TO; Board, Lucas, Ball,Mosso, Daily c., Stock Comp Team
FROM: D. Harrington 4/22/94

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U.S. SECURITIES AND EXCHANGE COMMISSION

STOCK OPTION ACCOUNTING: A COMMON SENSE APPROACH

REMARKS BEFORE

THE WESTERN ASSOCIATION OF VENTURE CAPITALISTS

AND THE

AMERICAN ENTREPRENEURS FOR ECONOMIC GROWTH

MENLO PARK, CALIFORNIA
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• **The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.**

U.S. Securities and Exchange Commission
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My visit here today reminds me of the start of the last point, of the third set, of a long, hard fought, tightly contested squash match. I am both pleased and pained to be in this position.

I am pleased to be here to listen to the valuable insights and battle-tested wisdom that each of you bring to the table.

I am pained, however, that when faced with the opportunity to hear first-hand reports from the cutting edge of the intersection of American business and technology, I am forced to spend my time talking of technical accounting rules and frivolous strike suits that threaten to drain the vitality out of the very best prospects that our country has to offer.

Of course, I'm sure that you are equally pained at the inordinate amount of time that you have spent discussing the stock option accounting issue. I'm also certain that if you could apply to your businesses the time spent either defending or worrying about frivolous shareholder lawsuits, your current and future shareholders would be that much better off.

Sooner or later, as a society we must begin to appreciate the incredible burden over-regulation places on our prospects for economic growth, or we risk the possibility of seeing more and more of our future success stories emigrating off-shore.

Today, I would like to give you a brief assessment of how I see both of the stock option and litigation reform issues playing out, and then respond to your questions. With any luck, you will gain some understanding of how both these issues are viewed in what some call the exotic, almost surreal, part of America that is inside the beltway. Then, you can decide for yourselves how best to approach these issues in the real world.

Let's start with the FASB's proposal to require that companies expense the value of employee stock options when issued.

I'm willing to bet that many of you are not aware of how much you have in common with the FASB. Next month marks the tenth anniversary of the FASB's efforts to figure out some reasonable approach to account for employee stock options. Like many entrepreneurs, the FASB has been working years on end, facing disappointments, dead-ends, and let downs, without yet bringing a product on-line.

Except for two big differences. First, the FASB basically has unlimited funding, which makes the years of frustration somewhat easier to handle. Second, the chances of them ever bringing out a final product that meets market specifications is, in my view, remote.

I say remote, because I believe that the holy grail the FASB seeks simply does not exist. It is virtually impossible to establish an accurate method to value an employee stock option at the date it is issued. Accurately predicting stock prices and volatility and interest rates five or ten years down the road presents an insurmountable obstacle. I'm certain that if you or someone you knew had this ability, you wouldn't be worried about meeting payrolls, but instead you would have your own hedge fund making millions and giving George Soros a good run for his money.

Finding accurate valuations for employee stock options could not be done a decade ago when the FASB first tried, it could not be done a few years ago when the FASB tried again, and it certainly cannot be done today. My guess is that it cannot be done ten years from now either. Unfortunately, that probably will not stop the FASB from trying.

Now let's see, if the FASB was a company, and it's only product in development was a method to value employee stock options, and the FASB board members were only paid with FASB options, what compensation expense should the FASB have to charge against earnings? Let me put it another way -- how much would you pay for those options? Don't answer that question just yet, because there is more to the story.

The FASB knows they have a valuation problem. In fact, next Monday, the FASB is gathering together a group of academicians in Connecticut to discuss the valuation issue. While I commend the FASB for their efforts in this regard, I doubt that these meetings will be fruitful, at least in the way the FASB hopes. On the hand, it is possible that after this meeting, the FASB will have a better understanding and appreciation of the extent of this problem that it has had at any time over the past ten years.

As you in this room know all to well, problem solving does not always mean finding the single right answer, because there may not be one. In fact, at times, the best way to solve a problem is to throw up your hands and admit the problem is unsolvable, and then

move on to alternative approaches that avoid that particular bottle-neck.

