HISTORY REPEATING ITSELF: THE DEBATE OVER ACCOUNTING FOR STOCK OPTIONS

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ABSTRACT

This paper discusses the similarities between a debate that occurred in Congress in 2002 over classifying stock options as a form of compensation expense and debates that occurred almost 10 years ago in Congress on the same topic. This recent Congressional debate was initiated as a partial response to the various financial reporting scandals that have come to light during the past two years.

Current accounting rules do not require the cost of stock options to be recognized as expenses in a company's income statement. While many members of the U.S Congress and some leaders in Corporate America are proposing that stock options be treated as expenses, a significant faction of the U.S Congress and many corporate leaders oppose treating stock options as expenses. To date, no formal legislation has been passed, though many companies have voluntarily chosen to expense stock options.

This paper examines the role that political lobbying and campaign contributions have had on various bills that have been proposed in the U.S Senate on the topic of accounting for stock options. This study reviews who were the key sponsors and co-sponsors of the various bills proposed and what industry groups strongly supported the sponsors and co-sponsors of the bills.

INTRODUCTION

This paper examines the role that political lobbying and campaign contributions have had on the congressional debates of 2002 and the early 1990's over financial accounting rules for stock options. While the role of campaign contributions and political lobbying in the setting of tax policy has been recognized and examined extensively in both the popular press (Alter, 1997) and academic research (Begay et al., 1993), the role that politics and campaign contributions plays in the setting of financial accounting standards has not received as much public scrutiny and discussion.

This paper focuses on a series of bills introduced in the U.S. Senate in the last 10 years related to the issue. However, before we discuss the role that political lobbying has had on this debate, it is important to explain where the Financial Accounting Standards Board (FASB) currently stands on this issue. In December 2002, the FASB issued Statement 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," which provides alternative methods of transition for a voluntary change to expensing stock options using the fair value based method of accounting for stock-based employee compensation. In addition, Statement 148 amended the disclosure requirements of Statement 123, "Accounting for Stock-Based Compensation," to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation (FASB, 2002). Under the provisions of Statement 123 that remain unaffected by Statement 148, companies may either recognize expenses on a fair value based method in the income statement or disclose the pro forma effects of that method in the footnotes to the financial statements (FASB, 1995).

In March 2003, the FASB announced that they would begin a project on stock-based compensation that will address whether to require that the cost of employee stock options be treated as an expense. As part of this project, the Board agreed to revisit its 1994 decision permitting companies to disclose the pro forma effects of the fair value based method rather than requiring all companies to recognize the fair value of employee stock options as an expense in the income statement (FASB, 2002). [1]

A final standard was initially expected to be issued by the FASB before the end of 2003, but is not expected to be issued until the first quarter of 2004. However, in April of 2003, the Board tentatively decided that the cost of stock options should be treated as an expense. In 2002 well before the FASB tentative decision, the idea of expensing stock options was already being met with significant opposition from numerous political and business leaders. While a number of major companies had voluntarily decided to reflect stock option costs as an expense in reporting their earnings before the FASB tentative decision, more companies have chosen to simply disclose the potential cost of these expenses in the footnotes to their financial statements. At the end of 2002, the FASB invited comment from industry leaders on the issue. Eighty-eight percent of the industry respondents to the FASB opposed mandatory expensing of stock options (FASB, 2003).

As noted above, the focus of this paper is on the role of political lobbying and campaign contributions on the debate on accounting for stock options. Consequently, it does not advocate one accounting method over another. Accounting for stock options is a complicated accounting issue without a clear cut answer. Strong arguments can be made for recognizing expenses at the grant date of an option and equally strong arguments can be made that because of various factors it is not possible to reasonably determine the cost of an option at grant date (Gleckman, 2002). While this paper does not take a position, a summary of the pros and cons for accounting for stock options as expenses can be found in Appendix A.

The Politics of Stock Options

With regard to the politics of the issue, this debate began to take shape in June 1993 when the FASB issued its original exposure draft on accounting for stock options[2]. The 1993 exposure draft concluded that the value of stock options issued to employees should be considered compensation and recognized in the financial statements. The exposure draft recommended that option pricing models be used to estimate the value of stock options. In addition, the FASB recommended that disclosures related to stock option plans be enhanced.

