CEASA CONFERENCE
April 11, 2005

Arthur Levitt Jr.: Please take your seats.

Columbia runs a very, very tight ship, and I'm delighted to be part of what I regard to be a very significant effort. And I'm sure none of you would be here today unless you had a pretty keen interest in the kinds of things that we're going to be dealing with. This effort has enormous impact, in my judgment, directed toward the restoration of public confidence in the reliability of numbers that are reported. And it's quite an offset to headlines that still dominate the media, and probably the substance of this kind of program, dealing with the most highly controversial and political issues, takes on very great significance. So we're going to have lunch briefly. And we promise to get you out of here by a quarter of two. And we thank you for your participation and look forward to a continuing dialogue.

I'm Arthur Levitt, incidentally.

A word or two about the center, a partnership between Morgan Stanley and Columbia University. What has been created, essentially, is a very specialized kind of think tank on financial reporting and equity-analysis issues. And the goal of the center is to come up with answers to very pressing, often very political and controversial, issues. The center is independent. It really doesn't take sides. And the thought being that, under the distinguished umbrella offered by the Columbia School of Business, that was the best way to establish its independence. It's their intent to take on specific issues of current importance, cast a wide net in academia, in the world of politics, to take on issues as controversial as
the one we're dealing with today and one which I personally believe is even more controversial, more intractable, in terms of pensions.

The methodology used in this and other projects will be to appoint a relatively small project team to run ideas through specific roundtable discussions with the broadest kind of exposure to those roundtables, and the end product being a white paper. The current projects are the debt-and-equity white paper, and pensions, and fair-value accounting. I can't think of any three more difficult issues to undertake.

The major presumption here is that the primary focus of financial reporting must be on shareholders and, indeed, that frames the document that is before you today. In my own corporate and political history, no issue has been more difficult for me than the issue of accounting for stock options. When I came to the SEC I had just left the leadership of a business group which was aggressively committed to undermining any government effort to expense stock options. And like so many other people coming to Washington [D.C.], it gives you an opportunity to reexamine some long-held ideas. And unfortunately, that process of reexamination didn't take me as far as it should have, and when confronted with a political firestorm I made the greatest mistake I made in my eight years in Washington by persuading the FASB not to go forward for fear that Congress would have overturned them. At that point in time I'm convinced that that would not have happened. Today I'm not quite so sure. But I am even more concerned today about the implications of this issue, of having Congress overturn the efforts of the FASB. There are some processes in public life that simply defy the political process. One is closing military bases—you can't possibly get Congress to vote on closing down a base. And the other is the establishment of accounting standards. And for FASB to be undermined,
to be overruled, I think would be . . . would have grave economic consequences.

I believe that there is a great likelihood that the SEC is going to defer the implementation of FASB’s recommendations. Now it hasn't been announced. There will be no public hearings in my judgment, but I suspect that it is moving through the commission by seriatim, and that we will find a deferral to probably January of next year. Now while there may be benefit to having companies report as of January rather than midyear, the danger of all this is to enforce and enable the political powers that—on behalf of high-tech America—to overrule the FASB, and that I think would be truly tragic.

So that’s the landscape that we’re faced with. I believe that any proposal, any rule, any congressional action, obviously has unintended consequences. I don’t think you could describe a single one that didn’t fall into that category. But I feel so strongly about the issue of good accounting—about full disclosure, about placing the emphasis on what investors are entitled to know—that even a flawed proposal is better than none at all. And I believe that my colleagues who have created a paper which highlights some of the flaws—and, in my judgment, improves the process—they too would agree with me that any effort to derail the process would be wrongheaded and disruptive.

So those are my own observations. I heartily embrace the methodology, the process, the brainpower that went into this, and the effort that lies behind it. And with that I will turn this over to Trevor to bring focus and open up issues that presumably you’ll have further questions and dialogue with.

Thank you.
Trevor Harris: Thank you, Chairman Levitt. I want to welcome you here. I'm not the main speaker today by any stretch of the imagination. The center was created with Stephen Penman, my codirector, and I, about just over a year ago, and our objective is to bring the best thinking of academia and practice together by bringing the great minds in both places. We've started somewhat slowly on these projects, and we have a great group of people here. And I'm hoping that what will happen is, after these presentations, is many of you will participate, because in some sense hearing from all of you is just as important as hearing from Stephen and Jim, who were . . . Jim was my former mentor and colleague at Columbia, then he made some errors and moved on elsewhere, and we brought Steve and Sid on at the same time. But this is a project that we hope, as Chairman Levitt said, will bring new thinking and different thinking to the whole process.