If the FASB could be convinced that at the present time the valuation problem is unsolvable, it could then start considering alternative approaches. They do exist, but as of yet, the FASB seems unable or unwilling to consider them.

This unwillingness is not surprising. The FASB has found itself under attack in a seemingly life-or-death struggle with the corporate community. Moreover, Senators, Congressmen, accountants and even a certain SEC Commissioner have been second-guessing the FASB's views, and essentially asking that this decision be taken out of the its hands. These attacks are taking its toll. For the FASB, it seems that the stock option accounting is no longer just another issue on its agenda.

To use the line from a Hollywood gangster movie, "This isn't business, this is personal." The FASB clearly feels it has been unnecessarily vilified in this debate, and to make matters worse, the board members believe with equal vigor that as to the accounting issues, they are in the right, and it's not even a close call.

Finally, as perhaps most importantly, the FASB is unable to defend itself when facing the demands that it consider the public policy issues that have the business community so up in arms. The FASB simply does not consider public policy -- it never has and probably never will. It's job description does not call for this type analysis, and by its own admission, it lacks the expertise to even perform the task. To the FASB, these public policy concerns simply do not exist. Of course, this attitude frustrates the opposition, who ultimately must live with the consequences of the FASB's decision.

The end result is that the FASB is tired of hearing public policy arguments, and those making the arguments resent that their real-life pleas are falling on deaf ears. The volume and intensity of the attacks on the FASB escalate, and the opposition continues its search for a more sympathetic audience. The FASB feels even greater pressure, but just digs in a little deeper, because, in its accounting heart of hearts, it believes it is right.

This vicious circle must be broken, as we all are paying the price for this confrontation one way or another.

Up to a point, I agree with the FASB. On a purely theoretical level, employee stock options are compensation, and they do have value. As I've said, trying to determine that value is a different story, and that is where the FASB and I part company. Not over the technical accounting issue, but over the valuation issue, and how it should be handled.

I've said as much in my speeches, and wrote an editorial for the Wall Street Journal to make sure these views were unmistakably clear and publicly disseminated. My bottom line here is relatively straight forward.

If you cannot accurately value the options, little is gained running a highly debatable estimate through the income statement. Financial statement users will just have to back out the number to use their own estimate. To preserve the integrity of the income statement, why not put the company's best guess at valuation in a footnote, and let the market decide how best to analyze this information? This footnote disclosure alternative would seem to make sense, because investors would get the information they needed, but the nasty public policy problems could be avoided.

The point is, if we have two alternatives designed to achieve the same goal, prudence demands that we consider all the pros and cons of each alternative to make the right choice. But the FASB is considering just half the picture, and somehow they need to realize that collateral consequences matter. Too often in this country we make regulatory decisions seeking to achieve one goal, but ignore the potential behavioral changes that often result from the regulatory change. Corporations do not act in a vacuum, and if the FASB's proposals are adopted, -- in essence, making employee stock options more expensive -- companies will change the way options are used.

Who losses? The lower level employees, who might otherwise have no stake in the company's success. Shareholders also lose, because companies will no longer be able to attract and motivate the key employees they need to survive and grow. Shareholders may also lose if we add disincentives to using the one tool that insures pay is based on performance. Indeed, we all may lose, if we add yet another hurdle to the long obstacle course young companies face.

The FASB responded to my Journal piece with a letter to the editor. Unfortunately, the tone and content of the letter suggests that they were more pre-occupied with defending themselves rather than

considering new alternative approaches. Despite my clear call for a footnote approach, the letter the FASB submitted does not mention the word footnote even once. The word disclosure did appear one time, in the last paragraph of a ten paragraph letter. The FASB assured the world that indeed, disclosure is being considered as an alternative. Discussing this alternative in its letter apparently was not possible.