The exposure draft met with significant opposition from the business community and the Congress, particularly the U.S Senate. Various industrial sectors (i.e., financial services, electronics/high tech and general business/retail) opposed the new accounting rules. Some of the arguments against the new rules were related to the technical complexity of the issue (i.e., that it was impossible to develop appropriate option pricing models). However, the primary argument made by political leaders and the business community was based on economic terms (Jacobson, 1995). At the time of this debate, numerous studies were quickly conducted to support the position that recognizing stock options as expenses in the financial statements would have dire economic consequences. For example, a Merrill Lynch study at the time stated that expensing stock options would have slashed profits among leading high-tech companies by 60 percent on average (McNamee, 2000).

In the words of Jim Leisenring, the vice chairman of FASB from 1988 to 2000, “It wasn't an accounting debate….We switched from talking about, 'Have we accurately measured the option?' or, 'Have we expensed the option on the proper date?' to things like, 'Western civilization will not exist without stock options,' or, 'There won't be jobs anymore for people without stock options.' ... People tried to take the argument away from the accounting to be just plainly a political argument." [3]

Two specific pieces of legislation**,** the “Equity Expansion Act of 1993” and the “Accounting Standards Reform Act of 1994” were introduced in the U.S. Senate to prevent the FASB from changing the accounting rules for stock options. This represented somewhat of a departure from the general policy of allowing the FASB to independently set accounting standards. Ultimately the FASB decided to encourage rather than require the use of a method that would have companies recognize stock options as compensation expense at the grant date. This decision was largely believed to be a result of the unprecedented political pressure that was placed on the FASB. The FASB’s decision to revise the accounting standard represented a shift from its general policy that financial standard setting should be based solely on determining the proper accounting treatment, rather than also considering some perceived economic cost to changing an accounting standard. In the words of James Hooton, who was then chief of Arthur Andersen's worldwide auditing, "It was the first time that accounting principles had become very, very much influenced by commercial interest and political interest."[4] Whether this was the first time the FASB revised an accounting policy due to political pressure is a debatable point. However, it did demonstrate the effect that campaign contributions and political lobbying by various industry sectors had on the development of an accounting standard.

In the years since 1994, the amount of campaign contributions by various industrial groups has increased dramatically. As noted on Table 1, between 1994 and 2000, four major business sectors (Financial Services, Electronics/High Tech, Lobbyist/Lawyers and General Business/Retail) all had more than 100% increases in their political campaign contributions. Most notably, the financial services sector increased over 200% and the Electronic/High Tech Industry increased almost 400%.

As noted above, the events of 1993 and 1994 may have been the beginning of politics/lobbying playing a significant role in the development of accounting standards. However, events in 2002 have shown that they were not the end of political lobbying. For example, at the beginning of 2002, as a result of the various financial reporting scandals during the previous year, the U.S Congress began to draft legislation related to reform in the accounting industry. This legislation ultimately resulted in the passage of the Sarbanes-Oxley "Accounting Industry Reform Act" on July 30, 2002. This legislation mandated various reforms to the accounting industry including the prohibition of auditors engaging in consulting services for their auditing clients and independent funding of the FASB.

However, the bill did not address the issue of accounting for stock options. Legislation related to the stock option issue, "Ending the Double Standard for Stock Options Act," was introduced as an amendment to the Accounting Industry Reform Bill. This amendment was vigorously opposed by the same business sectors, as well as many of the same senators, that opposed changes in rules for accounting for stock options in 1993 and 1994.

METHODOLOGY

This study reviewed the three bills discussed above and identified the sponsors and co-sponsors of the three bills. Data was then gathered related to the campaign contributions made by four business sectors (Financial Services, Electronics/High Tech, Energy and General Business/Retailers) to members of the U.S Senate. A comparison was made between the Senate sponsors and co-sponsors of the applicable legislation to a list of the "Top Twenty" Senate recipients of campaign contributions from each of the four business sectors.

In addition, within the financial services sector, the campaign contributions given by the accounting industry was examined separately. The accounting industry was examined separately because it was one of the strongest opponents to the proposed new rules. It was opposed by the accounting industry in general and the Big Six (now Big Four) accounting firms in particular.

The rationale for identifying the sponsors and co-sponsors of the legislation was that these senators were arguably the strongest supporters for those particular pieces of legislation. By comparing the sponsors to a list of the top 20 senators who received the most campaign contributions, we could identify possible relationships between the campaign contributions and the positions taken by various politicians.