And just to emphasize the objectivity, what happened in this process was they prepared a paper, Stephen and Jim. We then had a roundtable discussion where we invited people from all walks, including people from the FASB and ISB. There were two board members from each actually participating, someone from the SEC, people from practice, and so on. And one of the board members who probably everyone would know (but I'm not telling which board he came from), but he sent me a voicemail last week and said, "I'm not coming to the lunch because I gave you my view, and the authors clearly didn't listen to it. And so I didn't feel I could come again and give you the same view again." And the point of that is this person has very fixed views about many accounting issues. And the authors, the people who participate in these processes, are trying to sort of bring the discussion to a different level, and it's not just about coming up with the answer that they want, it's coming up with broader answers. And when you think about this particular topic, and clearly stock options
in some sense are only a piece of it, what actually happened is—and this is part of the regulatory difficulty we have—this project actually started in 1986 as part of the whole issue of financial instruments. But there was a discussion paper, which this is equivalent to, that was published—and I checked this yesterday, just to make sure—in 1990. So this has sort of been a debate that's been engaged on for over 15 years, and those of us in practice and in academia know we are very far away from a solution. And given that, the hope is that people will actually take a step back and try to look at this conceptual framework that Steve and Jim are going to talk about, because there are real issues here that will help to address a myriad of problems. And to put that in perspective, if you look at the Financial Accounting Standard 150 that came out of the deliberations—that's the latest one—they try to solve this issue of, you know, What's a liability versus equity in terms of how it's settled? Well, settlement is not the issue. The issue is that, as we know from those of us in practice and in academia, you understand the operations of the business and then you try to see how it's financed and what claims those different sources of finance have on the operations of the business—both the business itself and the cash flows that are generated from it. You've got to look at it from that perspective and then go down, in some sense, the pecking order that's associated with it. Once you take that view, you come up with a set of well-reasoned, logical answers. If you don't take that view, you come up with confusion and conflict all over the place. And that's essentially where all the standard setters are right now. They end up with conflicting solutions, in part, because they're starting from the wrong point, and that's what they're revisiting. What Stephen and Jim are trying to do is sort of get back to that starting point so we can work forward.

From a practice point of view, this is incredibly important. Those of us—and I see people like Janet and Michael here, and some of my friends
from the buy side—we all have to deal with issues—Well, what is the right earnings per share? What is the right PE, if there . . . if such a thing exists? How do you deal with enterprise-value-type issues? And, actually, how you classify these issues makes a huge difference. And one of the things that I find so interesting is when I talk to our clients about employee stock options, I always say, "The debate about the expense is not the issue, because it’s price times quantity. You can give me whatever price you want, but if I’m going to pay people compensation, OK, I can change the value of that option. I’m just going to have to give them more if, in fact, like us, we get part of our compensation in shares or options." That means if you’re going to pay it, the price is less of an issue. The real problem for those of us who have to value equity securities is, What do we do going forward as more of that future wealth gets transferred? Because the real hard part is, How much of this will we actually get if we want to hold the stock for a long period of time? And for the bondholders it’s terrific, because if you can pay for certain services you get without giving up cash, you get some of that risk transferred basically in your favor. So Chairman Levitt spoke about the shareholders being the sort of primary audience. If you believe that—and this is a huge issue that goes far beyond the expensing, and you know, the concern that if somebody who doesn’t want employee stock options might use this as a way to say "Don’t expense"—there’s a very simple answer: Listen to what these guys are saying and you have an answer. There’s a true-up process throughout accounting. But the true-up process will make this seem even more expensive from a reporting point of view. So that’s not one they’ve often wanted to go down.

So just to sort of put this in context, this is not just about employee stock options, but it’s a terrific example that illustrates a much more fundamental issue. And we in the capital markets will find all sorts of ways to partition where the different claims lie to give you a whole array
of opportunities if you're on the investor side. But if the accounting doesn't factor that in, then we end up with a morass and lots of other sort of problems that get created from there.

So I'm going to hand it over to Stephen and Jim, who are going to present this, but as I say, we hope that you will push them, push us, ask lots of questions, and debate amongst yourselves at the end. And I really appreciate all of you coming to this lunch. Stephen.

**Stephen Penman:** Thank you, Trevor, and good day. I'm going to take you through the basic ideas in the white paper. I'm your setup man. And then I'm going to hand over to Jim Ohlson, at the end of the table there, on the gruesome details. I'm not going to take you all through the details of the accounting. The idea is to give you the flavor, to give you the overview.

As both Chairman Levitt and Trevor indicated, the accounting in this paper is about reporting to shareholders. When we came to set up this center, we had the understanding that accounting is by fiat, the accounting can be anything you want it to be. And you can talk about GAP earnings and pro forma earnings and any sort of earnings, it depends what you want. Before you do any accounting, before you do any prescriptions about accounting, you've got to decide what you're doing. This paper is deciding that what we're doing is reporting to shareholders, reporting faithfully to shareholders, the owners of the business. So that should be very much understood when we come to our discussion.

