Testimony of
Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
April 28, 2004

Attachment 1

FACTS about FASB

FACTS about FASB 2003–2004

401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 • www.fasb.org

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;

- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;

- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;

- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and

- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

□ *To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

□ *To weigh carefully the views of its constituents* in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board's judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.

□ *To promulgate standards only when the expected benefits exceed the perceived costs.* While reliable, quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.

□ *To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.* Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.

□ *To review the effects of past decisions* and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

AN INDEPENDENT STRUCTURE

Financial Accounting Standards Board (FASB)

The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–1959) and then by the Accounting Principles Board, also a part of the AICPA (1959–1973). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

Financial Accounting Standards Advisory Council (FASAC)

The FASAC has responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces and such other matters as may be requested by the FASB or its Chairman. At present, the Council has more than 30 members who are broadly representative of preparers, auditors and users of financial information.

Financial Accounting Foundation (FAF)

The FAF, which was incorporated to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its advisory council, ensuring adequate funding of their activities and exercising general oversight with the exception of the FASB's resolution of technical issues.

Governmental Accounting Standards Board

In 1984, the Foundation established a Governmental Accounting Standards Board (GASB) to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, ensuring adequate funding and exercising general oversight.

Trustees

The Foundation is separate from all other organizations. However, its Board of Trustees is made up of members from constituent organizations having interest in financial reporting. Nominees from constituent organizations are approved by the Trustees. There also are Trustees-at-large who are not nominated by those organizations, but are chosen by the sitting Trustees. The constituent organizations are:

FAF Constituent Organizations

- American Accounting Association
- American Institute of Certified Public Accountants
- Association for Investment Management and Research
- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

The members of the FAF Board of Trustees are:

- Manuel H. Johnson (Chairman of the Board and President, FAF), Co-Chairman, Johnson Smick International;
- Stephen C. Patrick (Vice President, FAF), Chief Financial Officer, Colgate-Palmolive Company;
- Judith H. O’Dell (Secretary and Treasurer, FAF), President, O’Dell Valuation Consulting LLC;
- Robert E. Denham, Senior Partner, Munger, Tolles & Olson, LLP;
- Samuel A. DiPiazza, Jr., Chief Executive Officer, PricewaterhouseCoopers;
- Douglas R. Ellsworth, Director of Finance, Village of Schaumburg, Illinois;
- Barbara H. Franklin, President and Chief Executive Officer, Barbara Franklin Enterprises;
- William H. Hansell, Executive Director Emeritus, International City/County Management Association;
- Richard D. Johnson, Former Auditor of State, Iowa;
- Duncan M. McFarland, President, Chief Executive Officer and Managing Partner, Wellington Management Company;
- Frank C. Minter, Retired Vice President and Chief Financial Officer, AT&T International;
- Eugene D. O’Kelly, Chairman and Chief Executive Officer, KPMG LLP;
- Lee N. Price, President and Chief Executive Officer, Price Performance Measurement Systems, Inc.; and
- Jerry J. Weygandt, Andersen Alumni Professor of Accounting, University of Madison-Wisconsin.

AN OPEN DECISION-MAKING PROCESS

Actions of the FASB have an impact on many organizations within the Board’s large and diverse constituency. It is essential that the Board’s decision-making process be evenhanded. Accordingly, the FASB follows an extensive “due process” that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and, in several respects, is more demanding.

HOW TOPICS ARE ADDED TO THE FASB'S TECHNICAL AGENDA

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The auditing profession is sensitive to emerging trends in practice and, consequently, it is a frequent source of requests. Requests for action include both new topics and suggested review or reconsideration of existing pronouncements.

The FASB is alert to trends in financial reporting through observation of published reports, liaison with interested organizations and discussions with the EITF—see page seven. In addition, the staff receives many technical inquiries by letter and telephone, which may provide evidence that a particular topic, or aspect of an existing pronouncement, has become a problem. The FASB also is alert to changes in the financial reporting environment that may be brought about by new legislation or regulatory decisions.

The Board turns to many other organizations and groups for advice and information on various matters, including its agenda. Among the groups with which liaison is maintained are the Accounting Standards Executive Committee (AcSEC) and Auditing Standards Board of the AICPA, the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as the Association for Investment Management and Research (AIMR), Financial Executives International (FEI) and Institute of Management Accountants (IMA). As part of the agenda process, the Board may make available for public comment agenda proposals that concisely describe the scope of potential projects. The Financial Accounting Standards Advisory Council (FASAC) regularly reviews the Board's agenda priorities and consults on all major projects added to the technical agenda.

After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics.

Those factors include consideration of:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);

- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability and comparability are likely to be developed;

- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;

- *Practical consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;

- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;

- *Cooperative opportunities*—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and

- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the IASB or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

Board Meetings

The core of the Board's due process is open decision-making meetings and exposure of proposed standards for public comment. Every technical project involves a number of Board meetings. The Board meets as many times as necessary to resolve the issues. A major project generally includes dozens of meetings over several years. All meetings are open to public observers, although observers do not participate in the discussions. The agenda for each meeting is announced in advance.

The staff presents written material, including analysis and recommendations, to the Board members in advance as the basis for discussion in a Board meeting. The written material is the result of extensive research by the staff, including a detailed review and analysis of all of the significant alternative views for each issue to be discussed at the meeting. The meeting format calls for oral presentation of a summary of the written materials by the staff, followed by Board discussion of each issue presented and questioning of the staff on the points raised. The Board may reach conclusions on one or more of the issues presented. Any conclusions reached are tentative and may be changed at future Board meetings.

The Exposure Draft

When the Board has reached conclusions on the issues, the staff is directed to prepare a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote by written ballot to issue the Exposure Draft. A majority vote of the Board is required to approve a document. Alternative views, if any, are explained in the document.

The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information and an explanation of the basis for the Board's conclusions.

At the end of the exposure period, generally 60 days, all comment letters and position papers are analyzed by the staff. This is a search for new information and persuasive arguments regarding the issues; it is not intended to be simply a “nose count” of how many support or oppose a given point of view. In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions.

Further Deliberation of the Board

After the comments have been analyzed and studied, the Board redeliberates the issues. As in earlier stages of the process, all Board meetings are open to public observation. The Board considers comments received on the Exposure Draft, and often incorporates suggested changes in the final document. If substantial modifications appear to be necessary, the Board may decide to issue a revised Exposure Draft for additional public comment. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board. A vote is taken on the final document, again by written ballot. Four votes are required for adoption of a pronouncement.

Statements of Financial Accounting Standards

The final product of most technical projects is a Statement of Financial Accounting Standards (SFAS). Like the Exposure Draft, the Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board’s conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents.

Additional Due Process

For major projects, the Board generally goes significantly beyond the core due process described above. Soon after a major project is placed on the Board’s technical agenda, a task force or working group usually is appointed, including preparers, auditors and users of financial information who are knowledgeable about the subject matter. Experts from other disciplines also may be appointed. Care is taken to ensure that various points of view on the issues involved are represented.

The task force meets with and advises the Board and staff on the definition and scope of the project, the nature and extent of any additional research that may be needed and the preparation of a discussion document and related material as a basis for public comment. Task force meetings are open to public observers. Task forces and working groups play an important role in the standard-setting process by providing expertise, a diversity of viewpoints and a mechanism for communication with those who may be affected by proposed standards.

Before it begins deliberations on a new major project, the Board often asks the FASB staff to prepare a Discussion Memorandum or other discussion document. The task force provides significant assistance and advice in this effort. The discussion document generally sets forth the definition of the problem, the scope of the project and the financial accounting and reporting issues; discusses research findings and relevant literature; and presents alternative solutions to the issues under consideration and arguments and implications relative to each. The discussion document is published to invite constituents to comment on the project before the Board begins deliberations.

After a discussion document or an Exposure Draft is issued for public comment, the Board may decide to hold a public hearing or a public roundtable meeting. These meetings provide an opportunity for the Board and staff to ask questions about information and viewpoints offered by constituents who participated in the comment process. Any individual or organization may request to be heard at a public hearing, and the FASB attempts to accommodate all such requests. Public observers are welcome.