The source for who sponsored and co-sponsored particular pieces of legislation was provided by THOMAS. THOMAS is an Internet site established by the Library of Congress.[5] It stores a series of government databases including the Congressional Record Text and the Congressional Record Index. The source for which senators received the most financial support in particular business sectors was the Center for Responsive Politics. The Center for Responsive Politics is a non-partisan, non-profit research group based in Washington, D.C. that tracks money in politics and its effect on elections and public policy. The Center conducts computer-based research on campaign finance issues for the news media, academics, activists and the public at large.

In addition, to the three specific pieces of legislation noted above, a similar analysis was conducted of a 1994 Senate non-binding resolution condemning the FASB proposed changes for accounting for stock options, and a 2002 bill introduced as a response to the bill mandating significant changes in accounting for stock options. For the 1993-1994 legislative season (the 103rd Congress), campaign contributions received for 1994 election cycle were examined. For the 2002 legislative season (the 107th Congress), campaign contributions for the 2000 election cycle were examined since full 2002 campaign contribution data was not available.

RESULTS

Legislation in the Early 1990's

The first piece of legislation examined was the "Equity Expansions Act of 1993" (S. 1175).[6] This legislation was sponsored by Senator Joseph Lieberman from Connecticut and was co-sponsored by 14 other senators from both political parties. This bill, if it had been enacted into law, would have mandated that no compensation expense be reported on a company's income statement for stock option plans.

Table 2 identifies the sponsors and co-sponsors of this legislation that also were in the "Top Twenty" list of senators who received financial contributions from the four business sectors and the accounting industry. A review of the support received by the senators who sponsored or co-sponsored this legislation indicates that many of these senators received strong support from the aforementioned business sectors and the accounting industry.

Specifically in the finance, law and retail sectors, 50% of the senators who sponsored or co-sponsored the bill were classified as being on the "Top Twenty" list of senators who received support from that particular business sector (See Panel A of Table 2). In the electronics/high tech sector, 42.9% of the senators were part of the "Top Twenty" group. With regard to the accounting industry, a review of Panel B indicates that the senators also received strong support from the accounting industry (42.9%). In addition, it should be noted that many individual senators received strong support from 75% or 100% of the sectors examined.

The second piece of legislation examined was the "Accounting Standards Reform Act of 1994" (S. 2525). This legislation was also sponsored by Senator Joseph Lieberman and was co-sponsored by seven other senators from both political parties. This act, if it had been enacted into law, would have amended the SEC Act of 1934 to require that any change in an accounting principle or standard would require an affirmative vote of the majority of the Senate in order to be enacted. This law would have hindered the independence of the FASB, which has historically been responsible for developing accounting standards.[7]

In the same manner as Table 2, Table 3 identifies the sponsors and co-sponsors of this legislation that also were in the "Top Twenty" list of senators who received financial contributions from particular business sectors and the accounting industry[8]. A review of Panel A of this table indicates that many of the senators who sponsored or co-sponsored this legislation also received strong support from the various business sectors.

Like the "Equity Expansion Act" discussed above, in the finance, lobbyist/lawyers and general business/retail sectors, 50% of the senators who sponsored or co-sponsored the bill were classified as being among the "Top Twenty" group of senators. In the electronics/high tech sector, 37.5% of the senators were part of the "Top Twenty" group.

With regard to the accounting industry, the support received by supporters of the Accounting Standards Reform Act was also very strong. Specifically, 37.5% of senators were in the "Top Twenty" category. In addition many individual senators also received strong support from 75% or 100% of the sectors examined.

The final piece of legislation from the early 1990's that was examined was a concurrent resolution expressing the sense of the Senate on the stock option accounting standard proposed (S.CON. RES. 34). Unlike the two other acts discussed above, this act was not a formal bill, but rather a non-binding concurrent resolution and was passed by the Senate.

This legislation was sponsored by Senator Bill Bradley from New Jersey and was co-sponsored by 16 other senators from both political parties. This act stated that the accounting standards proposed by the FASB would have grave economic consequences particularly for businesses which rely heavily on entrepreneurship. It also stated the Board should not change the current accounting rules to require that businesses deduct the value of stock options from income.

