Corporate Governance: Back to Politics as Usual?

Less than a year ago, pressured by a public angered by plummeting stock prices and continuing corporate scandals, Congress approved the Sarbanes-Oxley Act, an overdue attempt to reform corporate governance. The act was unusual, not just because some of the measures it proposed were Draconian (perhaps overly so), but also because Congress discovered it had the backbone to stand up to corporate CEOs. Unfortunately, as public anger abates somewhat with a rising stock market, it seems to have gone back to business as usual: Last week, the head of the Financial Accounting Standards Board (FASB) had to take the extreme step of warning Congress against impeding efforts by the board to make corporations treat the stock options they grant employees as expenses.

Stock options are, as everyone knows, are simply options to buy a company's stock. Companies use them to pay employees. More important, the seven, eight, and even nine figure CEO pay packages are composed disproportionately of stock options. If they are a form of pay, and pay is an expense, why should stock options not be treated as an expense, reducing the earnings that are available to shareholders? Why would John Chambers, CEO of Cisco, call the proposed FASB accounting change "the engineering and high-tech job export act of 2003"?

Companies already report the estimated value of options they grant in a footnote. So the management's main objection is to seeing it reduce earnings. This is where they raise questions about the reliability and accuracy of the number. But firms already report many estimated numbers – such as the uncertain value of obligations to pay future worker pensions – as expenses. These are no more accurate than the estimated value of options. So why are they so against expensing options? Why does Intel claim in a letter to shareholders last month that expensing "has the potential for causing real economic harm to Intel?"

Maybe investors will be confused by the move towards expensing and bid down the stock price. But if this is the case, firms that grant lots of options should have seen their stock price bid down as FASB moves to force expensing gained force. An academic study finds little effect on the stock prices of firms that most heavily grant options, and concludes that expensing should have little effect on firm stock prices.

Perhaps expensing options will force CEOs to recognize the true cost of employees as Mr. Chambers seems to suggest. Clearly hiring and firing employees is ultimately a CEO decision, which should be based on a comparison between the cost of these employees and the revenues they generate. But if expensing stock options would lead to Mr. Chambers to fire some of his employees, should we infer that all these years he ignored the cost of stock options in deciding how many people to hire? And is he suggesting that a simple change in reporting requirement will change his way of computing the cost of his employees? Clearly not! Then why does he protest so much?

The academic study we cited earlier provides a clue. When the FASB last proposed expensing in 1993, a large number of firms wrote letters opposing the rule. The study cited earlier examined which firms wrote letters and found that they came disproportionately, not from firms that paid their rank and file in options, but from

firms that paid their CEOs largely with options. In other words, CEOs are not so much worried that they will be able to pay their employees with options but more worried that they will be able to pay themselves.

Why would they be more constrained if options are expensed? Even though sophisticated investors read footnotes, not all shareholders and, sadly, directors do. Expensing will make shareholders and directors face up to the true cost of the amounts they are paying CEOs. They will revolt if these seem excessive. This is all the more reason to mandate expensing – not because we think all CEOs are overpaid but because we think shareholders should make informed decisions. If worker pay and benefits are expensed, so should CEO pay and benefits. Expensing is not an accounting issue but a governance issue. And instead of supporting the FASB, Congressmen from California have introduced a motion for a three-year moratorium on expensing stock options.

This, unlike Sarbanes-Oxley, is more the typical pattern followed by politicians vis a vis corporate governance. In 1993, under pressure from corporate CEOs, Congress stood in the way of FASB mandating the expensing of stock options. In the late 1980s and early 1990s, under intense pressure from in-state CEOs who feared for their jobs, state legislatures enacted a number of anti-takeover statutes (laws that make it more difficult to acquire a company without the consent of the incumbent managers). As a recent study documents, these statutes weakened the most effective instrument to discipline managers and lead to an increase in managers' pay and a reduction in firm productivity.

The problem is many of the issues in corporate governance are fairly complex and do not excite public opinion. Far from the spotlight, politicians are more likely to succumb to vested interests. Even if actions seem populist, their ultimate effects can be quite elitist. Stock options are sold as ways to reward the rank and file rather than reward CEOs. Anti-takeover measures are described as ways to protect local jobs rather than protect the jobs of incompetent CEOs.

A seemingly successful governance action by Congress should make the pattern clear. In 1993, Congress limited the deductibility of executive salaries above one million dollars, as a populist cap on excessive managerial compensation. CEOs did not oppose it because the measure was completely ineffective. In fact, the law help raised managerial compensation. First, it was seen as a floor for executive cash pay (which board wants to appear so stingy to pay its CEO less than what Congress says a CEO "should" be paid). Second, it legitimized the use of stock options, which, unsurprisingly, were exempted from the cap.

With the stock market rising again, there will be a temptation for Congress to take the easy way out and listen to CEO lobbies. This will leave corporate governance reform half done. At best, this will diminish the productivity of U.S. firms and make it harder for small and medium sized firms to raise finance. At worst, this will set the stage for the next set of scandals. It is important that Congress see governance reform to its conclusion. A first step would be to let the FASB do its job.

Raghuram Rajan and Luigi Zingales are professors at the Graduate School of Business, University of Chicago and authors of *Saving Capitalism from the Capitalists* published by Random House.