Testimony of

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Senate Subcommittee on Financial Management, the Budget, and International Security

Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board

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Introduction

Mr. Chairman, members of the Committee, and distinguished guests, thank you for inviting me to speak with you today regarding this important issue.

My name is Don Delves. I am the President of The Delves Group, a Chicago-based consulting firm specializing in corporate governance and executive compensation.

Stock option expensing is truly one of the most pressing issues facing Corporate America today. Because the FASB has finally started to address the critical issue of stock option expensing in a meaningful way, long overdue change is happening in boardrooms across the country. In order for this process to continue, and in order to promote healthy executive compensation and higher levels of accountability to shareholders, it is critical that the FASB remain fully independent of the political process. The FASB and the business community must be free to debate this issue and determine the best possible outcome for the benefit of corporations and their shareholders.

As an expert in the compensation field with 20 years of experience, I see this issue as central to helping boards of directors hold management accountable, and to expect – and get – the best performance on behalf of the shareholders. Without stock option expensing, boards of directors have been seriously hampered in their ability to address the basic question of *how much pay for how much performance*. That fundamental capitalist equation – how much for how much – has been subverted for too long by bad accounting.

It is the board's job to marshal and allocate shareholder resources in the most effective way possible. Boards have at their disposal a very powerful tool – stock and stock options -- which they have the right and the ability to share with management and employees. Until now, however, boards of directors have not had the means to accomplish this goal in the most effective and responsible way. They have lacked a reliable way to quantify how much ownership and shareholder wealth was being given to executives and employees through stock option grants. As a consequence, boards have not effectively done their jobs of requiring commensurate performance in exchange for that ownership interest.

Working with companies and boards of directors as a compensation expert, I have been stymied in my efforts to design and implement pay-for-performance packages. The reason is simple: A bad accounting rule allowed a very narrow definition of a derivative security called an employee stock option to be granted without expense to the company. With no expense, these "free" options were liberally given out to executives and employees (although mostly to executives) with very little rigorous thought about the effect on shareholder value and future shareholder wealth.

This has had dramatic consequences for thousands of companies and boards of directors across the country. From 1994 to 2002, mainstream American companies tripled their use of stock options. In eight years, stock options exploded from 3%-5% of a company's stock on average to 13%-15%.[1] And what did we get in return? The sad answer is that we don't know – and neither do the boards of directors of America's corporations.

Also as a result of the proliferation of stock options, we have seen the dominance of one very narrowly defined form of compensation in executive pay. Not only have vast amounts of wealth been shared, with no commensurate demand for performance, it's been done in an extremely uncreative, one-size-fits-all way. Why? Because there was only one, very specific definition of stock options that allowed them to be free. The old accounting rules not only limited accountability, they almost entirely eliminated creativity in how compensation systems were designed.

The good news, however, is that because of the likelihood of the stock option expense, in boardrooms across the country companies are rethinking and redesigning their executive compensation programs. While the process is extremely healthy, some of the results are good and some are not. Many companies have made very positive moves toward requiring greater performance in exchange for valuable ownership interests. Other companies, however, have merely replaced stock options with stock grants that vest with the passage of time. Compared with stock options, this is clearly a step backwards.

The other good news is that the FASB's proposed expense for options has prompted companies to begin taking a hard look at the wealth transfer that has occurred from shareholders to executives through stock option grants. My firm has been working with

[1] Investor Responsibility Research Center (2002).

companies, and in particular with boards of directors, to help them calculate the sheer size of this wealth transfer. In many cases, the findings have been a shocking but necessary eye-opener for the board.

For example, in our work with a major corporation, my firm was able to demonstrate to the board that over a 10-year period, $1.2 billion in wealth had been transferred from shareholders to executives. Importantly, there was no readily available way that the board could have ascertained this number without our in-depth analysis. That's because it is impossible with existing financial statements to figure out how much wealth has been transferred from shareholders to executives. We had to really dig into the company's numbers to figure it out.

For the same company that had transferred $1.2 billion in wealth, we also calculated what the expense would have been over the same 10-year period using the FASB's proposed method. The result was a cumulative expense of approximately $600 million – roughly half the amount of the wealth transfer.

This is fascinating. Based on our analysis and work with a variety of companies, we believe that the FASB's proposed method will result, on average, in an expense equivalent to 50% of the wealth transferred over time.

What's interesting, though, is that while the FASB's proposed method captures half the wealth transfer over time, there is a problem here. This method requires companies to record that expense upfront regardless of what the wealth transfer ultimately will be. For some companies, the wealth transfer to executives will be very large and greater than the expense. For others, if the stock price goes down it will be less than the expense. And in some cases it could be zero.

My concern is this upfront expense could overly discourage the use of stock options. That would be too bad because stock options, if used appropriately, are a powerful incentive to increase the value of the company. Because of this, I like the FASB's alternative method that is allowed for certain non-public companies. This method, called the intrinsic value method, measures the expense over time as the stock price fluctuates.