Statements of Concepts

In addition to Statements of Financial Accounting Standards (SFAS), the FASB also issues Statements of Concepts. Those do not establish new standards or require any change in the application of existing accounting principles; instead, they are intended to provide the Board and constituents with a foundation for setting standards and concepts useful as tools for solving problems. The framework defined in the Statements of Concepts helps the Board identify the right questions to ask in structuring technical projects and contributes to a consistent approach over time. Because of their long-range importance, Statements of Concepts are developed under the same extensive due process the FASB follows in developing Statements of Financial Accounting Standards on major topics.

Other Documents

In addition to broad issues of financial accounting and reporting, the Board considers narrower issues related to implementation of existing standards and other problems arising in practice. Depending on their nature, application and implementation problems may be dealt with by the Board in Statements or Interpretations, by the staff in Technical Bulletins or in Implementation Guidance in question-and-answer form. All of those are subject to discussion at public Board meetings and to exposure for comment, although Technical Bulletins and Implementation Guidance are exposed more narrowly.

Emerging Issues Task Force (EITF)

The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. EITF members are drawn primarily from public accounting firms but also include representatives of large companies. The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the privilege of the floor. Lawrence W. Smith, FASB Director, Technical Application and Implementation Activities, also serves as Chairman of the EITF.

Composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by the FASB as an indication that no Board action is needed. A consensus is defined as an agreement, provided that no more than two of the thirteen voting members object. Consensus positions of the EITF are considered part of GAAP. If consensus is not possible, it may be an indication that action by the FASB is necessary.

The EITF meets six times a year. Meetings are open to the public and, generally, are attended by substantial numbers of observers. Because interest in the EITF is high, the FASB has separate subscription plans for keeping up-to-date on the issues.

Availability of Publications

To encourage public comment, Exposure Drafts and other discussion documents are distributed primarily through the FASB website.

Statements of Standards, Statements of Concepts and Interpretations also are distributed broadly when published through FASB subscription plans and may be purchased separately by placing an order at the FASB website.

The FASB strives to keep the public informed of developments on its projects through a monthly newsletter, *The FASB Report,* and a weekly notice, *Action Alert,* which provides notice of upcoming Board meetings and their agendas with brief summaries of actions taken at previous meetings. *Action Alert* is available by e-mail subscription at the FASB website.

FASB Website

The FASB website includes general information about the Board and its activities, information on upcoming public meetings, announcements of Board actions, summaries and status of all active technical agenda projects, summaries of previously issued FASB Statements and Interpretations, the quarterly plan for FASB projects and information about membership in the Foundation, as well as information on how to order publications online, by phone or mail.

The website can be accessed at www.fasb.org.

The Public Record

Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record. The public records on all projects are available for inspection in the public reference room at FASB headquarters in Norwalk, Connecticut. Copies of public records also may be purchased at prices that vary according to the volume of material that has to be copied by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for more information.

ADDITIONAL INFORMATION

General Information

For further information about the FASB, including Board meeting schedules, access the FASB website at www.fasb.org, call or write Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700 or via e-mail at director@fasb.org.

To Order Publications

Statements, Interpretations, Exposure Drafts and other documents published by the FASB may be obtained by placing an order on the FASB website at www.fasb.org or by contacting the FASB Order Department at 1-800-748-0659, weekdays 9:00 a.m. to 5:00 p.m. EST.

Public Hearings and Comment Letters
For information about submitting written comments on documents or about public hearings, access the FASB website at www.fasb.org or contact the FASB Project Administration Department at (203) 847-0700, ext. 389.

Public Reference Room and Files
The FASB maintains a public reference room open during office hours, Monday through Friday. The public reference room contains all FASB publications, comment letters on documents and transcripts of public hearings. Copies of this material may be obtained for a specified charge by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for an appointment.

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To order additional copies of *FACTS about FASB* without charge, contact Public Relations at (203) 847-0700, ext. 252, or fax a request to (203) 849-9714.

MEMBERS OF THE FASB

The seven members of the FASB serve full time and are required to sever all connections with the firms or institutions they served prior to joining the Board. While collectively they represent diverse backgrounds, they also must possess "knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting."

Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Expiration dates (at June 30) of current terms are indicated in captions beneath the members' photographs.

Robert H. Herz *was appointed FASB Chairman, effective July 1, 2002. He was a Senior Partner with PricewaterhouseCoopers, its North America Theater Leader of Professional, Technical, Risk & Quality and a member of the firm's Global and U.S. Boards. He also served as a part-time member of the IASB.*

He joined Price Waterhouse upon graduating from the University of Manchester in England with a B.A. degree in economics. He later joined Coopers & Lybrand as its Senior Technical Partner and later held a similar position with PricewaterhouseCoopers.

He has authored numerous publications and chaired the AICPA SEC Regulations Committee, the Transnational Auditors Committee of the International Federation of Accountants and was a member of the EITF.

G. Michael Crooch *was a Partner with Arthur Andersen and Director of the firm's International Professional Standards Group before joining the FASB on July 1, 2000. Mr. Crooch was the American Institute of Certified Public Accountants' (AICPA) delegate to the International Accounting Standards Committee (IASC) and served on the IASC's Executive Committee. He also served on the Institute's Accounting Standards Executive Committee, including three years as the Committee Chairman. He earned bachelor's and master's degrees from Oklahoma State University and a Ph.D. from Michigan State University.*

Leslie F. Seidman *was named to the FASB, effective July 1, 2003. Prior to joining the Board, she managed her own financial reporting consulting firm. Among the previous posts she held were Vice President at J.P. Morgan & Company, where she was responsible for establishing accounting policies, and Assistant Director of Implementation and Practice Issues at the FASB. She started her career as an auditor at Arthur Young & Company. She earned a B.A. degree from Colgate University and an M.S. degree from New York University.*

Edward W. Trott *was appointed as a member of the FASB, effective October 1, 1999. Since 1992, he headed the Accounting Group of KPMG's Department of Professional Practice. Before joining the Board, he was a member of the FASB's Emerging Issues Task Force, the Financial Reporting Committee of the Institute of Management Accountants, the FASB's Advisory Council and the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA. He holds a bachelor's degree from the University of North Carolina and an M.B.A. degree from the University of Texas.*

Katherine Schipper *was appointed to the FASB, effective September 2001. Prior to joining the FASB, she was the L. Palmer Fox Professor of Business Administration at Duke University's Fuqua School of Business. She has served the American Accounting Association (AAA) as President and as Director of Research. She was a member of the FASB's Advisory Council (FASAC) from 1996 to 1999. Ms. Schipper holds a B.A. degree from the University of Dayton and M.B.A., M.A. and Ph.D. degrees from the University of Chicago.*

Gary S. Schieneman *was appointed to the FASB, effective July 1, 2001. Prior to joining the FASB, Mr. Schieneman served as Director, Comparative Global Equity Analysis, of Merrill Lynch. He is a member of the American Institute of Certified Public Accountants (AICPA), the New York Society of Security Analysts and the Association for Investment Management and Research (AIMR). He received a bachelor's degree in accounting from the University of Illinois and earned an M.B.A. degree from New York University.*

George J. Batavick *was named a member of the FASB, effective August 1, 2003. He was previously Comptroller of Texaco Inc. where he had company-wide responsibility for strategy and policy matters covering all aspects of accounting and financial reporting. Prior to this post, he held a number of key positions, including Deputy Comptroller and Director of Internal Auditing. Before joining Texaco, he was with Getty Oil Company. He began his career at Arthur Andersen. He is a graduate of St. Joseph's University in Philadelphia where he earned a B.S. degree.*

FASB Staff

The Board is assisted by a staff of approximately 40 professionals drawn from public accounting, industry, academe and government, plus support personnel. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public and prepares recommendations and drafts of documents for consideration by the Board.

FASB Fellows are an integral part of the research and technical activities staff. The Fellowship program provides the Board the benefit of current experience in industry, academe and public accounting and offers the Fellows first-hand experience in the accounting standard-setting process. Fellows take a leave of absence from their firms or universities and serve as project managers or consultants on a variety of projects.

