THE WHITE HOUSE

WASHINGTON

May 5, 1992

MEMORANDUM FOR DEPUTY SECRETARY ROBSON
ASSISTANT SECRETARY POWELL
ASSISTANT SECRETARY MCLOUGHLIN
ASSISTANT TO THE SECRETARY GRAETZ

FROM: J. FRENCH HILL
SPECIAL ASSISTANT TO THE PRESIDENT

SUBJECT: Our Meeting with Richard Breeden, Tuesday, May 6, 1992

In addition to reviewing the SEC's timing and proposals for proxy reform, I want to make sure that we cover another critical issue: Valuation and Disclosure of Stock Options.

Disclosure:

No one can argue about the style and quality of the current proxy disclosure requirements for incentive stock options. Both are lacking.

As a result of their February Executive Compensation announcement, the SEC proposed for public comment significant disclosure improvements in both style and quality. We should ask Richard what his current thinking is on this format.

Valuation:

In the February announcement, the SEC also committed to a 120 day study of how best to determine a present value formula for stock options. This present value amount of options would be treated as a compensation expense and run through the company's income statement (this would be accomplished through an accounting change by FASB). This is opposed by the Business Roundtable (BRT), the National Venture Capital Association (NVCA), American Electronics Association (AEA), and United Shareholders of America (USA). During our January meeting, we cautioned Richard on the negative effects such a change could imply -- especially for start-up companies.

The FASB has tried for eight years to select a present value method and has failed. Sources say that Richard is giving up on a direct FASB accounting change and is moving toward a financial statement footnote or enhanced proxy disclosure using a present value formula -- but not running it through the income statement. I believe we should oppose the "present value approach" to this alternative as well.

The reasons for opposition are as follows:

(1) Making Accounting Changes Produces Accounting Losses. Options are already reflected in reported Earnings Per Share (EPS) through fully diluted shares. An AEA study of the use of present value accounting for options in 1987 found that company profits would be cut by 43.5%.

(2) Destroys Incentives for Option Use. Running large option values through the P&L as compensation will discourage use -- especially by small or early stage growth companies. Both public and private firms use large option grants to attract talented personnel and to tie their performance to the company's.

(3) Publishing a Single Value May Attract Populist Tax Proposals. Let's say an executive makes $100,000 per year and has options that have a present value of $1 million. Populists on Capitol Hill may count this in annual compensation even though it is yet unearned and unrealized. Further, the employee has received no cash to pay the tax.

(4) Present Value Calculations in either a Footnote or as a FASB Accounting Change are by Definition a Projection. Normally, the SEC prohibits firms from projecting financial performance projections. If the projections don't come true, there will no doubt be specious shareholder suits brought.

I am concerned that even a footnote utilizing a present value method will create problems. Why?

- FASB usually follows the SEC. This is Richard's "back door" way to achieve an accounting change.

Recommendation:

I believe all business groups would support a disclosure like that which is attached. It facilitates comparability among companies. But, it does not project future performance or attempt to select a discount formula (best left to an individual investor).

attachment

cc: Al Hubbard