The total expense, however, reflects the gain from the actual transaction when –and if – the executive exercises the option.

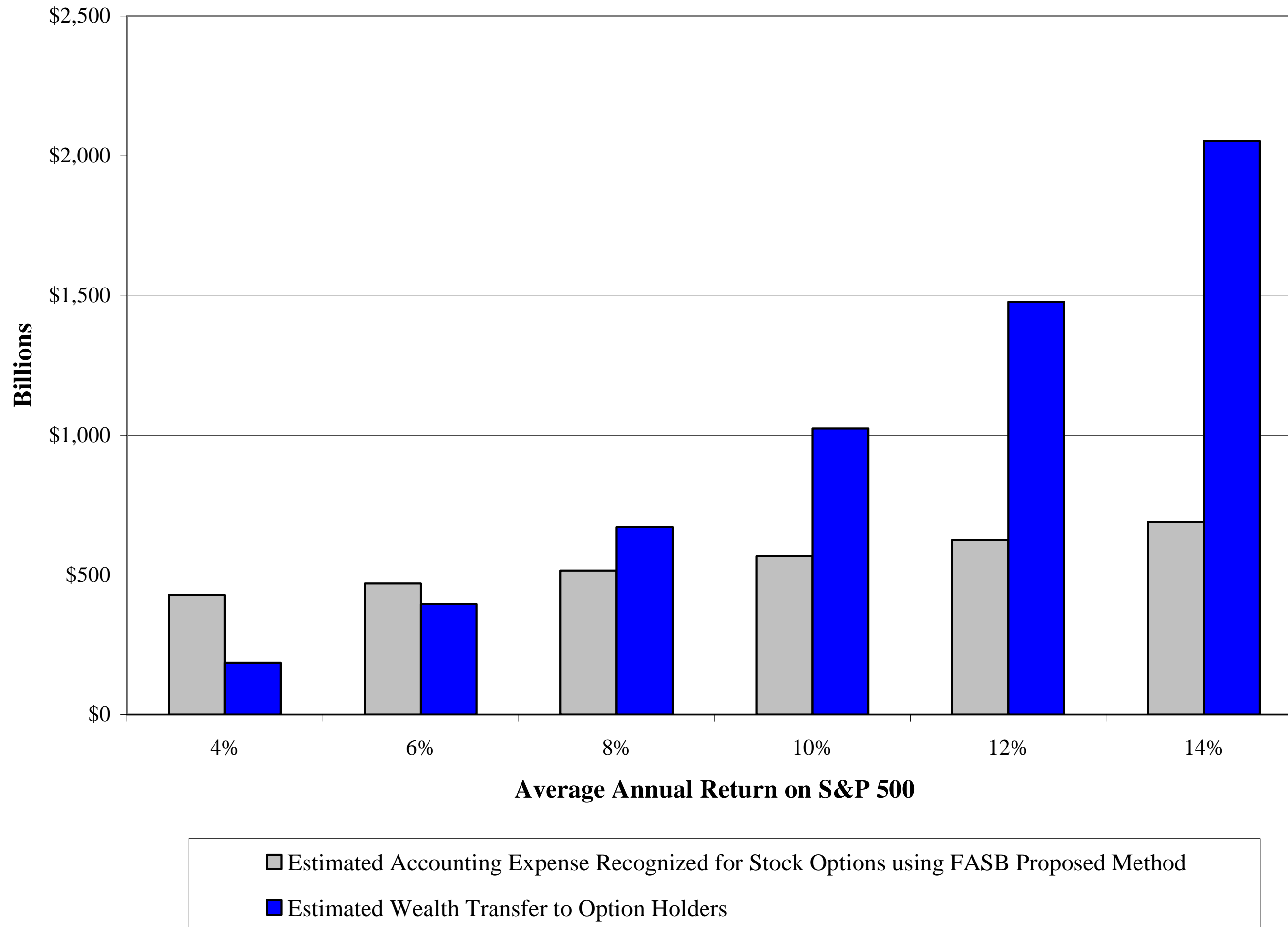
The intrinsic value method, while it may end up with a larger and more unpredictable expense, does a better job of reflecting the real cost to shareholders. So from the standpoint of good governance and effective compensation design, this method could produce better results, and more creative ways to use options and other ownership incentives.

The essence of the stock option issue is integrity and accountability in corporate governance. My job is to help management and boards of directors to understand the true cost to shareholders of using these incentives and to help ensure that they are getting the highest performance possible from executives in exchange for that cost.

In summary:

- It is critical for the FASB to debate and make decisions without government intervention.
- Since the FASB last tried to introduce an expense for options 10 years ago, vast amounts of shareholder wealth have been transferred to executives with little accountability or measurement.
- An accurate and meaningful expense for options is essential for America's corporations to operate with accountability and integrity.

Exhibit A



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