Once you have that perspective, certain things fall in place. I would hope this is not a controversial position—the annual reports are reported to the shareholders at the annual meeting, the auditors report to
shareholders, the board of directors has a duty to the shareholders. So we don't think we're on very slippery ground when we say, "Well, financial reporting should actually have something to say to the shareholders." If, in fact, you're reporting to shareholders, a couple of things immediately fall in place. On the balance sheet you've got claims. You've got to distinguish between the claims of the shareholders and the claims of others. We have to divide up this value here: What claims pertain to the shareholders and what claims pertain to others? And the income statement, if you want to report income saying, How well did the shareholders do this period? the income statement has got to be comprehensive, that is, you can't leave anything out. And these are really two very basic notions in the document.

Let's remind ourselves what we're talking about here, run through this very quickly. We're talking about this issue of these contingent claims that some people see as having some characteristics of equity, some characteristics of debt, fall somewhere in-between. Some see them as being able to be broken up between debt portions and equity portions. The examples, they've all got the generic form, that on the initiation cash is received by the firm or, in the case of employee options, services are received or services are promised. And ultimately there's a settling up. In these cases, the case of these claims, the settling up involves settling up with shares, common shares, sometimes with some cash involved. Examples are warrants. Cash is received and there's a settlement. If, in fact, the warrant is exercised, there is shares surrendered, debt of cash received. Convertible bonds, cash is received, there is some cash paid in interest on the bonds, but ultimately there's a settling up with shares disbursed, net of cash received. Convertible preferred stock, from the point of view of the common shareholders, and I stress that, the common shareholders, a convertible preferred stock, received cash, dividends are paid, and ultimately there's a settling up. In a sense, the common shares
are distributed net of cash received. Put options: firm writes put options, cash is received, and there's a settling up. If, in fact, the options are exercised, there is cash paid out in repurchase of the shares at a price greater than market value. Sometimes the settlement is net-share settlement.

The perspective we take in this paper, which follows very much from the ideas we are reporting to the shareholders, in answer to the question, What is the effect on shareholders' wealth? These claims are borrowings. As a feature, cash is received, initiation, it's a borrowing, and then you pay off the loan, the effective loan, either with cash or with shares, or a mixture of cash or shares. In paying off the loan, paying with the shares in substance is no different from issuing shares for cash and using the cash to settle the obligation. We call this borrowings. From a common shareholder's point of view, you're borrowing and you're settling the obligation with shareholders' wealth.

Employee stock options—which Chairman Levitt mentioned, of course, which is so controversial—these fall into the packet. As Trevor said, it's not just employee stock options, it's a whole packet here. Note that all these instruments have very common features; they fall into that generic timeline they indicated. One way of uniting employees based on the performance of a stock is a stock-appreciation right, an SAR. At initiation, a labor contract is signed, services are given or services are promised, and the labor contract is satisfied by paying cash to the employees on the basis of the appreciation of the common stock. GAP says that's wages, and indeed the cash paid as the stock price appreciates, and in settlement is wages expense. An employee stock option is in substance no different from a stock-appreciation right, except the settlement is a little different. There's a labor contract, services are given or promised, and at the end there's a settlement based
upon the appreciation of the stock. And that settlement, of course, is in shares at less than market value, or shares issued net of cash received at the exercise price. These two instruments are identical in substance; they differ only in form.

OK. Having understanding of the instruments, let's lay, set down, the principles on which our recommendations here, our policy recommendations, are built. A basic principle in finance: if you issue shares at market price, issuing shares at market price does not change the per-share value of the shares. OK, we understand that one, right? Correspondingly, issuing shares at less than market price hurts the existing common shareholders, the owners of the business. And repurchasing shares at more than market price in the exercise of a put option the firm has written hurts the shareholders. This is a very basic principle of finance that we teach almost first week in Finance 101. You cannot create value by issuing shares or repurchasing payers at the current market price. It doesn't change the per-share value. But if you actually issue shares at less than market price or repurchase at more than market price, it hurts the current shareholders. Call it dilution, if you wish.

If, in fact, we're reporting to shareholders, our document insists, we should recognize that in settling these borrowings, or settling these labor contracts, with shareholders' wealth, there's been gains and loss to shareholders.

As far as the liability is concerned, we see the claims as obligations, obligations to settle, to settle with the shareholders' wealth. And we see no difference in substance, from a shareholder's point of view—if you settle with cash you disburse assets, or you settle with the shareholders' wealth in terms of distributing shares at less than market price, or
repurchasing shares at more than the market price. These are obligations. And so, indeed, in our document we have now a definition of an obligation which distinguish debt and equity: Any claim where the obligation is to be satisfied by giving up shareholders' wealth is debt. It is not equity.

