



**Testimony of
Donald P. Delves**
President
The Delves Group

**Before the U.S. Senate Committee on
Governmental Affairs**

**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**

Tuesday, April 20, 2004



THE DELVES GROUP

10 S. LaSalle, Suite 1450
Chicago, Illinois 60603
Website: www.delvesgroup.com

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

¹ Investor Responsibility Research Center (2002).

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 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.

* * *

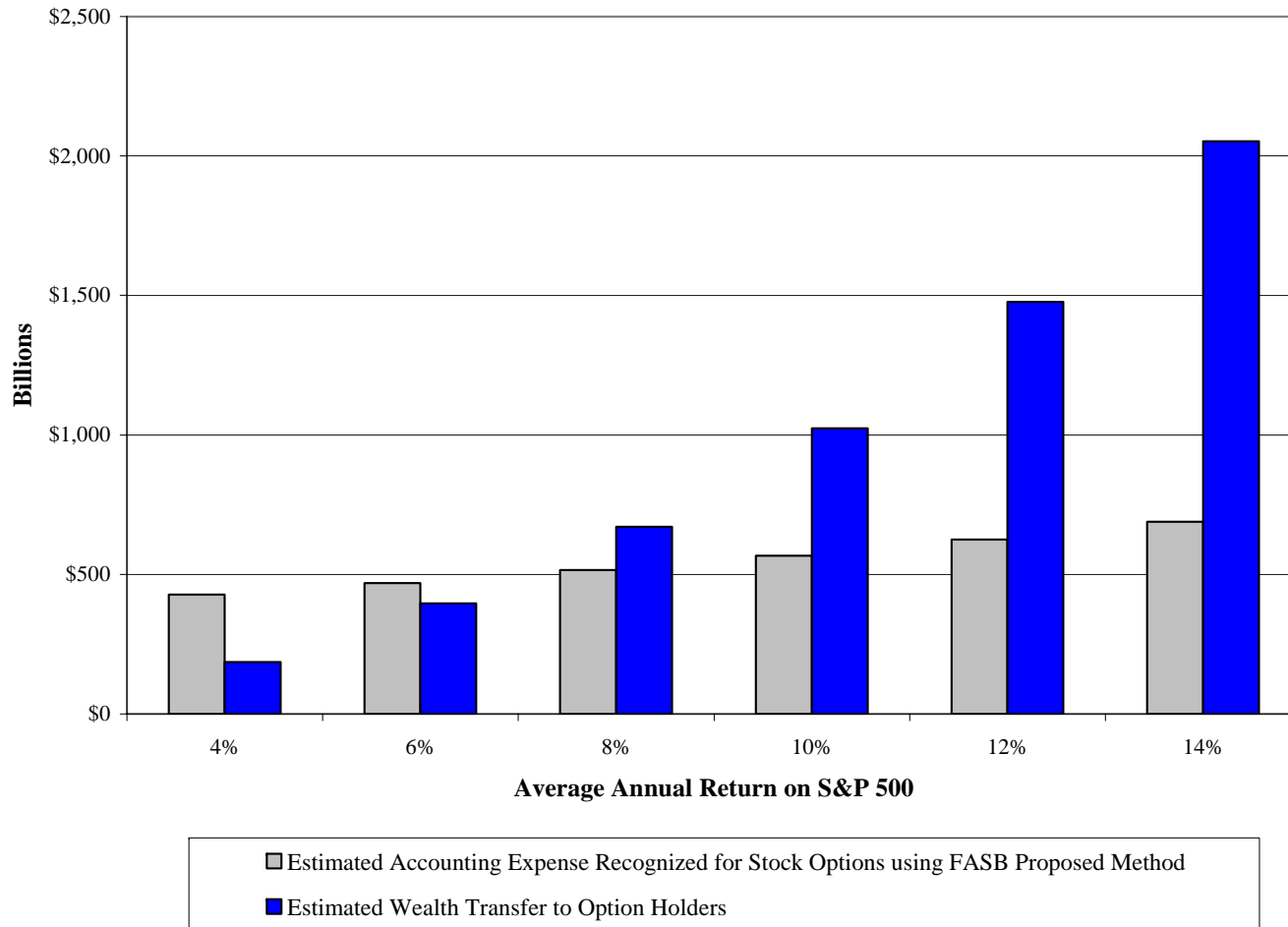
Donald P. Delves, principal of The Delves Group, is an expert in helping companies to get what they pay for from their executives and employees by designing effective pay and incentive systems. He strives to create a high level of alignment, information flow and accountability between the CEO, management, and all critical points in the organization. He is also the author of *Stock Options and the New Rules of Corporate Accountability: Measuring, Managing and Rewarding Executive Performance*, published in October 2003 by McGraw-Hill.