Suzanne Q. Bielstein *is Director, Major Projects and Technical Activities for the FASB. Previously, she served in various capacities at the FASB, including Assistant Director of Technical Research and Project Manager on the business combinations and combinations for not-for-profit organizations. Prior to joining the FASB in early 1999, she spent five years with Caradon plc in two different roles—Vice President of Planning, North America, and Vice President and Corporate Controller of Clarke American Checks, Inc. (a subsidiary of Caradon). Before joining Caradon, Ms. Bielstein was an Audit Partner at KPMG in Boston. Ms. Bielstein earned a B.B.A. degree in accounting from the University of Notre Dame.*

Kimberley Ryan Petrone, *who has been a member of the FASB staff since 1989, was named Director, Planning, Development and Support Activities in April 2002. Previously, Ms. Petrone was a Project Manager on the Board's business combinations project from 1997 through issuance of Statements 141 and 142 in July 2001 and has been involved in a number of other FASB projects. Before joining the FASB, Ms. Petrone was a Corporate Accounting and Financial Reporting Manager with Savin Corporation. Prior to Savin, she was with AMAX Inc. She earned a B.S. degree in accounting from the University of Bridgeport and an M.B.A. degree from the University of Connecticut.*

Lawrence W. Smith *was named Director, Technical Application and Implementation Activities of the FASB in August 2002. Prior to assuming this post, he was a Partner with KPMG for 14 years, headquartered most recently in Stamford, Connecticut. From 1992–1996, Mr. Smith served as a Partner in KPMG's Department of Professional Practice in New York. During his 25-year tenure with KPMG, he served as Engagement Partner and SEC Reviewing Partner on a number of international* Fortune *1000 clients. He is a past member of the Technical Standards Subcommittee of the Professional Ethics Committee of the AICPA. Mr. Smith received an M.S. degree in accounting from Northeastern University.*

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Excerpts from Recent Materials about the Importance of the FASB's Independence and Concerns about Proposed Legislation

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Enron, WorldCom, and other corporate governance failures demonstrate the dangers of not having independent accounting and auditing standards.

. . . .

If Congress interferes with the FASB proposal, the dangerous precedent of intervention into accounting standards will be set. Congressional interference is detrimental to the independent nature of the FASB and the accounting treatment of stock options is a matter best left to FASB to determine.

The Honorable Daniel K. Akaka, Ranking Member, Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 20, 2004

I know there are several bills in Washington that could erode confidence in the FASB, including the Enzi-Reid Stock Option Accounting Reform Act. While I personally won't tell you how to vote on that specific piece of legislation, it is absolutely critical that . . . you do everything you can to keep accounting standard setting in the private sector and preserve the role of the FASB. No accounting body has ever worked so well and it is unlikely that any replacement or increased government oversight will improve upon its performance.

W. Steve Albrecht, Professor of Accounting and Associate Dean, Marriott School of Management, Brigham Young University, March 5, 2004

Politics and financial-reporting standards don't mix. Accounting standards should be set by an independent and objective group of experts, free from political pressure, after careful study and an open comment period in which feedback is invited from all constituents. That is FASB's mandate. Elected officials must overcome the temptation to intervene and set a "politically correct" agenda for an independent standard-setter.

The Association for Investment Management and Research (a worldwide, non-profit professional association of 70,000 securities analysts, fund managers, and investment advisors), April 9, 2004

Financial markets' credibility and health would be best served if options were treated as an expense and Congress respected the independence of the FASB.

The Baltimore Sun, April 16, 2004

By and large FASB would be better off if Congress just stayed out of the rulemaking process.

Dennis R. Beresford, Executive Professor of Accounting, The University of Georgia, and former Chairman of the Financial Accounting Standards Board, March 22, 2004

It is very disappointing to see that members of Congress are again threatening to veto FASB on accounting for stock options. It is in no one's best interest to politicize accounting, and I hope that there will be a more evenhanded debate this time.

Dennis R. Beresford, Executive Professor of Accounting, The University of Georgia, and former Chairman of the Financial Accounting Standards Board, July 2003

I urge you to support the Financial Accounting Standards Board, its due process and the importance of maintaining the continuation of independent private-sector initiatives in the development and setting of accounting and financial standards.

Richard H. Booth, President and Chief Executive Officer, HSB Group, Inc., March 3, 2004

Companies who voluntarily expense have already begun to demonstrate that it yields more accurate earnings numbers, restores investor confidence, and can be accomplished without eliminating the benefits for rank-and-file employees. While H.R. 3574 would delay the implementation of FASB requirements, I strongly believe we must act now to increase discipline within the system and strengthen investor confidence by ending the special treatment that stock options have enjoyed for decades.

The Honorable Michael N. Castle, United States House of Representatives, March 3, 2004

I would like to reiterate my support for an independent FASB to bring this project to a timely conclusion with the accounting they have proposed.

Jack T. Ciesielski, President, R.G. Associates, Inc., April 21, 2004

In my years of observing the standard setting process, I've seen the Board develop improved accounting standards with an unmatched level of openness and fairness. Their standards will not make everyone happy – in addressing the complicated issues they're charged with, it's impossible to satisfy all parties involved. The reason we're here is because some of the FASB's constituents are so unhappy with their attempts to reform the accounting for option compensation that they've pulled Congress into the process. They're seeking a legislative answer to an accounting rule they oppose, and in doing so, usurping the FASB's authority to set standards. I believe that the FASB's ability to develop impartial standards resulting in robust information for investors to use would be seriously hampered if legislative intervention becomes the norm for disagreeing with their pronouncements, and a blueprint for such behavior was created the last time the Board attempted to remedy option compensation accounting ten years ago. While it may benefit a few of the Board's constituents to preserve the broken accounting model, in the long run our capital markets would likely suffer – and result in capital being misallocated in the economy.

Jack T. Ciesielski, President, R.G. Associates, Inc., April 20, 2004

Which brings me to the deeper and far more troubling core of what is wrong with this bill: the compromising of the FASB's independence. I oppose the injection of Congressional bias into the independent standard-setting process of the FASB – a process that was strongly endorsed by Congress during the development of the Sarbanes-Oxley Act, and ultimately embedded in the Act itself.

Jack T. Ciesielski, President, R.G. Associates, Inc., March, 1, 2004

The eagerness of lawmakers to work with Silicon Valley executives on legislation to control accounting standard-setting is a frightening sight to behold; it provides more evidence of the need for standard-setting that's out of their direct political grasp. An independent FASB is the best hope of America's individual investors, who don't have a well-oiled lobbying machine and aren't well-represented by elected officials.

Jack T. Ciesielski, President, R.G. Associates, Inc., May 5, 2003

Until the properly authorized expert independent organization, FASB, acts to correct this problem, many companies will hide behind differing earnings treatments and disdain performance-based options even while recognizing that they are the better approach to executive compensation. Congress should be careful not to politicize this issue and should permit FASB to take on this issue on its intrinsic merits. The recent support of the FASB by SEC Chairman Donaldson is encouraging as to the view at the SEC.

Peter C. Clapman, Senior Vice President and Chief Counsel of Corporate Governance, TIAA-CREF (a full-service financial services provider with approximately $262 billion in assets under management supporting the pensions of nearly 3 million individuals at nearly 15,000 institutions in the educational and research field), May 20, 2003

The Securities and Exchange Commission long ago recognized the private sector's role in establishing accounting standards. We believe it would be a shame for this Congress to undo almost 70 years of independent thinking in this critical area.

Scott Curtin, Managing Partner, Grant Thornton LLP, Kansas City, April 13, 2004

The integrity of financial reporting requires that U.S. companies expense all stock options, contrary to the proposal of the Stock Option Accounting Reform Act (S. 1890 & H.R. 3574). The expensing of only stock options held by the five most highly compensated executive officers has the effect of overstating the profitability and assets of a corporation, and thereby misleading investors.

Richard A. Curtis, Executive Director, The Highway Patrol Retirement System (a $625 million pension fund), February 5, 2004

It is critical for the FASB to debate and make decisions without government intervention.

Donald P. Delves, President, The Delves Group, April 20, 2004

While I am passionate about requiring the expensing of stock options, the principal purpose of this letter is to ask that the FASB be allowed to do its job. Congress should stay out of the debate. Congress has also been bashing auditors (partly justified) for not standing up to their clients. It is alleged that the auditors champion the interests of their clients for fear of losing fees. They are criticized of this even when the clients' interests prove to be correct. Many members of Congress are guilty of championing the interests of their constituents, regardless of how senseless the cause, for fear of losing political contributions. A pretty safe, if not honorable, thing to do 10 years ago. Now, however, when (it is estimated) 500 companies are voluntarily adopting the expensing of stock options and many investor advocates have favored expensing, those in Congress must realize it isn't only the ones that pass out all the contributions that have a vote!