Now, current GAP. Well, current GAP, to say the least, is very inconsistent on the treatment. Convertible bonds are debt. Warrants are equity. But a convertible bond is just a regular bond with a warrant attached, so to speak. Employee options are equity. Put options, at least under some circumstances under Statement 150, are liabilities. A warrant, a call option, is equity, but put options are liability. Preferred stock, from the common shareholders, can be equity—even their convertible preferred stock are equity, or of course they can be mezzanine, whatever that means. From an accounting point of view, who are these—what is a mezzanine, who's sitting on the mezzanine, whose mezzanine—if they have certain redemption features? Clearly there are inconsistencies here.

Now, the good folks at the FASB have struggled over this one for a long time. And I should say we're very much on their side, and this document is offered very much in the spirit of trying to resolve these issues.

Trevor mentioned a document from the FASB back in 1990, it's called "A Discussion Memorandum on Debt Versus Equity." Well, I think quite well they sorted out the issues. It's a very good document. I think, reading between the lines, that they're aware of these inconsistencies and are struggling to deal with them. What is debt and what is equity? It seems like a very basic question for financial reporting. They're offering this document as a solution. Decide you're reporting to the shareholders and then debt-versus-equity falls in place.
In cases where some of these instruments are reported as equity—an employee stock-option equity, a warrant equity—really, from a shareholder's point of view you're putting liabilities off balance sheet.

The income statement. Well the GAP income statement under the shareholder view of things is incomplete. The interest on convertible bonds is interest expense. But the cost of conversion, the loss of value to shareholders when the debt is converted, is not a financing expense. Financing expense, interest expense—as it were, borrowing cost—is understated on the income statement. Labor expense is recognized when you pay cash under a stock appreciation right, but when you settle an equity it's not recognized. And I hope you'll agree, employee stock option and a stock appreciation right are in substance exactly the same thing, substance over form. If FASB Statement 123(R), which is due to be implemented this year, perhaps with some deferment, of course, addresses the issue. Under a very severe political environment that Chairman Levitt has referred to, the FASB has finally gotten to the stage, with many of their efforts thwarted in previous rounds. And ought to be congratulated for their courage and persistence.

Our document says, "Well, if you really want to complete, go the whole hog, there's some further things to do. And doing this you'll sort out what is the difference between debt and equity, which is the problem that is nagging you."

Under FASB Statement 123(R), of course, an expense is recognized on employee stock options at grant date. We book the measured option value as a wages expense to be amortized over a service life. But that's a start, that's good. Unfortunately, the other side of the entry, the credit side, is treated as equity rather than a liability, a liability to issue stock.
And, of course, in fact, as this option goes into the money, no loss is recognized. And as it’s exercised, there's no recognition of a loss. An exercise-date accounting would treat the loss as occurring when, in fact, the option is exercised, and everything before is just an anticipation of this loss, a liability. Indeed, of course, 123(R) recognizes an expense, of course, if the option does not go into the money and ultimately is not exercised, there's no expense. But 123(R) doesn’t reverse, it doesn't settle up, there is no settling up to shareholder value. The feature of our document is, hey, you've got to settle up with the shareholders. And if, in fact, you recognize an expense and, in fact, it’s never exercised, there should be a gain to shareholders. I'm not sure if I'm quite right on this, but I think this is the only instance of accounting . . . accrual accounting has this attribute: that if you book too much now you're going to book less later. OK? Your accruals reverse. Here's one instance where, in fact, you're not going to get the reversing, a permanent effect on the book value of equity without there being any economic cost. Our proposal is for a settling up.

And so, of course, you've got adverse consequences. Accountants . . . we teach this in class, accounting principles should be consistently applied. And all transactions which are [the] same in substance should be accounted for in the same way, irrespective of the form. A stock-appreciation right, an employee stock option should have the same accounting. All these contingent claims exactly have the same form. Well, have the same basic form with some minor variations in the contractual terms. And so there's an application of a consistency principle here.

The title of our discussion today was "A Comprehensive Solution." A bit pompous it sounds, but indeed it is a comprehensive solution, that for all these types of claims which are similar in substance, they should have the same accounting. So what does that do? Well, of course, it finesse
the structural engineering, the financial engineering, to create instruments, which are in substance the same but in different form, to achieve a desired accounting.

And we’ve run off some examples. Convertible preferreds with low dividends, the high-conversion privileges. It looks like your financing costs are low. Buying with put options rather than loans. Well, FASB 150 [unintelligible] has a way to clearing this up. Rather than looking to a loan from a bank, buy a put option, repay with stock. Bonds with both put options and call features, with call features and put features. Did you construct them? We actually recognized interest revenue. And stock options rather than SARs. If, in fact, instruments with the same, same in substance, accounted for the same, this finesses the financial engineering and, we think, gives a representation of the economics of the business and brings transparency to the accounting, and above all satisfies the objective of faithfully reporting to shareholders.

OK, now I’m going to hand over to Jim Ohlson, who is going to take you through the details of the implementation of these notions. Thank you.