Mr. Delves has over 20 years of consulting experience. Prior to founding The Delves Group, Mr. Delves started and managed the Chicago office of iQuantic. Prior to that, he was a Senior Consultant at Sibson and Company and an executive compensation consultant with Towers Perrin. He has also served as a manager in personal financial planning and taxation with Arthur Andersen & Co., and as a financial consultant to middle market companies for Harris Bank.

A recognized expert on performance measurement and value creation, he writes and speaks regularly on these subjects. Mr. Delves holds an M.B.A. degree in finance from the University of Chicago, a B.A. summa cum laude, in economics from DePauw University, and is a Certified Public Accountant. He is also highly trained in organizational behavior and leadership development at the Wright Institute for Lifelong Learning of Chicago.

Exhibit A

Estimated Economic Impact of Stock Options Over the Next Ten Years (2004 - 2013)



ADDENDUM

Additional Testimony of

**Donald P. Delves
President
The Delves Group**

Submitted on: Tuesday, April 27, 2004

Thank you for the opportunity to participate in the discussion and debate on the Financial Accounting Standards Board's proposed mandatory expense for stock options. I am pleased to say that the hearing was the most in-depth discussion on stock options expensing that I've ever witnessed.

Clearly, this type of debate needs to be encouraged to air the various viewpoints on stock option expensing. This is necessary in order to move forward with a mandatory stock option expense, and determine the best methods to calculate and implement that expense.

In the spirit of continuing that debate, I would like to submit further testimony regarding specific points that were raised at the April 20, 2004, hearing.

Senator Enzie's Proposed Bill

Senator Enzie's testimony centered on the cost of a stock option expense to small companies, a burden that he believes should be alleviated. Senator Enzie's bill, however, does not focus on small companies. Rather, his bill calls for limiting the expense to options granted to the top five executives in a company. This flies in the face of any known accounting convention or principle. There are no accounting principles that would allow an expense to be constructed in this manner. Furthermore, his proposal calls for the calculation of an expense that would effectively be zero. Clearly, this bill is a ruse to maintain the status quo and should not be considered as part of the serious debate to move forward with a significant and meaningful expense for stock options. On the issue

of small companies and startups, there are other ways to address the impact of a stock option expense.

National Venture Capital Association

Mr. Heesen of The National Venture Capital Association made some very strong and persuasive points about the potentially detrimental effect of stock option expensing on startups.

Senator Levin, asked Mr. Heesen several pointed questions that were very insightful and positive. In Senator Levin's discussion with Mr. Heesen it became clear that startup companies do not like the FASB's stock option expense proposal – which calls for the expense to be taken based on the fair value as of the grant date – for two reasons. First, startups believe it will hamper their ability to establish a new company and obtain funding for it. The reason is that the proposal would require an expense be taken upfront for stock options, which may or may not result in any cost to the company in the future. Second, it is very difficult to estimate the value of an option for a company that has barely come into existence.

Senator Levin then asked Mr. Heesen if the National Venture Capital Association would accept the intrinsic value method (based upon the spread between the exercise price and the market price), as proposed as a possible alternative method by the FASB specifically for private companies. Mr. Heesen responded that this would require a quarterly “mark to market,” which he says would be difficult to implement because of the necessity to value the stock on a quarterly basis. I question this difficulty, given that it is possible to value a startup's stock based on the most recent issue or transaction, even if that occurred some time ago. Nevertheless, I am sympathetic to Mr. Heesen's point and concede that frequent valuations of private company stock could be costly and burdensome.

