



TESTIMONY OF

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CONCERNING ACCOUNTING FOR EMPLOYEE STOCK COMPENSATION

**BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE**

JANUARY 31, 1992

**U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

appreciation or other measures of company performance. 1/ Grants or awards of options or other stock-based incentive devices may be made under a myriad of different compensation plans.

The responsibility for establishing levels of compensation rests in the first instance with the company's board of directors. Under our federal system, the states traditionally have adopted the legal standards governing substantive pay determinations made by corporate boards. 2/ The Commission's role, as defined by

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- 1/ Reportedly, three broad categories of performance measures have been generally used in structuring executive pay programs: (a) market-based measures tied directly to variations in shareholder wealth, such as stock price appreciation and/or dividend payments (e.g., stock options and SARs); (b) internal business performance measures, either financial (e.g., performance shares and performance units premised on such typical accounting measures as return on equity, earnings, including pre-tax earnings, net income and earnings per share growth; or shareholder value models based, for example, on discounted cash flows); or non-financial (e.g., components of performance units/share formulae may be based on key factors contributing to enhanced competitive advantage, such as cost leadership and product or service differentiation); and (c) leadership and management performance measures focusing on the individual manager's specific contributions to the organization. See S. Burchman, Choosing Appropriate Performance Measures, published in Executive Compensation: A Strategic Guide for the 1990s 193-209 (1991, F. Foulkes, ed.).
 - 2/ In addition, the national securities exchanges and the National Association of Securities Dealers ("NASD") have adopted listing standards that require shareholder approval for stock option grants to company officers or directors under specified circumstances. See New York Stock Exchange Listed Co. Man. Sec. 312.03(a) (establishment of stock option plan or other arrangement pursuant to which officers or directors may acquire stock on terms not generally available to other shareholders or employees, unless stock to be issued as a recruiting incentive); American Stock Exchange Co. Guide Para. 711 (listing of additional shares reserved for options granted or to be granted to officers, directors and key employees, unless options are issued (a) to recruit, and underlying shares do not exceed 5% of outstanding common stock; (b) under a plan that does not authorize issuance of more than 5% of outstanding common stock in one year or 10% in five years); NASD Manual Sched. D, Para. 1812

information, including its financial statements and management's discussion and analysis of the company's results of operations and financial condition, 5/ typically is furnished in the company's glossy annual report. Information concerning director and executive officer compensation is provided in the proxy statement or information statement 6/ relating to the annual meeting. The basic purpose underlying this dual disclosure requirement is to provide the shareholders voting on the election of directors with information upon which to assess the performance of the directors in the management of the corporation. 7/

Even in those instances where an annual meeting is not held in a particular year or a reporting company is not subject to the proxy rules, similar compensation disclosure is required in the company's annual report on Form 10-K filed with the Commission. In addition, when a company registers securities to be offered or sold to the public under the Securities Act, comparable compensation disclosure is required in the prospectus. 8/

Commission rules administered by the Commission's Division of Corporation Finance require compensation to be disclosed individually for each of the five highest paid executive officers whose compensation exceeds \$60,000, and in the aggregate for executive officers as a group. 9/ Disclosure of three principal

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- 5/ This information is required to be delivered to shareholders with or prior to the company's proxy statement or information statement relating to the annual meeting. See Rules 14a-3(b) and 14c-3 [17 CFR 240.14a-3(b), 240.14c-3].
- 6/ An information statement, with disclosure comparable to that required in the proxy statement, must be provided to shareholders where a meeting of securityholders is held, but no proxies are solicited. See Section 14(c) of the Exchange Act [15 U.S.C. 78n(c)] and Regulation 14C thereunder [17 CFR 240.14c-1 et seq.].
- 7/ See generally Rel. Nos. 34-23789 (Nov. 10, 1986), 34-11079 (Oct. 31, 1974) and 34-7508 (Jan. 15, 1965).
- 8/ For more seasoned issuers, such information may be incorporated by reference from periodic reports filed under the Exchange Act.
- 9/ Disclosure of director compensation is made pursuant to more generalized requirements that prescribe a description of standard arrangements, and more particular discussion of any special arrangements for participation in board committees or special assignments. See Item 402(d) of Regulation S-K [17 CFR 229.402(d)].

When action regarding a stock option plan is submitted to a shareholder vote, further plan disclosure is required. ^{13/} With respect to all compensation plans in effect at the time of the vote or during the preceding three years, the proxy statement must disclose information relating to option grants and exercises over the three-year period to each of the five most highly compensated executive officers and all executive officers as a group. If any specific grant of, or any plan containing, options is subject to shareholder action, the proxy statement must contain the following information for the executives and executive group: (1) the title and amount of securities called for or to be called for by such options, (2) the prices, expiration dates, and other material conditions upon which the options may be exercised, (3) the consideration received or to be received by the company or subsidiary for the granting or extension of the options, (4) the market value of the underlying securities, and (5) the federal income tax consequences of the issuance and exercise of the options, both to the company and the recipient.

