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Statement of the Financial Economists Roundtable

On

The Controversy Over Executive Compensation

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Executive Summary:

The Financial Economists Roundtable met on July 13 and 14, 2003 to discuss the controversy over top-level executive compensation plans in US companies. Recent corporate scandals have drawn attention to the high levels of executive compensation in the United States and to the possibility that some executive compensation plans may have been one of the causes of these scandals by fostering a corporate environment of greed and dishonesty. The Roundtable provides a number of recommendations that we believe will mitigate the potentially harmful effects of some executive compensation plans and should ensure a better alignment of managerial and shareholder-owner interests. Among these recommendations are (a) treating the granting of stock options as an expense in company financial statements, (b) repealing section 162 (m) of the U.S. Internal Revenue Code, (c) more disclosure of financial transactions by executives that affect the sensitivity of their pay to shareholder wealth, and (d) various corporate governance changes that will enhance the independence and responsibilities of corporate boards and their compensation committees, and give shareholders the power to monitor and control executive compensation.

I. Introduction

Recent corporate scandals have drawn attention to the high levels of executive compensation in the United States and to the possibility that the structure of executive compensation plans may have contributed to these scandals by fostering a corporate environment of greed and dishonesty.

A widespread view is that top-management compensation in the United States is higher than that required to motivate managers and has created a corporate environment in which the incentives of managers are not closely aligned to those of shareholder-owners. In the 1990's average CEO compensation increased significantly, both in absolute and in relative terms. The inflation-adjusted level of average CEO pay for S&P 500 companies grew from $3.5 million in 1992 to $14.7 million in 2000. Over the last two decades, the average CEO pay has risen to a level about 419 times that of average employee compensation, up from only 42 times in 1980.[1] By far the largest component of this increase in CEO pay has been the dramatic increase in the use of stock option grants during the 1990's.

Many believe that top-level executive compensation also is not linked closely to long-term corporate performance. In recent years, many executives saw their compensation rise sharply even though those companies were doing poorly and their stock values plummeting. Further, it has been argued that overly generous compensation packages, and in particular the widespread use of stock option grants, may have created incentives for managers to manipulate company financial statements in order to drive up stock prices, contributing to the recent corporate scandals.

II. Why the increase in stock option compensation?

Stock option compensation increased sharply during the 1990's for several reasons.

First, during the late 1980's and early 1990's there was an increased demand from institutional investors, such as the United Shareholders Association, the Council of Institutional Investors, and large state pension funds, for companies to tie executive pay

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[1] Jennifer Reingold, "Executive Pay: The Numbers are Staggering, but so is the Performance of American Business. So how closely are they linked?" Business Week, April 19, 1999, p. 72.

to company performance in order to better align executive incentives with those of stockholders.

Second, accounting rules for stock options have reinforced the desirability of using stock options relative to other forms of compensation. Under APB Opinion 25, issued in 1972, the accounting expense associated with stock options equals the difference between the market price of the stock and the exercise price of the option on the date that both the exercise price and the number of options are fixed. This spread is zero when the exercise price is set at the market price of the stock on the grant date; so, the expense charge for such an option grant is zero. In 1995, Financial Accounting Standards Board (FASB) promulgated Financial Accounting Statement (FAS) 123 which recommended, but did not require, that options be expensed at their "fair market value" determined at the grant date, determined by using the Black-Scholes valuation model or another similar valuation methodology. Until late 2002, only a handful of companies had adopted the proposed FASB recommendation. Thus, since the firm typically bears no accounting charge and no cash outlay when granting options, the cost of option grants to the corporation and to corporate boards may be "perceived" to be low or even zero, which may have resulted in the overuse of stock options. Not expensing options also reduces the transparency of the cost of stock options to shareholders and investors and may reduce market scrutiny of this form of compensation.[2]