Raymond L. Dever, CPA (Retired), Tucson, AZ, February 26, 2004

The supporters of this bill insult the intelligence of anybody with knowledge of accounting or finance. Not expensing employee stock options is accounting *FRAUD*. Chairman Alan Greenspan says options "should be expensed," and the argument that they can't be accurately valued is "flat wrong." When it comes to options Silicon Valley will only be happy with options having a value of zero, anything else is not acceptable to TechNet. The Black-Scholes options' pricing model is time tested, elegant, and accurate.

Andrew H. Dral, Sacramento, CA, December 30, 2003

Allow the Experts to Require Expensing of Options—Keep Politics Out. Options are a critical compensation tool, but they are not free. Current rules allow companies to choose not to list options as an expense on their financial statements. When options are not expensed, financial statements do not accurately reflect a company's true financial state. In addition, current rules can encourage executive pay packages bloated with options grants that appear "free" to the company. The Financial Accounting Standards Board has stated its intent to require companies to list the cost of stock options in their financial statements. In 1994, Congress blocked a similar effort. . . . [T]his time, Congress must keep out and allow FASB to require options expensing.

The Honorable John Edwards, United States Senate, July 7, 2003

. . . [P]olitical interference with the private-sector accounting board is a dangerous precedence.

The Honorable Peter G. Fitzgerald, Chairman of the Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 20, 2004

Congress should not substitute political decisions for the technical accounting decisions of our private sector independent accounting standards board. I will use every option at my disposal to fight any legislation that would undo the new rule or otherwise threaten independence.

The Honorable Peter G. Fitzgerald, Chairman of the Financial Management, the Budget, and International Security Subcommittee of the Committee on Governmental Affairs, United States Senate, April 1, 2004

U.S. Financial markets remain the envy of the world due to the quality, timeliness and credibility of the financial information and disclosures provided by companies. The result is better allocation of resources and lower overall cost of capital. We here in Congress must ensure that this remains the case by allowing our standard-setter to operate independent of public and private special interests.

As we discuss FASB's proposal, I continue to encourage my colleagues to support the position that the role of FASB is to pursue transparency and accuracy in accounting standards, not to choose among competing public policies. We should not be setting accounting standards on a political basis.

The Honorable Paul E. Gillmor, United States House of Representatives, April 21, 2004

After the disastrous financial accounting scandals of ENRON and TYCO, it is best for accounting standards to be determined by the experts, not politicians. We urge you to oppose H.R. 3574 or any legislation that interferes with the full adoption of FASB's new draft rule and their independence.

The Honorable Paul E. Gillmor, The Honorable Michael Castle, and The Honorable Pete Stark, United States House of Representatives, April 1, 2004

H.R. 3574 would undo the progress made by the Sarbanes-Oxley Act of 2002 and recent Securities and Exchange Commission (SEC) Policy Statement reaffirming the Financial Accounting Standards Board (FASB) as the nation's accounting standard setter. Protecting the standard-setting process from political intervention was an important reason for these recent steps. The role of FASB is to pursue transparency and accuracy in accounting standards, not to choose among competing public policies. The FASB designs the ruler. It is for others to decide what to do with the measurements.

The Honorable Paul E. Gillmor, United States House of Representatives, March 4, 2004

We should not be setting accounting standards on a political basis. Also, the failure to expense options provides false and misleading statements to shareholders, because it does not accurately report the true costs to the company and shareholders, which explains the broad support for stock options expensing by financial experts such as SEC Chairman William Donaldson, Federal Reserve Chairman Alan Greenspan, former Fed Chairman Paul Volcker and Warren Buffett.

The Honorable Paul E. Gillmor, United States House of Representatives, March 3, 2004

Some members of Congress say they need to "protect" stock options to protect American technological leadership. That is a useful goal, and there are many things lawmakers could do to help attain it. Adequately funding federal research is one of them; conspiring with tech companies to perpetuate an accounting fiction isn't.

Lee Gomes, The Wall Street Journal, March 22, 2004

I think it would be a bad mistake for Congress to impede FASB.

The Honorable Alan Greenspan, Chairman, Federal Reserve System, April 21, 2004

We are writing to you to again express our views on H.R. 3574, "Stock Option Accounting Reform Act" and to urge Congress not to prevent the Financial Accounting Standards Board from doing its job of independently setting U.S. accounting standards. We believe that this pending legislation should be withdrawn and that the authority of FASB not be undermined by this legislation.

Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System (a $58.7 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S.), April 5, 2004

Requiring companies to expense only options granted to the CEO and the next four highest compensated executives, as proposed in S. 1890, is insufficient, and it appears to be based on a desire to report overly optimistic numbers rather than report comprehensive financial information. However, this is a decision that should not be made in Congress. Rather, the Financial Accounting Standards Board (FASB), an[] independent entity, is where this decision making should take place.

Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System (a $56 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S.), December 18, 2003

Congress should keep out of the accounting principles debate because most members of Congress are not schooled in accounting as an information science or as a behavior catalyst or as an economic measurement.

Mark E. Haskins, Professor of Business Administration, Darden School of Graduate Business Administration, University of Virginia, March 22, 2004

To make the problem worse, my industry is now trying to get Congress to compromise the independence of the accountants on accounting policy. Hopefully Congress will demur. The SEC and FASB are not perfect, but they are good accountants and need to retain their independence.

Reed Hastings, CEO, Netflix Inc., April 5, 2004

Allowing FASB to determine the proper accounting treatment for stock options will mean that the treatment will be fairly reflected in the financial statements. For Congress to intervene in the issue of the proper treatment of stock options would mean that the accounting rules would reflect considerations other than fairly representing the financial condition of the business. This does not promote transparency in financial statements and thus is not in the best interests of the investor. Therefore, we urge you to oppose . . . [S. 1890/H.R. 3574].

J. Thomas Higginbotham, American Institute of Certified Public Accountants (the national, professional organization of CPAs, with more than 330,000 members in business and industry, public practice, government and education), March 11, 2004

It may seem attractive to put off this fight once again, but it is not going away. H.R. 1372 is an understandable effort, but the studies contemplated by H.R. 1372 are no answer to the problem. They are only a reason for another delay.

The Honorable Roderick M. Hills, former Chairman of the United States Securities and Exchange Commission, June 3, 2003

This is not the first time FASB has attempted to require appropriate expensing of stock options. In the mid-1990's FASB attempted to require option expensing, but was pressured by Congress to abandon its position. This thwarting of FASB's role as an independent body did nothing to protect shareholders from the corporate collapses that have plagued investors over the past several years. This time, we hope Congress will respect FASB's independence and not interfere with a process that we believe will result in providing shareholders with more transparent financial statements.

James P. Hoffa, General President, International Brotherhood of Teamsters (representing 1.4 million active members and over 600,000 retirees, and individual pension and health and welfare benefit trusts with assets over $100 billion), March 3, 2004

The exposure draft by the Financial Accounting Standards Board, recommending that stock options be expensed on the income statement . . . produced an even greater howl of outrage from the tech sector and its tame politicians than had been expected. . . .

. When politicians . . . . start setting accounting rules, the U.S. financial system is in trouble!

Martin Hutchinson, United Press International, April 5, 2004

As we proceed today, I must caution my colleagues once again about the ongoing need to protect the independence of the Financial Accounting Standards Board. A decade ago, the Congress unfortunately strong-armed this private regulatory body into abandoning its efforts to adopt a rule requiring stock options expensing. We now know that this retreat contributed to the financial storm on Wall Street in 2001 and 2002.

The Honorable Paul E. Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, April 21, 2004

Other leaders on Capitol Hill have agreed with me about the wisdom of protecting the independence of the Financial Accounting Standards Board. Earlier this year, Senator Shelby and Senator Sarbanes, the two most powerful members of the Senate Banking Committee, asserted their bipartisan opposition to intervening in the activities of the board. Chairman Oxley has also previously said that compromising the independence of the private board that set accounting rules "could negatively impact efforts to improve the transparency of financial reports." I wholeheartedly agree. Deciding what should be accounted for and how it should be accounted for is the job of the Financial Accounting Standards Board, not the Congress.

