United States Senate

Permanent Subcommittee on Investigations
of the
Committee on Homeland Security and Governmental Affairs

Hearing on Executive Stock Options

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Dirksen Senate Office Building

Testimony of Lynn Turner

I want to thank Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee for holding this hearing on an issue that I believe is certainly of interest to both American taxpayers and investors.

I currently serve as a member of the board of a public technology company and trustee of a mutual fund. I have also had the pleasure of serving as a chief financial officer of an international company that employed the use of stock options, as an employee and audit partner of a major international accounting firm that prepared corporate income tax returns, as a former member of the Securities and Exchange Commission (SEC) staff, as an accounting professor, and as a managing director of research for a proxy governance and financial research firm that advises institutional investors with over $10 trillion in assets under management.

The issue of executive compensation has been one that has attracted much interest, regardless of the perspective from which observed. Analyzing compensation, and its key components including equity awards, has been critical from a corporate governance and investing perspective, as well as from the role of management. Ensuring that pay is properly aligned with performance and transparency is provided to investors is a key component of good corporate governance.

However, in the past decade, newspapers have heralded excesses in compensation at many a public company. Indeed, as the new SEC disclosure rules went into effect for the 2007 proxy season, investors learned there has been a lack of transparency with respect to compensation, including the impact of options. Unfortunately, last minute changes the SEC made to the disclosure rules in December of 2006, detracted somewhat from the transparency that might have been achieved.

<u>Abusive Stock Option Practices</u>

Likewise in recent decisions of the Delaware court of Chancery, the court took strong exception to the improper granting of stock options and lack of transparency surrounding that process.[1] This is especially disturbing given that over 250 public companies have

[1] See in the matter of Ryan vs. Giffor, Civil Action No. 2213-N, February 6, 2007 in which the court stated: "The plans do not grant the board discretion to alter the exercise price by falsifying the date on which options were granted. Thus, the alleged facts suggest that the director defendants violated an express provision of two option plans and exceeded the shareholders' grant of express authority." Also see in the matter of Tyson Foods Consolidate Shareholder Litigation, Consolidated C.A. No. 1106-N, February 6, 2007, in which the court stated: "Whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating, a practice that has attracted much journalistic, prosecutorial, and judicial thinking of late.74 At their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date on which the grant was actually made. Allegations of spring-loading implicate a much more subtle deception.75 …Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception…A director who intentionally uses inside knowledge not available to

acknowledged they have had to undertake investigations of backdating and/or spring-loading of options. And as the Senate hearings in September of last year noted, these improper and illegal practices certainly can have an associated income tax consequence. Unfortunately, to date, and over two years after the SEC became aware of such practices, the SEC has failed to bring but a handful of cases against those responsible for engaging in such behavior.

We can only hope that those who have acted outside of the law will be held accountable in the future, by law enforcement agencies. Academic research has suggested that over 13 percent of stock option grants from January 1, 1996 to December 1, 2005 were backdated or manipulated.[2] Accordingly, it appears that many companies have not disclosed to their shareholders past practices of manipulating the grants of stock options.

In the past, many argued that stock options aligned the interests of stockholders and employees. However, that proved to only be a partial truth. For example, after the bursting of the stock market bubble in 2000 and 2001, we quickly learned that employees holding stock options do not share in losses incurred when there are market downturns.

We have also seen other abuses of stock options. For example, when the stock markets declined with corresponding declines in stock values, it has not been uncommon for management and/or boards of directors to reprice stock options, lowering the price at which they can be exercised, thereby cushioning the blow from market declines for executives and employees. In essence, management was given a "mulligan," while shareholders were not afforded the same type of economic benefits.

Likewise, in recent years, we have seen over 1,000 public companies accelerate the date on which options are considered vested. This was often done when companies were faced with implementing the new accounting standards requiring expensing of stock options. And while some argued there was no benefit provided to employees, a recent study found that over $400 million of intrinsic value was realizable by employees of just 49 companies that accelerated the vesting of their options.[3]

Even the new accounting standard requiring the expensing of stock options has seen efforts to circumvent its principal objective of requiring the fair value of the option grant to be expensed. Perhaps that should be no surprise given that many, including certain members of Congress, opposed such transparent reporting to investors. But the world did not come to an end when such accounting was mandated. However, for some, it may have also brought on a practice of engaging in number management.

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shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary."

[2] What fraction of stock option grants to top executives have been backdated or manipulated? Randall A. Heron, Erik Lie. July 14, 2006.
[3] Options Closed: The End of "Accelerated Vesting". The Analyst's Accounting Observer, Jack T. Ciesielski. August 15, 2006.

One of the easiest and most powerful ways to reduce the amount of expense one has to report for the value of options is to reduce the volatility factor that is used to compute the value. Note that when volatility goes down, the corresponding expense reported for a stock option grant will also decline. Consistent with that notion;

> "Median volatility assumptions in 747 Russell 2000 companies started declining in 2003 and has decreased each year since then. Similarly, median volatility assumptions in 310 S&P 500 companies started declining in 2004 and also decreased in 2005. Median volatility assumptions in both indexes were little changed in the three prior years. The beginnings of those declines were coincidental with events signaling the coming of stock option expense treatment – the issuance of two exposure drafts dealing with the subject. The change in the volatility assumptions was broad-based; in those periods of declining assumptions, a wide majority of firms in each index notched down their assumptions.
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> Volatility assumption declines were especially broad-based in 2005. In the Russell 2000 during 2005, there were 894 companies out of 1,366 (having sufficient data) that decreased their volatility from the previous year – 65% of the total. In the S&P 500, there were 327 firms decreasing their assumptions out of 406 possible firms – over 80%. The median assumptions in both indexes declined 4% between 2004 and 2005."[4]

Accordingly, it appears some companies are either using questionable if not improper assumptions for purposes of calculating their stock option expense to be reported in their financial statements. This includes the use of option pricing models which have been properly challenged by the Council for Institutional Investors and its members.