A review of the support received by the senators who sponsored or co-sponsored the bill indicates that for each business sector roughly a third of the senators were in the "Top Twenty" category (See Table 4). While this is not as high a percentage as the other two bills, it still represents a significant number of the senators sponsoring the bill. With regard to the accounting industry 31% of the senators were in the "Top Twenty" category.

2002 Legislation

The first legislation from the 2002 session examined was the "Ending the Double Standard for Stock Options Act" (S. 1940). This legislation was sponsored by Senator Carl Levin from Michigan and Senator John McCain from Arizona and was co-sponsored by five other senators from both political parties. This bill, if it had been enacted into law, would have limited the amount of the deduction for stock option costs corporations are allowed to take for tax purposes to the amount of expense they reported for financial reporting purposes. As most corporations do not recognize significant expenses for financial reporting purposes, this legislation would have, in effect, largely eliminated the tax deduction for most corporations.

A review of Table 5 indicates that, unlike the other bills, only Senator McCain had received significant support from the four aforementioned business sectors. In addition, it should be noted that Senator McCain's strong support from these business sector groups may have been largely related to his 2000 presidential campaign.[9] Unlike the earlier bills, this bill was not supported by any of the business sectors that have been examined in this study. Rather, this legislation was strongly opposed by all these business sectors. Although Senators Levin and McCain wanted to get a vote on the Senate floor to have this bill added as an amendment to the Sarbanes-Oxley Accounting Industry Reform Act, this legislation was not brought up for a vote in the Senate.

The final legislation examined in this study was drafted in response to the Levin-McCain legislation. This legislation was the "Stock Option Fairness and Accountability Act" (S. 2760). It was sponsored by Senator Enzi of Wyoming and co-sponsored by nine other senators. Rather than mandating a specific method for accounting for stock options, this legislation instead basically called for further study on the stock option issue. It instructed the SEC to analyze and report recommendations to certain Congressional committees on the accounting treatment of stock options.

A review of the support received by the senators who sponsored or co-sponsored this legislation indicates that, in some respects, the senators received stronger support for this bill than any of the other bills discussed. While only 20% of the senators were in the "Top Twenty" list for lobbyists/lawyers, in the financial services and high tech sectors, 50% of the Senators who sponsored or co-sponsored the bill were classified as being in the "Top Twenty" category. In the general business/retail sector, 60% of the senators were in the "Top Twenty" category which was the highest percentage for any bill. With regard to the accounting industry groups, 50% of the senators who strongly supported the bill were in the "Top Twenty" category. The 50% support level for the accounting industry also represents the strongest level of support of all the pieces of legislation examined.

DISCUSSION

Five pieces of legislation were examined in this study, three from the early 1990's and two from 2002. An examination of the financial support received by the senators who strongly supported each of these bills provides evidence for the continuing significant role that politics and campaign contributions play in the setting of accounting standards.

The three pieces of legislation from the early 1990's and the 2002 Stock Option Fairness and Accountability Act were designed to either directly or indirectly prevent stock option costs from being recognized as expenses in a company's financial statements. As noted above, a series of business sectors/industries strongly opposed any changes that would require stock option costs being reported as expenses. Many of the senators who strongly supported these pieces of legislation were strongly supported financially by the aforementioned business sectors that vigorously opposed the expensing of stock options.

In contrast, the "Ending the Double Standard for Stock Options Act" which was proposed in 2002 was designed to encourage companies to recognize stock options as expenses. This was strongly opposed by the business sectors examined in this study, and the senators that strongly supported this legislation were almost completely absent from any of the "Top Twenty" business sector/accounting industry lists examined.[10]

While the three pieces of legislation from the 1990's provide strong support for the role that politics played in setting accounting standards at that time, the two pieces of legislation from 2002 seem to indicate that the role of lobbying/campaign contributions in the accounting standard setting process continues to be significant. The level of support for politicians who supported the 2002 "Stock Option Fairness and Accountability Act" was in many respects greater than any of the early 1990's bills that were also supportive of the business sectors position. In addition, the virtual lack of support by the business sectors for senators who strongly supported the 2002 "Ending the Double Standard for Stock Options Act" also indicates the financial consequences of taking positions on accounting standards contrary to the view of powerful business sectors.