The Honorable Paul E. Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, March 3, 2004

The expensing of stock options is long overdue. It will help bring corporate balance sheets into line with reality, and allow investors to measure the true value of executive compensation packages. . . . In the name of transparency, this bill would actually allow corporations to continue to obscure critical information. It is dramatically out of step with the increasing demand for openness and transparency in the wake of the corporate scandals of the last two years.

Adam Kanzer, Director of Shareholder Advocacy, Domini Social Investments, August 13, 2003

Although Congress has an important oversight role with respect to financial accounting and reporting for public enterprises, Congress should not be getting involved in writing specific accounting standards. The FASB must be allowed to exercise its independence to study the issues and promulgate appropriate accounting standards under a full due process open to public debate. Congress should not override FASB's expertise in accounting matters. The Board was established as an independent body to try and avoid undue influence by any single party. The Board's thorough, open, and public due process is subject to active oversight by the private sector Financial Accounting Foundation and the United States Securities and Exchange Commission. We would be very concerned if political influence was brought to bear on a financial statement line item.

Claude Lamoureux, Interim Chair, Accounting and Auditing Practices Committee, The International Corporate Governance Network (an international network of institutional investors, shareholder advocates and corporate governance experts collectively holding more than $10 trillion in assets), February 2, 2004

The bill, which purports to bridge the gap between expensing and antiexpensing factions, does nothing of the sort. It would require expensing only of options granted to each company's chief executive and the four other highest-paid executives – and mandate the use of a valuation method that amounts to a cure worse then the disease.

Louis Lavelle, BusinessWeek, November 26, 2003

FASB . . . resisted enormous pressure from corporate executives when they decided to end the accounting that keeps stock options off corporate books as an expense, thereby making a company's earnings look better than they are. Hopefully, Congress will also stand up to the powerful political forces being brought to bear to overrule FASB. Congress should protect FASB's independence and its resolution of controversial accounting issues based on accounting expertise rather than political considerations. That's what we committed to do two years ago when we enacted the Sarbanes-Oxley Act, and it is critical that, in this first big test, we continue to champion, preserve, and fortify FASB's independence.

The Honorable Carl Levin, United States Senate, April 20, 2004

Some in Congress are proposing to overrule FASB, but many industry leaders and investors have already spoken out against legislation that would interfere with FASB's independent judgment on accounting issues, including Alan Greenspan, William Donaldson, John Snow, Paul Volcker, Arthur Levitt, Charles Bowsher, Warren Buffett, John Biggs, the Investment Company Institute, Council of Institutional Investors, AFL-CIO, and Consumer Federation of America, to list a few.

The Honorable Carl Levin and The Honorable John McCain, United States Senate, March 31, 2004

Stock options are the 800 pound gorilla that has yet to be caged by corporate reform. Corporate scandals have shown how current U.S. accounting rules are fueling stock option abuses linked to deceptive accounting, excessive executive pay, and nonpayment of taxes by profitable corporations. Honest accounting of stock options would strengthen the accuracy of U.S. financial statements and help restore investor confidence in our financial markets. FASB and the International Accounting Standards Board have already proposed treating stock options as an expense, and over 275 U.S. companies have begun doing so on a voluntary basis. Legislation blocking requirements for stock option expensing is not only wrong on the issue, it is also an attack on FASB's independence. The legislation would take the unprecedented step of directing the SEC, once FASB exercises its independent judgment on an accounting issue, not to recognize or enforce that accounting judgment. It sends exactly the wrong message to investors about our commitment to accounting reform.

The Honorable Carl Levin, United States Senate, May 1, 2003

Naturally, Congress also has opinions. On the House side, a significant number of Representatives (many no doubt influenced by campaign contributions) think that FASB should be stopped in its tracks. But on the Senate side, Richard Shelby (R-Alabama), chairman of the Banking Committee, which has jurisdiction over the matter, seems determined to keep Congress out of it. The setting of accounting standards, he says, "should be left to the professionals."

Carol J. Loomis, Fortune, April 19, 2004

A lobbying blitz has begun to derail the FASB once again. Two bills have been introduced in Congress. One would deter the FASB from acting for three years while the issue was "studied," as if it hadn't been studied to death. The other would dictate a compromise rule change that would leave the issued hopelessly muddled.

. . . .

Congress, which has the ultimate say on whether Washington intervenes, is divided. Write your congressman: Don't let the silicon pigs skin you again.

Roger Lowenstein, author of "Origins of the Crash: The Great Bubble and Its Undoing" and an outside director of the Sequoia Fund, SmartMoney, April 2004

While I may suggest a different model than FASB ultimately adopts, let me be clear: *anything* FASB does on this is better than the existing approach, and *anything* Congress does to stand in the way is nothing but thuggery. FASB's interest is to optimize information flow. Congressional machinations to limit this flow are ultimately a cost to all of us for the benefit of the few. That's wrong.

We're not talking about a change in economics, but rather a change in information flow. Where Congress is seeking to restrict information flow for the benefit of few flies in the face of what a non-political entity like FASB is chartered to do in the first place.

Bill Mann, Senior Analyst, The Motley Fool, and Member of the FASB's User Advisory Council, March 17, 2004

The Senate holds hearings today to discuss a bill that would once again place political limitations on the FASB's ability to make decisions on what constitutes good accounting. AeA and other well-heeled lobbying groups have already spent enormous sums pressing their cases on why this is a disaster for American entrepreneurial spirit – as is their right to do. While I find their arguments bankrupt and their attitude decidedly anti-shareholder, they've got the kind of currency that counts in the halls of Washington: big dollars.

Bill Mann, Senior Analyst, The Motley Fool, and Member of the FASB's User Advisory Council, November 12, 2003

FASB has the expertise and independence to resolve stock option accounting, and Congress should not be legislating accounting rules or threatening FASB's independence.

The Honorable John McCain, United States Senate, March 31, 2004

The expensing of stock options allows investors, analysts, corporate executives and employees, and auditors to properly understand the bottom line of corporations. This legislation blocking stock option expensing not only undermines FASB's independence, but undermines the effort to restore confidence in our financial markets as well.

The Honorable John McCain, United States Senate, May 1, 2003

Any politician who touches this is touching a real third rail now. They'd be promoting bad accounting and kowtowing to rich C.E.O.'s of tech companies dangling campaign contributions.

Patrick S. McGurn, Special Counsel, Institutional Shareholder Services, March 21, 2004

This is tech-executive protectionism masquerading as reform.

Patrick S. McGurn, Special Counsel, Institutional Shareholder Services, November 20, 2003

H.R. 3574 holds that if a pricing model is used to determine the fair value of an option, the assumed volatility of the underlying stock shall be zero. It is the case that under the assumption of zero volatility, any pricing model used will give about the same estimate of value. Thus, in effect, H.R. 3574 specifies the option-pricing model to use for expensing. This option valuation model is seriously flawed as an estimator of fair value. It is universally accepted that a large part of an option's value is the result of the volatility of the underlying stock price. But there are no real-world traded stocks whose volatility is zero and furthermore, technology firms which issue large amounts of options tend to have above-average levels of volatility. Thus the *mandated* approach of H.R. 3574 will uniformly undervalue all options and for at-the-money options it will uniformly undervalue the options by a large amount. This one provision will *de facto* preserve the current and past practice of not expensing options issued at or out of the money.

Robert C. Merton, John and Natty McArthur University Professor, Harvard Business School, and 1997 recipient of the Alfred Nobel Memorial Prize in Economic Sciences, March 3, 2004

As a Certified Public Accountant, I am very concerned over the government intervention in the setting of accounting standards. At present two bills (S 1890 and HR 3574) are before Congress that attempt to implement a political remedy to the highly publicized stock option controversy.

I urge you to support the accounting and financial community's efforts to pursue a comprehensive and reasonable course in setting accounting standards. The Financial Accounting Standards Board is currently considering the accounting issues related to stock options in a national as well as global context.

I ask that you support private sector standards settings and oppose the S 1890.

Russell V. Meyers, Certified Public Accountant, Witt Mares Eggleston Smith, PLC, March 16, 2004

The tech lobby continues to argue against expensing options; we disagree and expose the flawed logic. . . .

Investors we surveyed don't accept the tech lobby's argument that job creation and U.S. competitiveness require keeping option expense out of the income statement. Investors also shun creative legislative attempts such as limiting expense to five executives and exempting newly public companies for three years.