**James Ohlson:** OK, thank you, Stephen. What I plan to do is sort of run through what the accounting is all about, and I think to some extent, of course, what I’m going to talk about you can sort of almost anticipate from what has already been said. What I’d like to emphasize are three things before we get up and running. First of all, what people have been repeating over and over is that the accounting here is predicated on that it's from the shareholders' perspective. And when I mean shareholders, I mean common shareholders. The fact that there are stock-related claims outstanding should be distinguished from being a stockholder. So that’s very important. This runs contrary to GAP, and this principle is indeed stage-setting. The second thing I’d like to emphasize is that when it
comes to income, we try to make a clear distinction between what's called recurring items and nonrecurring items. The way we approach it is by putting nonrecurring items in other comprehensive income, and this is sort of generally consistent with GAP. I will say a few more things about that later. Finally, but not the least, I would also like to emphasize that this is indeed a product by two academics. We are not daydreaming; this accounting is entirely doable. Now there will be always be some devil in the details whenever you have practical accounting, but we certainly think that what we are proposing as a practical matter is doable, and I'd like to emphasize that.

All right, so here we go. First of all, of course, if a stock-related claim is issued, you are going to have a liability. This is consistent with accounting for put options right now, it's inconsistent with accounting for warrants, and it's inconsistent with, of course, the accounting for stock options. There will be a liability outstanding. There may be some offsetting asset, and I'll talk more about that later when I get to the stock options.

If the company has a liability, there has got to be a regular cost associated with the liability, so you sort of have the effect of an implicit interest cost. And the basic idea is very straightforward. You have a liability at the beginning of a period, and you have some estimated cost associated with this liability, which is sort of going to be the expected return from the point of view of owners of that claim. And so you can impute a regular interest cost, which will be there in the income statement. Each and every period, you're going to have to revalue the liability. And if you have a market value, that's very straightforward. If you don't have the market value, then you're going to come up with some reasonable procedures. It's no different from a lot of other liabilities, and that's what companies are going to have to do in the case of put options.
We believe it can be done for options, which of course is inherent in some of the pronouncements, and we believe it can be done for warrants or whatever have you. So you revalue the liability. Now, as you revalue the liability, of course, you can view that really as a nonrecurring gain or a loss. If the company's doing well, the value of the claim, if it's an option, is going to go up in value. You can view that as essentially nonrecurring, or in our terminology is what you call a windfall gain or loss, and that windfall gain or loss is different from the regular financing costs. And we propose that this windfall gain or loss is just going to bypass an income statement and show up as other comprehensive income. This kind of accounting is entirely consistent with the way companies account for marketable securities. If you have unrealized gains and losses, you bypass the regular income statement, and you put it into other comprehensive income. So there is nothing in that approach which is sort of peculiar. One can object on . . . that GAP is not very good, but the key thing from our point of view is that there's a cost associated with a liability. Some of it's regular and occurring, some of it is nonrecurring, and the income statement in whatever form or shape it's put forward should make that distinction, of course.

And finally, the liability, of course, is somewhere along the line going to get extinguished, whether it's options, warrants, puts, convertible bonds, or whatever have you. Some of the settlements may need to be the fact that the claim is worthless or whatever have you, or sometimes it's going to be settled by cash or as the case may be. Now once your liability is extinguished and settled, of course, then the unrealized gains and losses is going to turn into realized gain or loss, so again the accounting from our security here serves as a metaphor, and we suggest that basically you do the same thing.
This is how the accounting runs. And again I'd like to emphasize that there are just two guiding principles. The accounting here is from the point of view of your common shareholders, and as you prepare income items we want to make a clear distinction between recurring items and nonrecurring items, or what we call windfall gains and losses.

So options always get the most attention. So there are some few twists here. The key thing is that the grant date—the accounting is essentially similar in some regard in that there's going to be a deferred compensation. Now in our accounting we're going to have a deferred compensation asset and a liability, and in our accounting we actually suggest for the deferred compensation asset should be treated as a contra-liability. GAP has problems recognizing tangible assets, and we tend to agree. Deferred compensation expense is not an actual asset, but it's a very natural contra-liability, now which you offset against option liability. So that works quite nicely. And so that makes the second point here. So that's sort of a difference at the grant date.

Overall, the average expense is going to be the same, but we are also going to have windfall gains and losses. So here's some additional treatment after grant date. We mark the liability of fair values absent of all the changes. However, but you notice here that this revaluation is not going to affect your regular income statement, OK? It's just for completeness when you settle up.