Third, section 162(m) of the U.S. Internal Revenue Code (IRC), a tax law enacted in 1993, may have unintentionally encouraged the use of stock options. The statue disallows tax deductibility for all compensation paid to "proxy-named executives" in excess of $1 million, unless such compensation takes the form of "performance-based" compensation. This law made stock options (as well as other performance-based compensation) less expensive than, for instance, base salaries and stock grants, because stock options satisfied the "performance-based" test as directly linked to the company's stock value.[3] Fourth, the bull stock market during the 1990's may have increased the

[2] Kevin J. Murphy "Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options," University of Chicago Law Review, Vol. 69(3), Summer 2002, pp. 847-869.
[3] Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," Journal of Economic Perspectives, Summer 2003, pp. 49-70.

demand by some executives to be compensated with stock options, because they expected returns to continue to be high.

Finally, some CEOs may have been able to "capture" their boards and persuade them to approve large pay packages, even if such packages were not in the interests of the corporation. For instance, Dennis Kozlowski, former CEO of Tyco, was granted nearly six million options – 5.1 million new options in Tyco, plus 800,000 options in a Tyco subsidiary – with a value of $81 million at the very time that Kozlowski was allegedly looting the company of millions of dollars. Where was the Tyco board? Indeed, the virtual absence of indexed option plans among U.S. firms seems inconsistent with the existence of an arms-length compensation process conducted by an independent and informed board. Why would shareholders want to compensate executives for a rise in the company's stock price that is unrelated to the manager's or firm's specific (or relative) performance?

III. Is Executive pay "excessive"?

Although there have clearly been instances of mega stock option grants being made to undeserving top-level executives during the last ten years, it is difficult to conclude that on average executive compensation is excessive. What is "excessive"? In theory, compensation is excessive if it is more than that required to minimize the principal-agent (shareholder-manager) costs due to the separation of ownership and management, or, alternatively, is more than that required to maximize shareholder wealth. Put another way, it is higher pay than the executive could command in a competitive labor market. It is difficult, however, to provide an operational measure that is consistent with these definitions. Thus, while it is probably safe to say that there have been incidences of excessive executive pay, we are not able to generalize from these cases about whether the average level of executive compensation is excessive.

IV. Policy issues raised by the increase in Executive compensation

Our analysis suggests three areas where changes can be made that would improve the process by which executive compensation is determined: accounting and tax rules related to stock option grants; corporate governance; and the contractual design of executive pay packages.

1. Accounting and Tax Treatment of Stock Options

Guiding principles should be that the choice of compensation structures should be left to the firm, and accounting rules and tax treatments should not favor one form of compensation over another (say stock options over cash or stock). (a) The Roundtable recommends that option grants be expensed by the issuing firm at the grant date. Currently, most firms do not show stock options as an expense in their financial statements and only report information about the grants in their financial statement footnotes. While some large companies (e.g., General Electric, Procter and Gamble, Coca-Cola, Microsoft) have publicly stated that they will expense options in the future, other heavy users of employee options, notably Intel Corp, have resisted expensing. The Roundtable believes that financial statements should reflect the true costs of doing business, and labor acquired and compensated with employee stock option grants impose a real economic cost on the current stockholders that should be shown as an expense and as a deduction from earnings. We are not, of course, the only ones to hold this view. Warren Buffett, for instance, has said, "If stock options are not a form of compensation, what are they? If compensation is not an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"[4] Expensing stock options also will enhance transparency and will help to eliminate the "perceived" cost advantages of options over other forms of executive compensation.

(b) The Roundtable also recommends that Internal Revenue Code section 162 (m) be repealed. As noted, this section limits the tax deductibility of compensation to $1 million unless such compensation is performance-based. This rule is a clumsy attempt to regulate the level and structure of executive compensation, and should be repealed. Corporations, through their boards and shareholders, should be free to determine the optimal form and level of executive compensation. If there is a concern that corporate boards are not exercising this function in a responsible way, the appropriate response is to

[4] John Dyson, "Accounting Issues Financial Reporting-Share Options- Logic Breaks Down," Accountancy, June 30, 2001, p. 97.

improve the performance of boards through changes in either corporate law or other corporate governance institutions, or to enhance the power of shareholders to monitor executive compensation directly.