Back to the issue of stock options and compensation, as a former regulator and chief accountant for the SEC, the biggest concern I have with respect to the granting of options, is the correlation academic research has shown between the use of options and fraud. For example, one academic study found that "…CEO's of fraud firms have greater option-based compensation than their control firms…We interpret our findings as being consistent with the view that there is a "dark side" to incentive compensation."[5] Authors of another study found "…that three factors increase a firm's probability of misrepresenting its financial position: performance below its industry's average performance, performance significantly above its own past performance, and its CEO receiving a high proportions total compensation as stock options."[6] Accordingly, it appears and I certainly believe, that stock options when not properly utilized, can serve as an addictive drug for executives, leading them to engage in unlawful behavior. Perhaps

4 Employee Stock Option Volatillity Assumptions; Real or Not? The Analyst's Accounting Observer, Jack T. Ciesielski. October 12, 2006.
5 Is there a Dark Side to Incentive Compensation? David J. Denis, Paul Hanouna, Atulya Sarin. March 2005.
6 Incentives to Cheat: The Influence of Executive Compensation and firm performance on Financial Misrepresentations - Abstract. Jared Harris, Philip Bromiley. March 2005.

that is why some well known individuals such as former Federal Reserve Chairman Paul Volcker have recommended against the use of stock options.

Remedies for Stock Option Abuses

In order to help foster good corporate governance and management, lawful behavior, and greater transparency for investors, I believe certain changes could be adopted that would help in a meaningful way to avoid the type of abuses and illegal behavior noted above.

As a former business executive and partner in a major international accounting firm, I have seen upfront how income tax laws and regulations do affect business decisions – sometimes in a negative fashion. It should be no surprise that my experience has shown management often tries to maximize both the amount and timing of expense deductions for income tax purposes, while minimizing them for purposes of financial reporting to investors. It is simply a matter of minimizing net income for tax purposes, and maximizing net income reported to investors.

Income tax deductions can have a very significant impact on the cash flow of any company and so it behooves management to maximize them. And of course, the analysis of any stock option program is going to include the impact of the cost on a net basis, after factoring in any benefits from income tax deductions. As such, these tax implications also provide a strong incentive for management to see how close to the "line" they can get when preparing their income tax returns and encourage taking of aggressive income tax positions. This is especially true for public companies. And as we have seen with recent corporate scandals, some seem blinded to when they are getting close to the line as opposed to going over it.

As a result, I would strongly recommend the creation of tax legislation and regulations that would foster a consistent calculation of the amount of the deduction for the fair value of options for both financial reporting and income tax purposes. I firmly believe there is an economic cost to the issuance of options. That cost should not vary simply because it is reported to the Internal Revenue Service on a Form 1120 as opposed to investors on a Form 10-K. Unfortunately, current income tax regulations have created incentives that have led to the abuses noted earlier and should be considered for appropriate modifications.[7]

Such legislation would create a very positive incentive for companies to stop manipulating and minimizing the amount of expense they report to investors. Rather, it

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7 Commission on Public Trust and Private Enterprise. The Conference Board Inc. 2003. The report of the Commission states: "It rejects the kind of solutions which resulted from legislation enacting Section 162(m) of the Internal Revenue Code (which limited the tax deductibility of cash compensation over $1 million). Stock options qualify for an exemption under Section 162(m) since they are largely considered to be performance-based compensation. Therefore, Section 162(m), especially combined with the favorable accounting treatment for stock options under current accounting principles, contributed to fixed-price stock options becoming the dominant form of executive compensation."

would result in a more balanced approach in which both transparency for investors and income tax considerations would be balanced. In essence, a desire to report higher earnings to investors by manipulating the amount of stock option expense downward, would be appropriately balanced by the desire to maximize income tax deductions, and in doing so, maximizing cash flows.

Legislation giving shareholders an advisory vote on compensation, such as that recently passed in the House should also be adopted. Many foreign countries such as the United Kingdom, the Netherlands, and Australia have adopted such legislation and policies as a matter of good corporate governance. Such policies have also become a very important and integral part of the regulatory scheme in those countries. More importantly, a shareholder advisory vote provides the owners of the business with an opportunity for meaningful input and dialogue on compensation when the boards of directors and management fail in their fiduciary obligations.

I believe active and appropriate oversight by the SEC of reporting of executive compensation is needed as well. Actions taken to date indicate that many responsible for the option backdating scandal will either never be known, or will avoid accountability for behavior outside the law. Neither of these should be permitted to occur. Likewise, the use of models to fair value options that are intended simply to minimize and manipulate the value of stock options should be more closely examined by the SEC and prohibited.

This concludes my remarks and I would be happy to answer any questions the committee might have.