And then we're going to have a recognized and implied interest cost, we think, that could be viewed naturally as part and parcel of a compensation expense, in addition to amortization. It's not a big deal. And then we have unrealized gains and losses, and then finally we're settling up.
So what does this come down from a political point of view, so to speak? On the average, our approach, the expense, is pretty much going to be the same, on the average, as for proposed accounting. The balance sheet is not going to be all that different because we're going to have a deferred compensation expense offsetting the liability. So on average, it's not going to be much of a difference. The real difference here, of course, is that the accounting here is in the spirit of ultimately everything is going to have to be trued up. And that means that when you get down to the settlement, all of these nonrecurring gains and losses are going to have to become realized, so ultimately there is going to have to be a trueing up. And that's sort of very much in the spirit, of course, of how the accounting run for tax purposes. So from that point of view you get a consistency.

All right, so that's my little spiel here. If you want more details here, I have a summary of a proposed accounting. Again here, it's just a restatement of what I've been talking about here. And you can look at it again here. Those of you who love intermediate accounting, I have explicit statements as to what the balance sheet and the income statement is going to be all about. And finally, some people like numbers, so that's also to be digested in conjunction with having coffee and cakes.

All right, so that's my key thing here. And again here, what is it that I'd like to emphasize? The accounting is from a point of view of common shareholders. That's really the guiding principle. And from that point of view, the proposal is radical. If you buy into that premise, I think most of the rest pretty much falls into piece as being fairly consistent with generally accepted accounting principles.

OK, thank you.
Arthur Levitt Jr.: Thank you very much. We have a very interesting, elaborate, and I think soundly based theory that’s been put forward. But we are operating in a very real-life market. And the market moves regardless of our theories. Many of you probably know already that games are being played in anticipation of outcomes. A hundred and two companies with a medium market capitalization of over 600 million dollars accelerated the vesting of stock options in anticipation of FASB’s efforts. Technology companies comprised 36 percent of the accelerators. And by this acceleration, over a billion dollars of stock-option expense has circumvented income-statement recognition in future periods. So this is an enormously dynamic period.

You have before you a theory. I’m personally prepared to say that I think it represents certain specific improvements and refinements. And I think all of us agree that we hope that this would do nothing to slow down the process of recognizing the expenses involved in the granting of stock options.

Now we're running a little bit overtime, but I'd appreciate having your questions directed to specific panel members or all of the panel, so questions rather than statements. Who's first? Yes.

Man: Do you know why the FASB insisted on proceeding with this treatment of the stock options as equity? Is it really to make consistent with the long [unintelligible] of these stock-option warrants that you mentioned, or is there some other reason? It looks kind of tortured. Your method seems a lot better.

Stephen Penman: Well, the FASB has a problem because they work on a conceptual framework. There’s a document called "Concept Statement No. 6" that defines a liability, and in that document a liability is defined
as an obligation that requires a distribution of assets, cash. OK? So when there's settlement in shares they say, "Hey, this is not a liability because it doesn't involve the distribution of cash." From a creditor's point of view that may be fine, because you worry about the cash. From a shareholder's point of view, it's not fine. And so, not speaking at all for the FASB, I presume that the designation of an option liability as equity follows that definition. That's caught them in a bind because now 150 with put options, they said, "No, this has got to be a liability," because they can see the effect of borrowing there. OK? Rather than needing a loan from your bank, you borrow on a put option. And so they're in a bind. Their document said, "Well, we'll call some things liability-related claims and some as equity-related claims," which is just putting names on things. You can see that in science, sort of puts names on things. But this I think is their problem. And that's . . . and they've freely admitted the problem. We're in a bind here. And in the discussion of 150, they've said that we have to really reexamine this question as well as a liability.

Trevor Harris: I think there might be some staff members from FASB here that are free obviously to answer. But the other issue is a more generic one. The reason why this is a general framework is if you look at what's going on in the business-combinations area, now minority interest is going to be treated as part of equity. That's totally inconsistent with this. And the problem with the current framework is that, depending on the topic, you end up in a bind relative to the rest of what's called the literature. And so you always end up with the potential to look in a different place, to get a different answer, which just creates some of the rule-based issues that exist right now. And they're always being pushed to answer it relative to a set of rules. And so I think that part of the difficulty, frankly, it faces . . . they're dealing with a lot of existing practice which is based on a conceptual framework that doesn't allow for what Steve and Jim have done, which is sort of go a little bit above that.
And they're revisiting with the ISB their conceptual framework. And part of I think what we hope in the center is that they can start using something like this as a basis for reestablishing a conceptual framework so that they can then go down to the details beyond that.

James Ohlson: I mean there's one more point one can make, which is that it's the history of GAP that they never had the strict shareholders' perspective, quite aside from the problems associated with the more complicated securities. It's well to note that the accounting for preferred stock, which from the point of view of the common shareholders is just like a regular liability, and that's how we always have to teach it. But preferred stock, regular or the preferred stock is treated [as] part of what they call owners' equity. And the preferred dividends do not show up in the income statement. Now, of course, the readers of financial statements—they always know that's nonsense. In other words, you have to redo the financials. So from that point of view one has to recognize that it is indeed the case that any proposal to take on a shareholders' perspective is quite radical. And that's a statement that goes quite aside from the complexity associated with minority interest war and stock options and whatever have you. But in the end, we think that's what will happen.