The FASB spent most of its letter extolling the virtues of neutral financial statements, as if that point were in dispute. Listening and seeing the FASB shield itself with arguments about the sanctity of financial statements reminds me of the scene in Casablanca, when the police chief strides into Rick's cafe, blows his whistle and announces, shock upon shock, "There's gambling going on here." Has it really taken the FASB 10 years discover that options are accounted for differently depending on their nature?

Contrary to the FASB's claims, I do not have a fundamental disagreement with the FASB over the neutrality of financial statements. That is not what the stock option debate is about, and the FASB does a disservice to itself and all investors to frame the issue in such a self-serving manner. But make no mistake about it, I do disagree with the FASB over how best to account for an expense that defies accurate valuation.

At its essence, the dispute boils down this: if you are unable to accurately value employee options, is it better to put your best guess in the income statement, or in a footnote? The FASB, and some inside the SEC, believe that any number is better than zero if investors are to understand that some expense has been incurred.

I take another approach, from the school of thought that, indeed, you can learn a lot about business in kindergarten. In my view, two wrongs do not make a right, and if you know that the number for your expense is wrong, there is no need to make the income statement wrong too. Investors do need to know that some expense has been incurred, a problem adequately remedied by appropriate footnote disclosure.

As I continue to watch the stock option accounting debate unfold, and wince over the amount of money spent over the past ten years, I am convinced that the FASB will be unable to resolve the valuation issue, regardless of the number of hearings held or studies done. The ultimate decision remains the same, and you cannot get

around deciding whether investors are better off with a guess in the income statement, or a guess in the footnotes.

Consequently, I believe it is time to quit talking and start doing. This on-going debate has become an endless soap opera that is taking up valuable time that you, me, the FASB, Congress and everyone else involved could better spend doing other things. Not necessarily more important things, but other things.

Clearly, the ball is in the FASB's court. At this point the board members are the accounting experts deemed responsible for the nation's accounting policies, and they should go ahead and give it their best shot. The time has come to fish or cut bait, and the FASB must make a decision. Then the SEC, and perhaps even Congress, can make their decision, if one has to be made.

As an aside, I urge you all to consider whether you really want Congress involved in this dispute. In the short run you may receive the relief you request, but once you crack the door, you may soon find your house overrun. Congress is not necessarily the best place to resolve complicated disputes, and in the long run, may not be the best body to set accounting policy. Perhaps as you work on your income taxes this week, this point will take on some added meaning.

I hope that the FASB will act soon, and I challenge them to do so. Uncertainty in business serves no master well. For you here today, quick action is of particular importance. Funding and capital allocation decisions are being made with an eye five or even ten years down the road, and what the FASB eventually decide may severely impact how these decisions are made. The FASB owes it to you and all its other constituents to act sooner rather than later.

The FASB may not be inclined to act so quickly. Certainly, SEC review of their actions is likely, if not a given. As a practical matter, deciding whether or not we review necessarily entails exploring the basis for the FASB's decision; so either way, the FASB understands its ultimate conclusions will be subject to intense SEC scrutiny. This eventuality hopefully will not cause FASB to delay its decision while it builds its case. As I've said, this debate probably has already taken up more than enough of everyone's time, effort and money, and further delays can only mean more time spent contemplating the latest rumor of a compromise, or preparing for what may or may not actually occur.

Of course, there are difficult issues involved, and I'm not suggesting that the FASB make a hasty decision just for the sake of making a decision. These issues may require additional study before they can be resolved, and if the FASB feels so inclined, these studies should take place.

But the FASB should not waste time building a record to justify its action. Their exposure draft has built-in milestones, with footnote disclosure mandated for 1994 year-end financial statements, and expensing by year-end 1997. I believe the FASB needs to be subjected to time constraints as well, to provide all involved with a date certain when this issue will be resolved, at least at the FASB's level.

If the FASB were start-up company dependent on outside financing, market forces would compel them to either turn out a product or close their doors. The FASB should at least put themselves in the same position as those who must live with their pronouncements.

