

Testimony by Paul A. Volcker
before
The U.S. House of Representatives
Committee on Financial Services
Washington, DC
Tuesday, June 3, 2003

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to address the question of the appropriate accounting treatment of employee stock options.

As you know, I am chairman of the Trustees of the International Accounting Standards Committee Foundation. That position reflects my interest in encouraging international convergence toward a single set of global accounting standards, a matter strongly in the interests of the world business and financial communities. As a Trustee, I also feel a strong responsibility to assure that the standard setting process is coherent and appropriately disciplined. To that end, the decision-making International Accounting Standards Board (the IASB) that we Trustees appoint is made up of experienced professionals, working full time and committed to the broad public interest in consistent and reliable financial reporting. To help assure their independence and freedom from more parochial concerns, they have been provided with fixed terms.

I do not suggest that standard setting can or should take the characteristic of edicts from an insulated ivory tower. Far from it. The Trustees, who exercise broad oversight over the IASB, have richly varied experience and come from around the world. The decision-making Board has been drawn not only from the accounting profession but from operating businesses and "users" of financial information. There is a sizable Advisory Council regularly meeting with the Board. Elaborate consultative procedures to take account of the variety of perspectives among both reporting companies and the investing community have been developed.

Given inevitable differences in particular national, industry, and political concerns, controversy -- sometimes strong controversy -- cannot be avoided. What is essential is that, at the end of the day, the decisions reflect well-

reasoned judgments about how to best serve the needs of investors for reliable and consistent reports that fairly reflect the financial results of publicly traded companies.

To put the matter most pointedly. If the U.S. Congress, or political authorities in other countries, seek to override the decisions of the competent professional standard setters - including those of the IASB for which I have responsibility - accounting standards will inevitably lose consistency, coherence and credibility, weakening the fabric of the international financial system.

Obviously, the proper accounting treatment of stock options is one of the highly controversial areas under review. As a Trustee of the IASC Foundation, I do not think it appropriate for me to comment on the substance of particular matters before the Board. However, I believe it has become clear that the great weight of professional opinion here and abroad is that as a part of employee compensation, the grant of a stock option has value, represents a cost to the issuer, and therefore should logically be reflected as an expense in income statements.

I might note in that respect that even companies that oppose expensing of stock options on their public financial statements have, when options expire, reported an expense in preparing their tax returns, a treatment long sanctioned by the IRS. Present American practice has another odd and counter-productive anomaly. Stock options with performance criteria, a seldom used but preferred approach in the opinion of many compensation experts, must be expensed. Much more widely used fixed-price options, with much more questionable and uncertain characteristics in aligning employee and investor interests, are not expensed.

If there is widespread agreement on the logic of expensing fixed-price stock options, the precise method of doing so is certainly arguable. I do not believe, as some have suggested, that fact in itself can justify taking no action. Much less should it be an excuse for political dictation of an intellectually flawed approach. Apart from the consequences with respect to stock option accounting, such an approach would create an exceedingly unfortunate precedent for other controversial issues bound to arise. In fact, as you deliberate about stock options, the European Commission is being strongly lobbied to reject a Financial Reporting Standard proposed by IASB which largely

incorporates an approach toward financial instruments already in place in the United States for some years.

The IASB has proposed one approach toward the manner of expensing stock options. As you well know, the U.S. FASB has the whole question under review. The common hope is that a convergence of views might be reached. While it would be inappropriate for me to intrude on that decision-making process, I cannot repress a related thought. If, instead of rejecting the logic and stonewalling acceptance of the basic idea of expensing grants of fixed-price stock options, the business community might usefully attempt to reach a consensus within its ranks about how expensing might best be measured and reflected in income statements. That, it seems to me, might be a real contribution to sensibly resolving what is clearly a difficult problem.

One final thought. I think it clear that the grotesque escalation of executive pay over recent years has been importantly a function of the greatly expanded use of fixed-price stock options for a small group of senior executives. That development has been encouraged and defended by the theory that such options align the interests of managers and owners. Obviously, the fact that those options are not expensed has provided a practical incentive even if the theory has proved weak.

Experience provides ample evidence that the relationship between reward and performance is capricious. In bull markets - and in the 1990's, we here in the United States experienced the greatest of all stock market bubbles - the payoffs from options became enormous, for the exceptional performer certainly, but for the mediocre and too often for relative failures as well. The image of executives exercising options worth tens of millions of dollars shortly before market collapse and even bankruptcy are fresh in mind.

In contrast, in prolonged bear markets, even the best of managers may not benefit. Then the temptation to repriced options or issue new ones at depressed prices seems nearly irresistible, hardly in keeping with the notion that options are rewards for exceptional performance. Increasingly, it is becoming more widely recognized that options may and do tempt some executives to manage short-term earnings and market expectations in a manner counter to the basic interests of the company.

I recognize that start-up companies, long on ideas and short of cash, may find stock options a useful form of compensation -- a rational decision by an owner-entrepreneur who understands and bears the cost. There are also large companies that have long made a practice of spreading stock options widely among employees and find that a useful approach.

But none of that argues against recognizing a real expense in financial reporting. I am afraid that the absence of expensing has, quite obviously, encouraged the obvious abuse of large stock options, concentrating the benefits on a limited group of top management personnel.

In my own view, large companies with widely dispersed ownership should, as a matter not of law but of good corporate practice, be discouraged from active use of fixed price stock options, particularly when concentrated on a small group of executives. If expensing of such options leads to that result, and greater use of more effective means of aligning management and owner interests, then that would be constructive.