Steven Milunovich, CFA, First Vice President, and Richard Farmer, Assistant Vice President, Merrill Lynch Global Securities Research & Economics Group, Global Fundamental Equity Research Department, Merrill Lynch, February 3, 2004

Consider the 10-year war over stock options accounting. Even the scarecrow can see that options should be deducted from revenues along with employee costs. But some technology titans, who like being able to siphon off shareholder wealth, continue to battle against truth in financial statements. They urge employees to write to Congress and they pay lobbyists to sprinkle money in all the right places on Capitol Hill.

Gretchen Morgenson, The New York Times, March 21, 2004

Investors and the capital markets rely on transparent financial reporting and an independent accounting standard-setting process. As we have previously stated in other contexts, we urge Congress to preserve the independence of the Financial Accounting Standards Board (FASB) and to avoid legislation that would have the effect of restricting the FASB's ability to establish accounting standards.

Further, we reaffirm our support, already expressed to the FASB, for the mandatory expensing of all employee stock options, whose fair value would be determined in a manner suitable for the reporting company.

Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, Eugene O'Kelly, Chairman and Chief Executive Officer, KPMG LLP, James H. Quigley, Chief Executive Officer, Deloitte & Touche USA LLP, and James S. Turley, Global Chairman and CEO, Ernst & Young LLP, March 17, 2004

I firmly believe that Congress should continue to leave accounting standard setting in the private sector, with the understanding that the SEC already has ultimate authority with respect to accounting at publicly traded companies.

By not supporting this legislation, you would be acting to maintain high-quality independent private-sector financial-accounting standard setting in the United States.

Mark W. Nelson, Eleanora and George Landew Professor of Management and Professor of Accounting, Cornell University's Johnson Graduate School of Management, March 3, 2004

THE stock market bubble might have been less severe. The wild swings in federal budget deficits might have been reduced. Companies would owe a lot less money. Less wealth would have been transferred from shareholders to managers, then perhaps less paper wealth would have been created. Richard A. Grasso might still be running the New York Stock Exchange.

All that might have happened if American politicians, a decade ago, had not forced the Financial Accounting Standards Board to back down from its proposal to force companies to record as a compensation expense the value of stock options given to employees.

. . . .

Now the accounting standards board is trying again, and this time it will probably succeed, although there is no guarantee. Some companies are pushing a "compromise" that would deduct the expense – at ridiculously low values – of only those options given to high executives. There is no logical reason options given to one employee would be an expense while those given to another would not. But the hope is that politicians will be able to claim they are voting for little-guy recipients, not greedy corporate bosses.

Floyd Norris, The New York Times, April 2, 2004

Congressional action on this issue will ultimately only damage the FASB's credibility and will make it even more difficult in the future for the FASB to adopt standards with which any constituency disagrees. The ultimate losers if that occurs will be investors, who play a significant role in our economy by investing in companies debt and equity securities, and, ironically, those who oppose the FASB's efforts to improve the accounting for stock-based compensation. As noted in the FASB's mission statement, accounting standards "are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information." If investors do not have confidence in the accounting standards used in preparing financial statements, they either will not invest or will charge a significant premium for the capital they provide. Either outcome would have an adverse economic consequence, both for the companies attempting to raise capital as well as for our economy as a whole.

Edward Nusbaum, CEO, Grant Thornton LLP, March 17, 2004

. . . EDS is withdrawing its membership in the Employee Stock Option Expensing Coalition. EDS supports the Financial Accounting Standards Board's (FASB) current project to improve the accounting for equity-based compensation, including the mandatory expensing of all employee stock options. It is expected that the FASB project will result in a final standard in November 2004. We are committed to fully complying with the language and intent of the requirements of that standard when issued. EDS supports the independence of the FASB. We are not interested in participating in any effort that might be viewed as undermining FASBs standard setting process. Please refrain from using EDS' name as a supporter of the Coalition's efforts.

Michael E. Paolucci, Vice President, Global Compensation and Benefits, EDS, March 4, 2004

HR 3574 would for the first time directly insert Congress into the FASB's independent, objective, thorough, and open accounting standard setting process. It would establish a precedent that would surely prompt others to seek political intervention in future technical activities of the FASB, irrespective of the public good that results from credible, transparent financial reporting.

Ned Regan, President, Baruch College, and Trustee of the Financial Accounting Foundation, March 23, 2004

As the 10th largest institutional investor in the U.S., OPERS has a fiduciary duty to protect the financial futures of its retirees and members. The bill would allow corporations to continue to report overly optimistic numbers rather than report more accurate and comprehensive information. . . . Any effort to diminish the important role of FASB as an independent body will only serve to further harm investors who have already experienced a loss of both money and confidence in the U.S. capital markets.

Cynthia Richson, Corporate Governance Officer, The Ohio Public Employees Retirement System (with assets of approximately $58.7 billion, OPERS is the largest state pension fund in Ohio, the 10th largest state pension system in the U.S. and the 17th largest in the world), January 14, 2004

This bill is a bad idea for three fundamental reasons:

- It undermines the authority of the FASB at a time when it is essential that we restore faith in our financial reporting system,
- The bill does not reflect the economic substance of the transaction taking place and provides a political, rather then an economic answer to an important valuation problem, and
- It undermines the faith of young people in the integrity of our political system.

Larry Rittenberg, PhD, CPA, CIA, Professor of Accounting, University of Wisconsin, and Terry Warfield, PhD, Associate Professor of Accounting, University of Wisconsin—Madison, March 10, 2004

Just a year after giving near unanimous approval to legislation designed in part to allow FASB to develop accounting rules free from the threat of outside interference, some members of Congress have already reneged on that promise and are trying to prevent FASB from adopting a stock options expensing rule that it believes is in investors' best interests. . . . If they succeed, they will not only undermine the transparency of corporate financial disclosures, they will deal a fatal blow to the independence of the accounting standard-setting process.

Barbara Roper, Director of Investor Protection, Consumer Federation of America, August 13, 2003

Congress should not politicize or interfere with FASB's independence and professionalism in setting accounting standards to improve the accounting for equity-based compensation or for any other project. As CPAs, we urge you to strongly oppose H.R. 3574 and H.R. 1372, and any other legislation that would override the independent judgment of FASB. We hope you will agree with our view that the accounting standard setting process is best left to independent experts in the private sector.

The Honorable E. Clay Shaw, Jr. and the Honorable Collin Peterson, United States House of Representatives, March 23, 2004

I don't think we should make those rules in the Banking Committee or even in Congress. . . . [FASB] understands the implications. There are economic implications here, but it also gets into corporate governance and honesty in financial statements.

The Honorable Richard C. Shelby, Chairman of the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 30, 2003

For these reasons, we strongly oppose the "Broad-Based Stock Option Plan Transparency Act of 2003" ("HR 1372"), which would prohibit the SEC from recognizing as GAAP any new accounting standards related to the treatment of stock options for more than three years. More is at stake here then just option accounting or executive compensation. Our markets will be damaged if it appears that our accounting standards are still being held hostage to the political dynamics that prevented effective regulation in the 1990s. The credibility of the American capital markets is at stake.

Damon Silvers, Associate General Counsel, AFL-CIO (representing more than 66 national and international unions and their membership of more than 13 million working women and men, and with union-sponsored pension plans with $400 million in assets), June 3, 2003

In 1993, Congress stepped in and pressured FASB into revising a similar proposal to expense stock options. Some in Congress would again limit FASB's rule making abilities. I strongly urge members not to support legislation that would prevent FASB from implementing its new rule. It was a mistake in 1993; it would be a mistake now, and a continuing disservice to investors.

The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, April 20, 2004

This new bill doesn't do anything. . . . This is just a veiled attempt to try and let them [the tech industry] off the hook.

The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, November 20, 2003

With all due respect, the appropriate process and forum for setting technical and high-quality standards for financial accounting and reporting is not lobbying in the halls of Congress. Rather, the standard-setting process needs to stay with an independent and expert FASB, solely dedicated to that fair, unbiased and transparent financial reporting essential to the growth and stability of the nation's economy. Enactment of H.R. 3574 can only undermine investor trust and confidence in the market, and frustrate that proper deployment of capital critical to our economic prosperity.