If the FASB believes it lacks sufficient information to make a decision, then it should say so, and withdraw all or part of its exposure draft. The world has waited ten years for a decision, and waiting another few years is acceptable as long as the threat of expensing in 1997 is taken off the table. If the FASB wanted, it could even leave the footnote disclosure portion of the exposure draft intact, so that investors receive the needed information in the interim. But as long as expensing remains a requirement rather than a possibility, this debate will continue, with no end in sight until the FASB reaches its ultimate decision. The vicious counter-productive circle of attack, counter-attack, lobby and attack some more will continue, to everyone's detriment.

Conclusion

At some point, we have to total up the amount of money spent in Stamford, Connecticut and Washington, D.C., in Silicon Valley and elsewhere, and ask -- How does this help U.S. companies raise capital and compete internationally? How does it help create jobs, or motivate employees? And most important, how will it help investors and our markets make better investment decisions? Is the FASB proposal the best way, the only way, or just one of several ways to accomplish everyone's goal of protecting investors in today's global markets. Separating the accounting and public policy decisions makes

little sense, especially when the accounting issues involved are so unsettled that the FASB and the AICPA cannot agree on the proper accounting approach.

As I said at the start, the next step for the FASB is its valuation summit next Monday. I think it would be a good sign if the FASB emerges from this meeting with the realization that the valuation issue is indeed a Gordian knot, and instead of trying to untie it, they may be better off cutting the exposure draft in half.

Indeed, there would appear to be no losers if this occurred. Investors would get the information the FASB wants provided. You and other businessmen could return your attention to running their businesses and building value for your shareholders, without worry that come 1997, your worlds will be turned upside down. And the FASB can continue to study the valuation issue free from the relentless pressure and ire that has been unleased in their direction.

Moreover, once footnote disclosure is provided, we will soon have an assessment of the real usefulness of this information. Then maybe we can quit worrying about field tests, public hearings, summits, models and mathematical theories, and look to the one source that always provides the quickest, most efficient answer to every valuation problem it ever considers -- our capital markets. Once we see what type of answer the markets provide, handling the accounting issue may become that much easier.

Before I take your questions, let me add just a few words about litigation reform. There is no need here to preach to the choir about the huge waste caused by unnecessary strike suits. Fortunately, help may be on the way. This issue is starting to generate the critical mass needed to enact truly meaningful changes, and the Dodd-Domenici bill introduced in the Senate last month may be just the vehicle to get the job done.

Class action reform is one of the key components, and the bill seeks to end abusive practices by giving investors, rather than plaintiffs lawyers, more control over the class action suits, and limiting the opportunities for frivolous litigation.

Specifically, the bill would prohibit the payment of referral fees to broker or dealers by lawyers looking for potential clients. Moreover, the bill would require that plaintiff steering committees be created so that those harmed -- the investors -- have more say in how

the litigation is handled. The bill also seeks to impose some control over fees by, among other measures, tying the lawyers' fees to the amount recovered by investors, rather than some hourly rate.

Finally, to stop certain plaintiffs, or their lawyers, from suing over and over trying to win race to the courthouse -- reportedly, one name-plaintiff had filed 38 class-action claims -- the bill also requires that name plaintiffs either hold 1% of the companies securities or $10,000 worth of stock. Of course, this might require that a few small shareholders get together, but if fraudulent conduct occurred, meeting these minimal requirements should not deter one class-action suit from moving forward.

The goal here is not to end shareholder litigation. The goal is to end frivolous litigation, and to make sure that redressing shareholders grievances, rather than lining lawyers pockets, is the driving force behind shareholder strike suits. Too often, fear and greed are the motivating factors underlying settlements, and it's time that changed. We owe to all shareholders -- both those paying the awards and those receiving them -- to make resolving disputes as fair and as efficient as possible.

Everyone wins when justice is truly served. Our markets are cleaner and more attractive, and the cost of capital is cheaper. One way or another, however, we all pay the costs for the waste and abuse currently found in our system. Our markets and our companies simply will not be able to compete in the global economy if we continue to weigh them down with excessive litigation costs.

Thank you.