United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

September 14, 1993

Mr. Patrick McGurn
Director, Corporate Governance Service
Investor Responsibility Research Center
1755 Massachusetts Ave., N.W., Suite 600
Washington, D.C. 20036

Dear Mr. McGurn:

I am writing concerning the issue of stock options and S. 1175, the Equity Expansion Act. Because I believe this bill is harmful to the interests of investors and business, and would reverse gains made in advancing pay-for-performance compensation of America's top corporate executives, I wanted to alert your organization to the problems with this bill and the need for stock option accounting reform.

I believe that compensation policies linking executive pay to corporate performance are crucial to American competitiveness, and I have spent the past two years trying to change federal practices that discourage this pay-for-performance link. Hearings and legislation I introduced in 1991, helped produce SEC decisions which have enabled stockholders, for the first time, to voice concerns in stockholder votes at annual meetings about how CEO pay is set in their own companies, and also required corporations to clarify the amounts and reasons for executive pay. A third major reform involving stock options, however, remains at issue.

Right now, stock option compensation is the only form of executive pay which a company can deduct from its taxes as an expense, but is not required to include in its financial statement as an expense. That's why stock options are such a popular, off-the-books method of payment of executives, and why I refer to them as stealth compensation.

As you know, the Financial Accounting Standards Board (FASB) recently issued for comment a draft proposal requiring that stock option compensation be recorded on company books as an expense. This earnings charge would not take effect, however, until after a three-year period in which companies would be required only to disclose the expense incurred. This disclosure period would enable FASB to gather additional information about the true impact and fairness of the earnings charge and familiarize companies with the requirements of the FASB proposal.

The comment period on FASB's proposal ends December 31, 1993, and FASB plans to hold one or more public hearings in the first quarter of 1994. Some stock option beneficiaries, however, are attempting to shortcircuit FASB's deliberative process by urging immediate action on S. 1175 to block any reform. In light of FASB's ongoing public process, the three-year period to gather additional information, and the absence of any earnings charge before 1997, however, legislative action on S. 1175 during this Congress would be premature and inappropriate.

Secondly, legislating any accounting rule threatens to politicize what should be a neutral process. FASB is a private, independent organization of leading accountants whose mandate is to issue principles and procedures for the entire accounting profession. It consistently opposes all legislation affecting its substantive decisions as an improper intrusion on its independence. Because of that FASB position, when I introduced my bill in this area, S. 259, I stressed my reluctance to move in the legislative arena and my belief that legislation was appropriate only because FASB had failed for many years to act on an issue it had itself identified as requiring reform. My bill explicitly provides that no federal decision on stock option accounting should be made if FASB first resolves the issue. And when FASB finally issued its draft proposal, I indicated I would not attempt to move my legislation. In contrast, S. 1175's purpose is not to encourage FASB to act on a reform long promised, but to overturn a position FASB has already taken. By legislating an accounting rule in this manner, S. 1175 would set a disturbing precedent with ramifications far beyond the stock option debate.

Moreover, although cast as a bill to help business, S. 1175 would perform a disservice to business in several ways. First, granting a tax break to stock option holders, paid for by removing a company's tax deduction, would not help business. It would instead reward individuals at the expense of their companies and stockholders, further draining corporate capital to pay for their compensation. Second, by interfering with FASB's independence and politicizing accounting rules, the bill would threaten the credibility of corporate financial statements. Third, by blocking FASB's accounting reform S. 1175 would further the market distortions associated with this type of compensation.

Stock options, which are rarely used by our foreign competitors, typically provide 30 per cent or more of the pay of chief executive officers (CEOs) of large American firms. Business Week has reported that in 1992, average CEO pay at the 365 large corporations it tracks increased 56 per cent from 1991, due primarily to stock options. Examples include one health care executive who received $127 million in 1992, of which $126 million came from exercising stock options.

A 1991 hearing before my Subcommittee on Oversight of Government Management disclosed that, in too many cases, runaway CEO pay is hurting American competitiveness by dramatically outpacing: (1) company performance, (2) the pay of other workers, and (3) the pay of CEOs at foreign corporations. Contrary to its reputation as a pay-for-performance mechanism, stock options have contributed to the problem through such pay abuses as stock option swaps and megagrants. Swaps occur when a company's stock price drops, and the company replaces worthless stock options with new ones at the lower stock price, in effect rewarding executives for poor corporate performance. Megagrants occur when a company gives an individual options for hundreds of thousands or millions of shares, so that even a miniscule rise in stock price produces huge dollar gains for the option holder. Such practices have undermined the link between stock option pay and corporate performance, while adding millions to CEO paychecks.

Federal policy has fueled the CEO pay explosion by sanctioning the accounting loophole that permits corporations to pay their executives with stock options that never appear on the company books as an expense -- despite their cost to the company.

Federal policy has also sanctioned an existing accounting bias against certain stock option plans that tie option gains to performance goals, such as requiring company stock to outperform the overall stock market before any gains may be realized. Right now, companies seldom use these "performance stock options," because, under current accounting rules, they incur an earnings charge. Instead the vast majority of companies use "plain vanilla" stock options to escape any accounting for their cost. FASB has stated that there is no substantive justification for treating these stock option plans differently. Nevertheless, current accounting procedures discourage use of stock option plans that more closely align pay with performance.