Edward J. Theobald, Chairman, Board of Trustees, The New Hampshire Retirement System (a trusteed, employee-contributory pension plan, covering over 60,000 New Hampshire public workers: fire, police, teacher, state and local public employees; the fund invests billions of dollars in publicly traded companies solely for the purpose of funding the retirement benefits of its members), March 15, 2004

FASB's decision to require stock option expensing in 2005 will strengthen investor confidence in the financial statements of large and small businesses, thus lowering their cost of capital. The efficient allocation of capital to the most economically valuable business activities depends on consistent accounting rules. For this reason, we believe all businesses should expense stock options, so that stock options do not artificially boost any company's reported reports. Congress should let FASB do its job.

Richard L. Trumka, Secretary-Treasurer, American Federation of Labor and Congress of Industrial Organizations (representing 13 million members, benefit plans with $5 trillion in assets, and pension plans holding almost $400 billion in assets), March 3, 2004

Convergence is extremely important to us. We will be horrified if politicians stepped in and forced FASB to alter standards.

Sir David Tweedie, Chairman, International Accounting Standards Board, April 19, 2004

I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:

Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?

Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet the need, in a world of globalized finance, for a common set of international standards?

The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, and former Chairman of the Federal Reserve System, April 20, 2004

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.

The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, and former Chairman of the Federal Reserve System, June 3, 2003

Speaking not only as a constituent but also as an advisory credit union professional to the FASB, the importance of this issue is paramount to millions of Americans who desperately need confidence in the accounting rules for American businesses. The independence of the standard setting process is vital to their best interests.

Please do not support legislation that seeks to circumvent this process.

Scott M. Waite, Senior Vice President, Chief Financial Officer, Patelco Credit Union, March 17, 2004

We are quite concerned that overt actions, however, well-intentioned they may be, that have the effect of undermining the authority of the FASB to set accounting standards will be detrimental to the Board and its constituents. As we cannot envision a viable alternative to the private sector standard setting process we have today, it is important that Congress not undertake actions that would undermine and potentially cripple that process. We believe that the legislation should be withdrawn and that responsibility for the resolution of this matter be left to the FASB, with vigilant oversight by the Securities and Exchange Commission.

Kim R. Wallin, CMA, CFM, CPA, Chair, Institute of Management Accountants (the largest organization in this country devoted exclusively to management accounting and financial management professionals inside the corporation, with approximately 65,000 members), March 31, 2004

Opponents of expensing also claim that Congress must act because the green-eyeshade types aren't taking into account the devastating effect they say expensing will have on the economy; the legislation they are pushing would block the FASB rule while an economic impact study is conducted. Yet the CBO says requiring expensing "is unlikely to hurt the overall economy" and in fact could make it more productive. The anti-expensing forces are running out of arguments.

The Washington Post, April 7, 2004

The good news is that the Senate, where Banking Committee Chairman Richard C. Shelby (R-Ala.) opposes the measure, doesn't seem inclined to succumb to the opponents' unpersuasive arguments – or their (perhaps more persuasive) campaign contributions. The risk is that the anti-expensing forces, unable to get their measure through the Senate on its own, will try to attach it to a spending bill or some other must-pass legislation. Anyone who remembers the recent corporate scandals should guard against that.

The Washington Post, April 2, 2004

Worse still, Mr. Enzi's bill would in effect block FASB's own expensing rule from taking effect while a "comprehensive economic impact study" is conducted. And Mr. Enzi would require FASB to adopt a "truing-up" requirement under which the actual cost of the option (once it's exercised, expires or is forfeited) is ultimately reflected on the corporate books. There are legitimate criticisms of the complexity and manipulability of the expensing models that FASB is considering, and truing-up may be a reasonable approach, but isn't this just the kind of decision that ought to be left to the accountants at FASB – not the non-accountants in Congress?

The Washington Post, January 2, 2004

At the same time, there are disturbing signs of backsliding. Less than a year after affirming the importance of maintaining the independence of the Financial Accounting Standards Board, which writes the non-auditing rules for accountants, lawmakers are foolishly weighing interfering with the board's move to require expensing of stock options.

The Washington Post, July 30, 2003

You don't need to know where you come out on this arcane dispute to know who ought to be deciding it – and who ought to keep their noses out of it. This is a matter for accountants, not politicians, and it would have been handled by the accountants long ago were it not for the political clout (and the campaign checks) of high-technology companies.

The Washington Post, May 21, 2003

Investors expect and deserve accounting standards that promote transparency and meaningful financial reporting, and an independent standards-setting process best satisfies their needs.

We urge Congress to recognize the critical contribution of an independent FASB to the effective operation of the capital markets, and to reject any proposal that would substitute legislation for the FASB's independent standards-setting process.

Jack A. Weisbaum, Chairman of the Board, BDO Seidman, LLP (a national professional services firm providing assurance, tax, financial advisory and consulting services to private and publicly traded businesses), March 19, 2004

Ohio's public pension fund managers strongly support the independent authority of FASB in setting accounting standards, which would be severely undermined by H.R. 3574. This legislation would be a significant setback in the new era of honest accounting that has been ushered in by the Sarbanes-Oxley Act.

Daniel K. Weiss, CPA, JD, Chief Financial Officer, Highway Patrol Retirement System, On Behalf of the State of Ohio Public Employee Pension Funds (representing one-and-a-quarter million members and beneficiaries, and combined invested assets of 135 billion dollars), March 3, 2004

Congressional interference on stock option expensing, or any other accounting issue, is always inappropriate. The Council finds the current legislative efforts to impair the FASB's independence particularly disappointing during a time when investors have collectively suffered tremendous losses in the U.S. capital markets, due in part to corporate scandals resulting from overly-aggressive or fraudulent accounting practices. Any efforts to stonewall the FASB will ultimately hurt millions of U.S. investors.

Ann Yerger, Deputy Director, The Council of Institutional Investors (an association of more than 140 corporate, public and union pension funds collectively responsible for more than $3 trillion in pension assets), March 2, 2004

Requiring companies to expense only options granted to the CEO and the next four highest compensated executives, as proposed in S. 1890, is insufficient, and it appears to reflect an interest rooted more in attractive numbers then comprehensive information. But this is a decision that should not be made in Congress in the first place.

Ann Yerger, Deputy Director, The Council of Institutional Investors (an association of more than 140 corporate, public and union pension funds collectively responsible for more than $3 trillion in pension assets), November 21, 2003

As a partner in a Wall Street law firm and the author of the text *Accounting Irregularities and Financial Fraud*, I have been becoming increasingly concerned over the prospect of political considerations potentially influencing the formulation of generally accepted accounting principles. That is particularly the case with S. 1890, insofar as the political analysis is apparently to include an assessment of the "economic impact" of the accounting standard rather than solely the overriding objective of reporting the truth. At public companies, allowing the "economic impact" of an accounting decision to influence the public reporting of financial results is often labeled "fraud."

Michael R. Young, Partner, Wilkie Farr & Gallagher LLP, March 8, 2004

Testimony of
Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
April 28, 2004

Attachment 3

Press Release and Listing of Members of the Small Business Advisory Committee

NEWS RELEASE 03/18/04

FASB Establishes Small Business Advisory Committee

Norwalk, CT, March 18, 2004—In an effort to increase involvement by the small business community in developing U.S. accounting standards, the Financial Accounting Standards Board (FASB) has established a Small Business Advisory Committee. Committee members will be a resource to the FASB in providing additional and ongoing input on accounting issues before the Board.

While the FASB has met with members of small business in the past as part of its due process procedures, establishment of a formal committee that provides the perspectives of this group will offer greater opportunity to share ideas, knowledge and experience with the Board as well as with the other group members.

"The FASB has always recognized small businesses as an important constituency," commented FASB Chairman Robert H. Herz. "Formation of the Small Business Advisory Committee should be a win-win for everyone involved, and the Board looks forward to working with the group."

The Committee, whose members represent diverse perspectives and experiences, comprises 24 lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community.

The Committee's inaugural meeting is slated for May at the FASB's offices in Norwalk, Connecticut.

About the Financial Accounting Standards Board

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information. For more information about the FASB, visit our website at www.fasb.org.

The Financial Accounting Standards Board

Serving the investing public through transparent information resulting from high-quality financial reporting standards developed in an independent, private-sector, open due process.

Small Business Advisory Committee Members

Mr. Michael S. Cain
Senior Executive Vice President
Frost National Bank

Mr. Daniel J. Donoghue
Managing Director
Private Capital Group
Piper Jaffray Inc.