III. Current GAAP for Stock Option Plans

The evolution of tax and accounting guidance for stock option plans provides an important perspective on the basis for existing GAAP. Early accounting guidance was prompted by an increase in the use of certain types of option and purchase plans following the enactment of tax legislation in 1950. ^{14/} That legislation created tax-advantaged stock compensation arrangements that, with a brief lapse, have continued in various forms to the present day. ^{15/}

^{13/} Schedule 14A, Item 10 [17 CFR 240.14a-101, Item 10].

^{14/} Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, 1953, at Chapter 13B, footnote 1.

^{15/} The Revenue Act of 1950 authorized "restricted stock options," which did not result in a tax deduction to the company for compensation expense or taxable income to the employee provided, among other things, the exercise price of the option was equal to at least 85 percent of the fair value of the stock at the grant date. In the Revenue Act of 1964, Congress replaced restricted stock options with "qualified options." While many of the tax attributes remained the same, one change required the option price to equal at least 100 percent of the value of the stock at the grant date. In turn, the Tax Reform Act of 1976 abolished qualified stock options, but similar provisions (including the "100 percent" exercise price requirement) were later reinstated by the Economic Recovery Tax Act of 1981 in the form of Incentive Stock

will pay, if any. After that date, no further adjustments to expense are recognized for changes in the value of the award.

As a result of these two provisions, APB 25 effectively established two types of compensatory plans -- "fixed" plans in which compensation expense is measured only at the grant date and "variable" plans in which the final measurement of compensation expense depends on events occurring after the grant date.

For fixed plans, the measurement of expense is fixed as of the grant date and is not adjusted for subsequent events such as increases in the value of the underlying stock. Assume, for example, that an employee is granted an option to purchase 100 shares of stock at an exercise price equal to the current value the stock, \$10 per share, contingent only on whether or not the employee remains with the company for a stated time period (the "vesting" period), say three years. In this example, compensation expense is measured at the grant date since all of the information required for measurement is known at that time. No expense is recognized since the exercise price of the option, \$10 per share, is at least equal to the market value of the stock at the grant date.

If, however, the market value were to exceed the exercise price on the grant date, then the amount of compensation would be measured based on that difference. For example, if the market value of the stock was \$13 per share on the grant date, a total of \$300 of compensation would be computed [100 shares x (\$13 - \$10)]. That amount would then be charged to expense ratably over the period in which services are rendered by the employee, which is generally the vesting period (in this case, \$100 per year for three years). In practice, the issuance of fixed options with an exercise price below the market value of the stock at the grant date is not common.

Measurement of compensation expense is not finalized at the grant date for variable plans, however, because it is uncertain how many shares the employee will receive or the price to be paid. 17/ This uncertainty may be caused by a variety of factors. For instance, in a performance plan, the right of an employee to exercise the options may be contingent on whether the company meets specified performance targets in the future (related to, for example, net income, sales, or return on equity). Because the number of shares the employee will receive is not known until it

17/ At least one other circumstance can also make a plan variable. Paragraph 11(g) of Opinion 25 requires that if the employer pays cash to an employee to settle an earlier award of stock or options, and that cash payment occurs shortly after issuance of the award, the cash payment should be used to measure compensation expense.

separate issues relating to stock compensation have been considered by the FASB's Emerging Issues Task Force (EITF) since 1984. 19/

Because the majority of employers issuing fixed stock options set the exercise price at least equal to market value at the grant date, most fixed stock options do not result in the recognition of compensation expense. However, outstanding fixed stock options are included in the computation of earnings per share by public companies. Under APB Opinion No. 15, Earnings Per Share, the dilutive effect of outstanding stock options is reflected in earnings per share calculations through application of the so-called "treasury stock" method. Under this method, earnings per share is reduced as the market value of the stock increases over the option exercise price.

IV. Lack of Compensation Expense for Fixed Options

This Subcommittee requested an explanation of why current GAAP permits a corporation not to recognize compensation expense in its financial statements when stock options are provided to executives. 20/

It is important to understand that current GAAP does result in the recognition of compensation expense for some types of stock compensation arrangements. Plans that are considered to be variable for accounting purposes result in the recognition of compensation expense based on fluctuations in the market value of the company's stock. For example, as illustrated above, stock appreciation rights result in compensation expense to the extent

19/ The FASB established the Emerging Issues Task Force in 1984 to assist in the early identification of emerging financial reporting issues and of problems in implementing authoritative pronouncements.

20/ It is interesting to note that the issue of not recording compensation expense for certain types of options or awards is not new -- it was even controversial when Opinion 25 and ARB 37 were issued. For instance, two of the eighteen APB members dissented to the issuance of Opinion 25, and three members qualified their assent, at least in part for reasons relating to the method of measuring expense. Four of those five members advocated recording compensation expense to approximate the value of an option at the date of grant, with no subsequent adjustments to reflect changes in market values after that date. However, this view was not adopted by the APB when issuing the Opinion. See APB 25, summary of dissenting and assented with qualification opinions.

will certainly continue to be a focus of FASB deliberations in the stock compensation project.