2. Corporate Governance

To increase the likelihood that the process for setting executive compensation is conducted as an arms-length bargaining process, the Roundtable believes that it is important that corporate boards be independent of managers and have some compensation expertise. (a) The Roundtable agrees with and endorses recent proposals directed at making compensation committees more independent, such as the new NYSE rule which would require that only independent directors serve on compensation committees. In addition, the Roundtable recommends that at least one member of the compensation committee possess sufficient expertise in compensation practices so that the committee can understand the compensation contracts and the methods used to value the different forms of compensation, as well as the likely effects of these on the incentives of managers. This recommendation would broaden the existing requirement for "financial literacy," which is targeted more towards accounting literacy than financial literacy.

(b) The Roundtable also endorses the proposed NYSE requirement that all top-management compensation plans, as well as material changes in these plans, be approved by a shareholder proxy vote. Items requiring such approval should include material changes in the level of salary, equity-linked compensation, and severance packages.

(c) Lastly, the Roundtable recommends that any financial transactions by top-level executives that materially alter the sensitivity of the pay package to the value of the company be reported to the compensation committee and the board. In particular, hedging transactions entered into by an executive that change the sensitivity of his/her compensation or equity position in the company with respect to shareholders' wealth should be disclosed in advance to the board and approved by the board. Such transactions may materially change the managerial incentives associated with pay packages and should be monitored accordingly.

3. Design Features of Compensation Contracts

While the design of compensation packages should be the responsibility of corporate boards, we believe that boards should give serious consideration to the following mechanisms when designing and approving compensation contracts. It is our view that many of the perverse incentives attributed to stock options are due to poorly designed contracts rather to inherent flaws in option compensation.

First, executives should not be rewarded or punished for outcomes that are beyond their control. Compensation schemes may include some form of indexation as a means of relating pay to the component of company performance that is more directly within the control of executives. For example, the exercise price of stock options could be pegged (or indexed) to a well-defined market index. The concern that the incentives effects of indexation can be undone by the executive through market transactions can be greatly mitigated by the disclosure requirement in 2 (c). A possible reason for the virtual absence of indexed options is the current difference in the accounting treatments for index options and regular options. Since the exercise price of index options is not set at the current stock price and is unknown, indexed option grants must be expensed under current accounting rules, whereas standard stock option grants do not have to be expensed. If all option grants were expensed, as we recommend, there may be less reluctance to use indexed stock option grants.

Second, the "repricing" of existing options by corporations should not be prohibited, because repricing can be useful in enhancing the effectiveness of compensation contracts. Repricing refers to the practice of replacing options with new ones that have lower strike prices, typically in response to a fall in the stock price of the firm. Repricing of stock options has been widely criticized as rewarding managers even for bad performance. There can, however, be good reasons for repricing the options. When stock prices decline, perhaps for reasons unrelated to an executive's performance, existing options may become virtually worthless, destroying the original incentive features associated with the use of options. Repricing can restore these incentives and realign managerial-shareholder/owner interests. It is important, though, for boards to ensure that repricing does not benefit poorly performing executives or create perverse managerial incentives. When there clearly has been poor managerial performance, the remedy should be termination of the managers, and not the repricing of their options.

Third, vesting requirements and restricted stock periods should be used to ensure that managers' incentives are linked to long-run corporate performance, and not to short-run financial results. In the spirit of this objective, the Roundtable endorses the Sarbanes-Oxley Act requirement that CEOs and CFOs have to disgorge any profits from bonuses and stock sales obtained during the 12-month period following a financial report that is subsequently restated because of “misconduct.”

FINANCIAL ECONOMISTS ROUNDTABLE

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