While this paper concludes that an analysis of the data provides strong support for the continuing role that politics plays in the setting of accounting standards, it should be noted that a number of senators not on any "Top Twenty" lists also co-sponsored bills that were supportive of the various business sectors interests. Also the paper is definitely not implying that any individual senator or senators supported a bill solely as a result of campaign contributions received from a particular group.

As noted at the outset of the paper, accounting for stock options is a complicated technical accounting issue without a clear answer. Rather than implying that a senator's position was based solely on campaign contributions from a particular business sector, it is this study's position that it is reasonable to assume that strong financial support by particular business sectors may have played a role in some senators' positions on various pieces of legislation.

It is also important to note that the only piece of legislation discussed above that was passed by the full Senate was the 1994 non-binding resolution that stated the FASB should not change the current accounting rules to require that businesses deduct the value of stock options from income. However, various sources cited above stated that just the introduction of this legislation in the early 1990's had a significant role in the FASB changing its position at that time. Given what happened in the 1990's, it is reasonable to conclude that these earlier bills and the introduction of bills taking a position against stock options in 2002 may have also had a significant impact on the FASB decision making process.

CONCLUSION

The importance of political lobbying and campaign contributions on the legislative process is certainly not a new story or one relevant only to the setting of financial accounting standards. However, given all the recent problems of the accounting profession, the role of politics in the accounting profession has particular importance at this time.

While this study focused on legislation introduced in the early 1990's and in 2002, the pattern of government leaders taking a strong role in the setting of accounting standards appears to be continuing. In May 2003, Senator Ensign of Nevada and Senator Boxer of Californian co-sponsored S. 979 the "Broad-Based Stock Option Plan Transparency Act of 2003."

This bill was a reaction to the tentative decision of the Financial Accounting Standards Board in April to mandate the expensing of stock options. This bill would place a three year moratorium on the mandatory expensing of stock options. It would temporarily prevent the Securities and Exchange Commission from recognizing any accounting standard related to the treatment of stock options. The bill would further require the SEC to adopt rules requiring companies to report information regarding their stock option plans and, after three years, the SEC would be required to issue a report. Commenting on the bill, Senator Ensign stated, "This issue was brought to my attention by a couple of hundred chief executive officers and leader in the high tech world. This is their No.1 issue because when they are properly structured stock options are valuable incentives for productivity and growth" (Carney, 2003).

Whether Senator Ensign and Senator Boxer's bill should become law is a debatable issue. What appears more certain is that, for the foreseeable future, politics, political lobbying and campaign contributions will continue to play an important role in the setting of accounting standards and the accounting profession in general. Consequently, business professionals and academic researchers may want to continue to monitor the positions political leaders take on particular accounting issues and what groups provide financial support to these political leaders.

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[1] The International Accounting Standards Board (IASB) is also currently examining the issue of accounting for stock options. The FASB has said it will work with the IASB toward a converged standard that would reduce or possibly eliminate any differences between those that use the IASB standard and those that follow United States' generally accepted accounting principles.

[2] The lack of political interest in this issue before 1993 is likely related to the fact that historically no significant stock-based employee compensation has been recognized under APB 25 "Auditing for stock issued to employees."

[3] Transcript of "Bigger than Enron" a *Frontline* Public Broadcasting Service television special (June 20, 2002).

[4] Transcript of "Bigger than Enron" a *Frontline* Public Broadcasting Service television special (June 20, 2002).

[5] The THOMAS website can be found at http://thomas.loc.gov.

[6] S. stands for a Senate bill as opposed to H.R. which would be a House of Representatives bill.

[7] The SEC has historically had the right to reject accounting standards promulgated by the FASB. However, before this legislation being proposed, the SEC did not have to formally approve each standard developed by the FASB. In addition, while the FASB has traditionally solicited opinions from the public (i.e., corporations, public accounting firms, government officials) through the use of exposure drafts, the FASB has always acted as an independent entity.

[8] Tables 4-6 analyze particular bills in the same manner as Tables 2 and 3.

[9] In the 2000 election cycle, the politicians that received the overall highest contributions were George W. Bush, Al Gore and John McCain, who were all presidential candidates (Center for Responsive Politics).

[10] As noted above, of the seven senators who strongly supported the bill only Senator McCain was on some of the "Top Twenty" lists and this may have been largely due to his 2000 Presidential campaign.