V. FASB Project on Stock Compensation Plans

Many of the issues raised by this Subcommittee have been the subject of debate within the accounting profession since Opinion 25 was issued in 1972. There has been a continuing concern that the accounting for stock compensation plans is unduly affected by the form of the particular compensation plan involved. Critics charge that, as discussed above, the existing accounting rules permit plans that have essentially the same economic effect to receive different accounting treatment based on their form.

Other difficult issues also were encountered in applying Opinion 25. For example, in the early 1980s a new form of compensation plan was developed involving the issuance of "junior" stock to employees. 22/ Because of concern over the manner in which APB 25 should be applied to these plans, the SEC's staff asked the FASB to clarify the accounting for junior stock. In 1984, the FASB responded by issuing Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock. 23/ In the appendix to Interpretation 38, the FASB acknowledged the criticisms of some commentators that the existing provisions of Opinion 25 do not reasonably measure compensation for plans such as junior stock plans. However, the FASB indicated that any perceived

22/ Junior stock generally is subordinate to common stock with respect to voting, liquidation, and dividend rights, and is convertible into common stock upon the attainment of certain performance goals or upon the occurrence of certain transactions. It generally is not transferable and has a fair value lower than regular common stock because of the subordinate rights and uncertainty of conversion.

23/ The accounting practice at that time was to measure compensation expense as the excess, if any, of the value of the junior stock at the grant date over the amount the employee would be required to pay. Under that approach, compensation expense generally did not result. Questions arose about whether grant date measurement was appropriate under Opinion 25 given the variable number of shares of common stock into which the junior stock was contingently convertible. FASB Interpretation 38 concluded that junior stock plans should be accounted for as variable plans, resulting in the recognition of compensation expense based on increases in the market value of the common stock after the grant date.

On the other hand, changes in the value of issued and outstanding equity instruments are not recognized at all by the issuer corporation. For example, if a company acquires land through the issuance of an option to purchase the company's common stock, the value of the option at the date of its issuance is recognized at that date. That amount also becomes the cost of the land. The amount initially recognized for both the option and the land is not changed when the value of the underlying stock, and thus the value of the option, subsequently changes. So, deciding whether a stock option is a liability or an equity instrument is critical to the accounting. As a result of this dilemma, in 1988 the FASB deferred work on the stock compensation project pending resolution of the broader conceptual issues regarding the distinction between liabilities and equity.

In 1990, the FASB issued a Discussion Memorandum (DM) entitled Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both. The DM was a neutral document highlighting certain issues for comment. The FASB currently is considering the approximately 100 comment letters to the DM, along with the input received at a public hearing during 1991. While the FASB continues to study the issues relevant to debt and equity distinctions, accounting for stock compensation remains a separate project on the FASB agenda.

VI. SEC Consideration of Possible Changes

Disclosure Requirements. Current compensation disclosure requirements were adopted by the Commission in 1983, after a seven-year effort to update and improve those that evolved over approximately 30 years. During this seven-year period, the Commission proposed and adopted three different formulations and issued five interpretive releases. This extended process of review focused the Commission on the need to strike an appropriate balance between excessively detailed, complex discussion of all compensatory packages and overly simplified disclosure that did not accurately portray the nature of the compensation received.

The Commission once again is engaged in a comprehensive examination of the present compensation disclosure system, within the ambit of its ongoing review of the federal proxy rules. In this connection, the Commission is considering a variety of proposals for revised compensation disclosure, including those set forth in Senator Levin's bill, S. 1198. 26/

26/ "The Corporate Pay Responsibility Act." Also under consideration are bills introduced in the Senate and House, respectively, by Senator William Cohen (S. 2030) and Representative John Bryant (H.R. 2522).

The FASB project on accounting for stock compensation arrangements encompasses several difficult issues. One fundamental issue is how compensation expense for stock and option awards should be measured. Resolution of this issue will involve consideration of various option pricing models or other methods that might be used to approximate the value of the rights provided to employees. At the same time, I anticipate that the measurement approach selected by the FASB will not be overly burdensome, costly, or difficult to use. Another difficult and contentious issue involves determining when the measurement should be finalized, such as at the date of grant, vesting, exercise, or some other date. That is, at what point should changes in the value of the award no longer be viewed as relating to the compensation of an employee? Also, the FASB needs to ensure that the conclusions reached in this project are consistent with the accounting for other liability and equity instruments in general.

As a former member of the FASB, as an accounting practitioner for over 30 years, and now as the Chief Accountant to the SEC, I understand the difficulties the FASB has encountered to date with respect to the stock compensation project, and I appreciate the reasons for considering this issue within the context of the broader project on distinguishing liabilities and equity. I understand that the FASB presently intends to resume consideration of this issue in 1992. The Commission's staff will continue to oversee this project closely.