**Man:** But is this likely to be the issue around which the opposition to your proposal might revolve? It seems to me that the real key question here is the optionality of the contract, and that you might be able to treat something as equity either if the price is set at the grant of the option—right?—but there's also an obligation to buy the stock at that price, which means that the owner would be long to fall and short to put. Or that the contract which was written to buy the stock at the existing price at the exercise of the option, and therefore there's no predetermined strike price, there's really no optionality for the holder.
Trevor Harris: I'm going to try and answer you in a less technical answer. When people have opposed the expensing, there are two arguments that tend to come up. One is the measurement issue. And the second is—which we've only seen post-2000, we never used to see that argued that much before—was but a lot of these options end up out of the money, and so there's no real value to them. This solves that problem, OK, because essentially what you've done is you've done a risk transfer from the shareholders to the employees.

The second part of answering your question is . . . Jim and Stephen, and to some extent the two of us have talked about the shareholders, but it's a very explicit shareholder, it's the current shareholder. Once you take the current shareholder, that optionality is true in every obligation. It's true in purchase of inventory. I mean there's optionality, as Chris Cobb would say, in every element of the financial statements. So I think you can take that argument, but it's very simple, in at least my mind, and I think what Chairman's . . . what cash can the current shareholders take out and put in their pockets at the end, out of the operations of the entity, after all the other finances have been paid? That's what you're trying to get.

Arthur Levitt Jr.: I'd like to pose the question to the audience whether there are any here who really believe the exercise in recognizing stock options as an expense is wrongheaded and shouldn't be done. I'm operating on the assumption that most of this group does not feel that way. Good.

James Ohlson: With you standing there, no one's going to say no. However, I think there's one point which is worthwhile to keep in mind, is that some people who are against expensing options argue that the problem is
taken care of when you calculate the EPS number. And of course one can argue against that, but the key thing is that some people say that the proper way of thinking about it is that you have to straighten out the EPS calculation, and I think that should be recognized as a way of looking at it which has some logical merit. We actually believe that if you do it properly, if you have the proper numerator, you need to worry about how to make adjustments in the denominator. But it's well to recognize that there are sort of two points of view. The numerator needs to be straightened out, or the denominator needs to be straightened out. And we say the numerator, and therefore you don't have to worry about the denominator. But I think that's sort of an important aspect.

**Trevor Harris:** There's a question of whether you're going to account for the value through numerator or denominator. I mean you could buy your inventory with shares, OK. You're going to account for cost of goods sold with the denominator. It would seem to be that would get sort of out of it. That's not a very good discipline.

**Arthur Levitt Jr.:** Other questions? Yes.

**Man:** You mentioned previously that a lot of companies had accelerated their option expensing. And despite that we saw what we calculated at least as an increase in unreported option expense in 2004 for the first time in about five years. We also saw that the volatility assumptions underlying the option grants went down. So it seems like, given the statements that the SEC has made recently with respect to the leniency they're going to provide companies on how they arrive or how they calculate the assumptions underlying their option grants, we could be in a position where we're seeing the pension accounting issues all over again. Where the assumptions about volatility, dividend yields, risk-free rates can allow companies to manipulate the underlying option grant
value, or the value of the option at the grant date, in the same way companies were able to manipulate the value of their pension liabilities.

**Arthur Levitt Jr.**: I think you’re absolutely right. And when you have a process that is so highly politicized, very often the effort to arrive at so-called political equity results in distortions that really defy the kind of clear, hardheaded reporting that you were striving for. The SEC is operating under huge political and business pressure. And I would hope that efforts to temporize don’t create a much worse process. And your analogy with pension accounting is very on target. All too many companies and municipalities have made those compromises, which has not bettered but worsened their situations. And I certainly hope the same doesn’t hold true for the options debate.

**Trevor Harris**: One of the problems with the current FASB proposal is that if you do lowball the option value, through lowball to the estimate, it never comes back and hits you because there’s no settling up. So if you lowball your depreciation, OK, it always comes back and hits you. You lowball anything else in accounting it always comes [back], that’s how accrual accounting works. If you don’t have the settling up, you don’t get the ultimate cost of doing that.

**Man**: The discussion is largely about how to account for different compensation techniques, for example, in the stock-option area. But if you think about what happens when the tracking of accounting expenses for stock options takes hold operationally, there will have to be a different way to compensate the highly compensated individuals who have gone to options in part because of the lack of deductibility of compensation over a certain hurdle. How do you see the ability to compensate key individuals changing and adapting to the income-statement impact that will accrue if options are accounted for differently, and what will be the
next area of compensation to try to settle up for those employees who are otherwise well-cared-for now through the use of options and not through cash?