Senator Levin then acknowledged that difficulty with the periodic stock valuation, and asked if the National Venture Capital Association would accept accounting for options on

the date they are exercised, using the spread at exercise. This would be the same as the tax treatment. Mr. Heesen responded that perhaps this was possible.

I agree that the grant date/fair value accounting method is probably not right for startup companies. A better approach would be either the intrinsic value method or the tax treatment that Senator Levin suggested. The intrinsic value method or the tax method would provide for a significant and meaningful expense that reflects the true cost to shareholders, while still allowing startups to use stock options as a powerful recruitment tool, but with no initial expense.

Possible Balance Sheet Treatment of Options

When a stock option is granted to an executive of a start-up company, it is a very different transaction than when an option is granted to an executive of a large established publicly traded organization. When an executive goes to work for a start-up, he or she usually receives a relatively low amount of cash compensation, and a significant number of options. In this case, the person is making an investment of time, effort, creativity and skill in exchange for an ownership interest that may or may not be worth something in the future. There is a strong argument that this transaction is not compensation and therefore, not an expense at all — at least initially. It may, in fact, be an investment that should be recorded on the balance sheet as a capital transaction.

Intrinsic Value Method

As I said in my testimony at the hearing, the intrinsic value method is a relevant and meaningful choice for just about any company, and it may be preferable to the fair value/grant date method for two reasons:

1. There would only be an expense if the stock price appreciates.
2. It captures the true cost of options to shareholders more effectively than the FASB's proposed fair value/grant date method.

For these reasons, I believe the intrinsic value method would do less to discourage the use of stock options than the proposed fair value/grant date method. Further, it would give

boards of directors more meaningful data on the cost of options to shareholders. The result would be more creative solutions in executive compensation.

Restricted Stock vs. Options

Another point was raised at the hearing regarding the relative merit of restricted stock vs. stock options, and the benefit of making either options or restricted stock performance-based. As a veteran executive compensation consultant, I have a number of important points to raise on this topic:

- The lack of an expense for stock options has seriously hampered the debate and discussion over the relative costs and benefits to shareholders of different methods to compensate executives. Boards of directors have done an inadequate job of designing and choosing the best incentives and allocating shareholder resources because of a lack of an expense for stock options. A significant and meaningful expense for options levels the playing field and allows boards to weigh the alternatives and make more effective choices.
- It is true that stock options cause executives to take risks that they ordinarily would not take. That is precisely why stock options are granted to executives. When too many options are granted, however, executives have an incentive to take too much risk. Consequently, options need to be granted in moderation and possibly balanced with other incentives. This balancing process cannot be and has not been accomplished without an expense for stock options.
- Restricted stock that vests solely based on time is in no way preferable to stock options. Companies that have replaced options with time-vested restricted stock have moved backward, not forward, in the drive for greater accountability and pay for performance. Restricted stock may be preferable to stock options only if it vests or is earned based on the achievement of meaningful performance goals.

Stock Option Expense Needed for Creative Executive Compensation

From an executive compensation design perspective, the FASB's proposal is both welcome and long overdue. In the past, if any performance criteria were attached to

stock options, they caused a company to incur a significant and unpredictable expense under the “variable accounting” treatment. With the FASB’s proposed method, all forms of stock options will have an upfront expense. This makes it much easier to develop an array of alternatives tailored to each specific situation, based on a wide range of performance metrics.

As the debate over stock option expensing continues, the impact on companies from startups to traditional firms must be measured and evaluated. This will allow the FASB and the accounting industry to determine the best methodology and timing for a stock option expense. The issue, however, is not whether to have an expense. Rather, it is how the expense should be calculated and implemented. This is where the debate needs to move in order to have a fair and meaningful expense that can be embraced by all companies as part of creative and responsible executive compensation.



THE DELVES GROUP

216 South Jefferson, Suite 600
Chicago, Illinois 60661
Website: www.delvesgroup.com