold; it provides more evidence of the need for standard-setting that's out of their direct political grasp. An independent FASB is the best hope of America's individual investors, who don't have a well-oiled lobbying machine and aren't well-represented by elected officials.

Math Phobia

Another Silicon Valley weapon that has been refined in the last nine years is the anti-Black-Scholes missile, aimed at the well-known if poorly understood option-pricing model. Call it a weapon of mass distraction: Rather than attempt to refute the inconvenient fact that an option represents something given to an employee in return for service, the opponents of option expensing muddy the issue by claiming that the accounting doesn't work. They invoke math phobia related to the Black-Scholes model's complex formula. A recent Wall Street Journal opinion piece by Intel's chief executive officer derided its use in valuing employee stock options, claiming that it produces "results that are inherently inaccurate and unreliable for this purpose" and that the model is "unworkable."

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(over please)

Intel's own financial statements, however, say that when it comes to determining the fair value of equity options and warrants, Intel uses a Black-Scholes option pricing model. (Incidentally, warrants have longer lives than the Black-Scholes model was designed to handle—just like employee stock options.) How can the model be "inherently inaccurate and unreliable" and "unworkable" when applied to employee stock options, yet perfectly fine when valuing financial instruments held by the company as assets? If they despise the Black-Scholes model when it comes to employee stock options, why hail its validity for valuing similar instruments appearing elsewhere in the financials?

Intel isn't alone in its utter hypocrisy. Other critics of option expensing are guilty of the same contradiction. In a 2001 acquisition, Apple Computer issued stock options—with a four-year life, same as for its employee stock options—as part of the consideration given to the shareholders of the acquired company, and valued them using a Black-Scholes option-pricing model. In the same year, Medtronic capitalized the cost of employee stock options exchanged in an acquisition—and in recording the acquisition, valued them using the Black-Scholes model. Palm issued a five-year warrant to a customer in 2001, and valued it with the Black-Scholes model. And QLogic issued warrants to customer Sun Microsystems, valued by—you guessed it—the Black-Scholes option-pricing model. Accounting standards governing those transactions did not require the use of that much-demonized mathematical formula; firms have latitude in choosing the methodology used to estimate fair values.

How come the Black-Scholes model is acceptable for recording other option values when it's unacceptable for employee compensation options? The answer is clear. When you do option math in Silicon Valley, the only suitable value an option can have at the time it's given to an employee is "zero."

But stock options are compensation. Employees are happier when they have them. (If you want to make employees unhappy, just try taking them away.) Options give an employee the right to buy shares of stock at a fixed price for, usually, the next ten years—a pretty powerful economic benefit. Wouldn't you like to be able to lock in the price of a car, a house, or a college education for a decade? Would you expect to get that right—that option—for free? Well, maybe if you're a technology company executive, but the rest of us who live in a more rational economic world know there's a price to pay for that right.

A stock option's minimum value should be the current stock price discounted by the risk-free rate over the option term, less the present value of dividends foregone, if any, by holding an option instead of stock. That boils down to the option's time value. If companies had a genuine interest in developing reasonable values for option compensation, they might propose solutions to the valuation problem starting with this fundamental financial premise—but because the minimum value won't equal zero, they continue to present absurd quasi-metaphysical reasons as to why options "can't be valued." Or even more bizarrely, they contend that options are "already accounted for."

Dire Consequences

Maybe history isn't rhyming this time; maybe the outcome of this stock-options war will be different. The market and the economy certainly provide a different backdrop this time. Obviously, Enron changed a lot of investor perceptions—and even a few political minds—about the importance of honest accounting.

Self-righteous Silicon Valley types whine that by recognizing the cost of option compensation, they're being made to suffer for the sins of Enron, Global Crossing, WorldCom and so on. That's a misplaced argument. Whether the cost of option compensation is fair is for the owners of companies to decide, and they must realize that they need to see the cost first.

The FASB's 1994 defeat couldn't have happened without the apathy of investors. Neither institutional nor individual investors supported the FASB much in its quest to end dysfunctional accounting for stock- option compensation. If history is to be kept from rhyming, both kinds of investors must make their voices heard at the FASB and in Congress. ■