Arthur Levitt Jr.: That's very difficult to tell. I personally do not accept the arguments made largely by Silicon Valley that this is the end of options. Paul Volker would tell you it should be the end of options, that they have resulted in abusive executive compensation, they've been the driver for that kind of compensation, and options just should be banned. I don't feel that way. I think that if options have value, the expensing of options may diminish the use of that program, and I have enough confidence in the resourcefulness of the business community to come up with alternate plans, whether it be more cash compensation, a whole host of other devices that have been used through the years. But I believe the notion that the expensing of options will eliminate them as a useful compensation tool, I simply do not accept, I think that's wrong.

Man: [unintelligible] is that if the cash compensation is no longer deductible over a base minimum, how do they operate up against the tax code, which is providing a different constraint?

Arthur Levitt Jr.: They'll simply go ahead and not have the deductibility. We'll have a new standard of compensation, and new elements of compensation. I don't know precisely what they will be, and I wouldn't personally be overworried at the diminution of the amount of options granted. I think there probably will be some diminution, but not the elimination, in my judgment. Yes.

Man: I think this question is for Steve. On the theory that these things are forms of borrowing, you identify an interest cost and then proceed to identify an appreciation-depreciation adjustment, an equity gain or loss,
something of that sort. I worry when one security begins to look like another. And I worry about the case where the option has a strike price of zero. Would you once again carve out an interest cost on what amounts to an equity issue, and remember that from the point of view of me, one shareholder, every other shareholder has that kind of contract with me. Should we recognize in every shareholder a return, an interest return, and then look to a gain or loss?

**Arthur Levitt Jr.:** Good question.

Stephen Penman: Jim’s allowed to answer, too.

James Ohlson: This is not the first time we've heard this question. And since we've heard this question before, you expect to get a good answer. The difficulty we face, of course, is that—and this is true in accounting in general—if you come up with any concept or any kind of contract, you can always create the contract which is almost identical to what you already have in place. And basically what you're suggesting, of course, which is an important point, is that the warrant with a zero exercise price is the same thing as a common stock if the company doesn't pay any dividends. So what does this mean as a practical matter? Well, it means that essentially, somewhere along the line, you're going to have to come up with, you know, a rule. And our basic idea simply is that in general we don't see this as being a problem, and in general if there's any kind of contract outstanding which in some sense has sufficient dissimilarity to regular common stock, it should be classified as a liability. This problem also arises, as it were, if you have a company that issues common stock with a put option attached to it. So you can come up with many kinds of securities which are very, very, very similar to regular common stock. So what we would then say is, Well, you know, we have to, you know, try to deal with that as, you know, we move along.
And we're never going to have easy and straightforward answers to these kinds of questions.

Man: If we went the other way and declared no interest on this, I gather we could end up at another seam, which is where we construct one of these things so it looks really a lot like debt, and we'd have zero interest debt. And then . . .

James Ohlson: Yes.

Man: So because this thing is something of a hybrid, or a continuum between debt and equity, we have, in effect, a changing interest component. Does that suggest that maybe we should be reflecting that in some way? I'm thinking of Black-Scholes type equations which actually allow that to some degree. Where you could get the interest in such a way that it would be seamless. I'm thinking of the curve of an option that hasn't matured yet, where at one end you've got a—I forget the derivative, the Greek's name—but it's a one, a delta of one or zero. Might the same thing be doable here so that this thing moves from being all equity with a zero strike to all bond or all borrowing with some other sort of strike, we'd have a continuum. Seamlessness is obviously a good thing, and I'm just identifying two potential seams and asking you to sew them together.

Trevor Harris: These kinds of questions are going to arise. I mean, another example is a convertible bond which has absolutely no chance of conversion. We're not recommending here that regular debt gets market to market, OK? At some point you say, "Well, it's just a characteristic of regular debt." Well now we're no longer going to market to market, and fair-value it, and calculate the employed interest rate. We're going to treat it like regular debt, because it's so far out.
Arthur Levitt Jr.: Last question before we . . . . Yes.

Man: Chairman Levitt, is there any word that the IRS might change the treatment of the tax expense that goes with the option? As far as I understand, it doesn't occur until the option is exercised, and in many cases provides a tax shield that is much larger than the expense that's reported to shareholders and actually shelters income in future periods against taxation. Isn't that the true problem with these stock options?

Arthur Levitt Jr.: I'm not aware of any such effort.

James Ohlson: And I would could conclude that the IRS has actually got the accounting right. They use exercise-debt accounting. They use exactly the method that this is. So the companies are getting it on the tax side, they're just not taking it on the accounting side.

Trevor Harris: Yes, you're getting a tax benefit without recognizing the expense associated with where the tax benefit came from.

Arthur Levitt Jr.: Thank you very much for being with us today, and thank you gentlemen for a first-class job.