Since 1984, FASB has voted repeatedly and unanimously that all stock options should be treated in the same manner -- as a compensation expense. By issuing its draft for public comment, FASB has taken the first step toward closing the stock option loophole and ending discrimination against plans that tie stock option pay to corporate performance.

Critics of the FASB proposal make a number of arguments to support their position. I'd like to go through several of them to show why they are invalid.

(1) The first claim made by some is that stock options merit special tax and accounting treatment, because they increase employee commitment, improve corporate performance and conserve capital. In fact, there is no empirical evidence that firms with stock option plans perform better than those without. If such evidence did exist, then companies would have a self interest in using stock options and would have no need for special tax treatment or accounting loopholes as encouragement.

(2) A second claim is that stock options cannot be valued and so cannot be charged to earnings as a compensation cost. No one disputes that stock options are valuable compensation -- that's why executives want them. To determine their value, experts have used option pricing models for years, while companies have used pricing models or other means to calculate specific option awards for specific employees.

(3) A third claim is that while stock options may provide valuable compensation to an employee, they impose no cost on a company, because the company is giving out its stock rather than cash or other assets. This argument, however, flies in the face of long-standing accounting principles which require companies

that pay their employees with stock to record a compensation expense. Stock and stock options are both company costs which should be reflected in a company's financial statements.

(4) A fourth claim is that stock options are an essential means to attract key personnel to small emerging companies that are otherwise cash poor. This is no reason to oppose the FASB proposal, however, since stock options would remain available after the proposal goes into effect, companies would still have access to this employment lure, and stock options would remain less expensive than cash compensation.

(5) A fifth claim is that stock options are an essential means for small emerging companies to attract capital. In fact, stock options allow employees to avoid contributing any capital to their companies until they exercise their options. Then, at the time of exercise, option holders are permitted to purchase company stock at a below-market value and typically sell it for personal gain on the open market, thereby diverting capital that would have gone to company coffers if the company itself had sold the stock. Stock options thus actually reduce the capital of emerging companies in exchange for retaining talented employees.

(6) A sixth claim is that stock options are essential to job creation by allowing small emerging businesses to stretch otherwise scarce capital. In fact, the vast majority of small businesses in the United States create jobs without any use of stock options. In companies that do use them, stock options may appear to be a "free lunch" when issued, but actually reduce company capital when holders cash in low-priced options on rising stock.

(7) A seventh claim is that many small businesses will be unable to operate profitably if they have to charge stock options to earnings. However, most small businesses do not use stock options. Moreover, to address problems that private companies might face in valuing their options -- the vast majority of small businesses are privately owned -- FASB's proposal would allow them to use a special valuation formula resulting in a lower charge to earnings.

(8) Some critics claim that emerging companies which rely on stock options will be financially damaged by an earnings charge, because reduced earnings on a company's books will lead to reduced stock prices which in turn will lead to investor flight. This argument was recently disproved, however, when in 1992 FASB required companies to charge their earnings for expenses associated with retiree health benefits. Those charges are far larger than any associated with stock options. Yet company stock prices were not only largely unaffected, the market as a whole has continued to rise. Market observers have explained that the retiree health benefit charges recognized expenses that everyone already knew existed and, thus, did not alter the market's evaluation of the affected companies. The same will hold true for stock options. Also instructive is the Coca-Cola Co. which, in 1991, gave its CEO stock worth $60 million. Because it gave him stock -- rather than stock options -- the company was required to charge the entire amount to earnings. Its stock price did not drop.

(9) A final claim is that forcing companies to expense stock options will stop them from awarding options to all employees and restrict them only to executives. This argument is a red herring, since few companies distribute stock options company-wide. In the case of large corporations, only about one dozen in the whole country give stock options to all employees. (One such company, Pepsi, has indicated that it will continue its program, despite a charge to earnings, due to excellent results.) In the case of emerging companies, a 1992 survey by the American Business Conference found that only 5 per cent gave stock options to hourly and salaried employees. In the case of small businesses, the vast majority do not use stock options at all. Ultimately, each company will have to decide whether stock options truely motivate their employees or whether the loss of the accounting loophole renders this compensation too expensive. In so doing, market discipline -- not accounting rules -- will be the key to the decision.

All forms of executive pay other than stock options are already recognized as corporate expenses. It is time to bring stock options under the rules of ordinary compensation. Recognizing this cost will strengthen the credibility of corporate financial statements; enable company officials, stockholders and investors to gauge the true impact of stock options on company finances; and subject stock option compensation to the market discipline that comes when a company's bottom line is affected. Ending accounting rules that discriminate against pay-for-performance stock options is also overdue. The ultimate beneficiary will be American competitiveness.

I hope that your analysis of the stock option issue and S. 1175 will include consideration of these concerns. If you have any questions, please contact Elise Bean of my staff at (202) 224-3682. Thank you.

Sincerely,

Carl Levin, Chairman
Subcommittee on Oversight of Government Management

CL:ejb