Mr. Robert A. Dyson
Director of Quality Control
Friedman Alpren & Green LLP

Mr. Mark Ellis
Chief Financial Officer
Michael C. Fina group of companies

Mr. Richard E. Forrestel, Jr.
Treasurer and Secretary
Cold Spring Construction Company, Inc.

Mr. William G. Hall
Chairman and Chief Executive Officer
William G. Hall & Company

Mr. Michael L. Hansen
Partner and Board Member
Mid-States Construction Company and Eagle Metal Finishing, LLC

Mr. Gregory P. Hanson
Vice President and Chief Financial Officer
Avanir Pharmaceuticals

Ms. Jane Hoffman
Chief Financial Officer
National Cooperative Business Association

Mr. W. Stephen Holmes
General Partner
InterWest Partners

Mr. Joe Joseph
Managing Director
Putnam Investments

Mr. Francis C. Jumonville, Jr.
Chief Financial Officer and Secretary-Treasurer
Airtrol, Inc.

Mr. Mauricio Kohn
Principal
Kohn Financial Consulting, L.L.C.

Mr. Steven C. Mayer
Executive Vice President & Chief Financial Officer
Human Genome Sciences, Inc.

Mr. Russell V. Meyers
Partner/Member of the Firm
Witt Mares Eggleston Smith, PLC

Mr. Edward E. Nusbaum
Executive Partner & Chief Executive Officer
Grant Thornton LLP

Mr. Darrel L. Posegate
Executive Vice President & Chief Financial Officer
Home Federal Bank

Mr. Charles L. Saeman
President/Chief Executive Officer
State Bank of Cross Plains

Mr. Edgar Anson Thrower
Chief Financial Officer
Contec, Inc.

Mr. Scott M. Waite
Senior Vice President and Chief Financial Officer
Patelco Credit Union

Mr. Grafton H. Willey, IV
Managing Partner
Tofias PC

Ms. Deborah Anne Wilson
Chief Financial Officer
Utility Service Co., Inc.

Ms. Candace Wright
Audit Director
Postlethwaite & Netterville

Ms. Lark E. Wysham
Executive Vice President and Chief Financial Officer
Citizens Bank/Citizens Bancorp

Testimony of
Robert H. Herz
Chairman
And
George J. Batavick
Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
April 28, 2004

Attachment 4

Notice for Recipients and Summary of the Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal")

NO. 1102-100 | MARCH 31, 2004

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Share-Based Payment

an amendment of FASB Statements No. 123 and 95

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Major Projects
File Reference No. 1102-100

Comment Deadline: June 30, 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by June 30, 2004. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1102-100. Those without email may send their comments to the "Director of Major Projects—File Reference No. 1102-100" at the address at the bottom of this page. Responses should *not* be sent by fax.

Any individual or organization may obtain one copy of this Exposure Draft without charge until June 30, 2004, by written request only. Please ask for our Product Code No. E177. For information on applicable prices for additional copies and copies requested after June 30, 2004, contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116

Notice for Recipients of This Exposure Draft

This proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and generally would require instead that such transactions be accounted for using a fair-value-based method.

This proposed Statement would neither change the accounting in FASB Statement No. 123, *Accounting for Stock-Based Compensation,* for transactions in which an enterprise exchanges its equity instruments for services of parties other than employees nor change the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. The Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The Board invites comments on all matters in this proposed Statement, particularly on the specific issues discussed below. Respondents need not comment on all of the issues presented and are encouraged to comment on additional issues as well. It would be helpful if respondents comment on the issues as stated, include any alternatives the Board should consider, and explain the reasons for the positions taken. Where appropriate, it would be useful if respondents identified the specific paragraph or group of paragraphs to which their comments relate.

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements.

In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Attribution of Compensation Cost

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

Income Taxes

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

Transition

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

Nonpublic Entities

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, *Statement of Cash Flows,* to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

Differences between This Proposed Statement and IFRS 2

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

Understandability of This Proposed Statement

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

Public Roundtable Meetings and Small Business Advisory Committee Meeting

The Board plans to hold several public roundtable meetings with constituents to discuss issues related to this proposed Statement. Those roundtable meetings tentatively are scheduled to take place around the end of the comment period in the San Francisco Bay area of California, and in Norwalk, Connecticut. The specific dates of the public roundtable meetings and instructions for constituents interested in participating in them will be announced in a future issue of FASB *Action Alert*. Each roundtable meeting can accommodate a limited number of participants. The Board plans to seek participants for each meeting that represent a wide variety of constituents including investors, preparers of financial statements, auditors, valuation experts, and others to ensure that it will receive input from diverse views. The Board also plans to discuss the views of constituents representing small and medium-sized businesses regarding this proposed Statement at the inaugural meeting of the Small Business Advisory Committee on May 11, 2004, in Norwalk, Connecticut.

Summary

This proposed Statement addresses the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services. It also addresses transactions in which an enterprise incurs liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of those equity instruments in exchange for employee services. This proposed Statement does not change the accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans;* the Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The objective of the accounting required by FASB Statement No. 123, *Accounting for Stock-Based Compensation,*[*] as it would be amended by this proposed Statement, is to recognize in an entity's financial statements the cost of employee services received in exchange for valuable equity instruments issued, and liabilities incurred, to employees in share-based payment transactions. Key provisions of this proposed Statement are as follows:

a. For public entities, the cost of employee services received in exchange for equity instruments would be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost would be recognized over the requisite service period (often the vesting period). Generally, no compensation cost would be recognized for equity instruments that do not vest.

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[*]Unless the text indicates otherwise, all references to Statement 123 in this summary are to that Statement as originally issued—that is, before the effects of this amendment.

b. For public entities, the cost of employee services received in exchange for liabilities would be measured initially at the fair value of liabilities and would be remeasured subsequently at each reporting date through settlement date. The pro rata change in fair value during the requisite service period would be recognized over that period, and the change in fair value after the requisite service period is complete would be recognized in the financial statements in the period of change.

c. The grant-date fair value of employee share options and similar instruments would be estimated using option-pricing models adjusted for the unique characteristics of those options and instruments (unless observable market prices for the same or similar options are available).

d. If an equity award is modified subsequent to the grant date, incremental compensation cost would be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately prior to the modification.

e. Employee share purchase plans would not be considered compensatory if the terms of those plans were no more favorable than those available to all holders of the same class of shares and substantially all eligible employees could participate on an equitable basis.

f. Excess tax benefits, as defined by this proposed Statement, would be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits would be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost would be reported as income tax expense.

g. This proposed Statement allows nonpublic entities to elect to measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement. That election also would apply to awards of liability instruments. This proposed Statement also requires that public entities measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement if it is not reasonably possible to estimate their grant-date fair value.

h. The notes to financial statements of both public and nonpublic entities would disclose the information that users of financial information need to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

Background

APB Opinion No. 25, *Accounting for Stock Issued to Employees,* was issued in 1972. Opinion 25 required that compensation cost for awards of share options be measured at their intrinsic value, which is the amount by which the fair value of an equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award's intrinsic value should be measured; that criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring fixed awards' intrinsic values at the date of grant generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, which resulted in a large amount of specialized and complex accounting guidance.[†]

Statement 123 was issued in 1995 and was effective for share-based compensation transactions occurring in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the

[†]That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System,* March 25, 2003 [www.sec.gov]).

application of the fair-value-based method to fixed awards results in compensation cost being recognized when services are received in exchange for valuable equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board's decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

Reasons for Issuing This Proposed Statement

There are four principal reasons for issuing this proposed Statement:

a. **Addressing concerns of users and others.** Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for valuable equity instruments. Financial statements that do not faithfully represent the economic transactions affecting an issuer can distort the reported financial condition and operations of that issuer and can lead to the inappropriate allocation of resources. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information.

b. **Improving the comparability of reported financial information through the elimination of alternative accounting methods.** During the summer of 2002, a number of public companies announced their intention of voluntarily adopting Statement 123's fair-value-based method of accounting for share-based compensation transactions with employees. Since then, approximately 500 public companies have voluntarily adopted or announced their intention to adopt the fair-value-based method. Despite the many public companies that have voluntarily adopted the fair-value-based method of accounting, there remains a large number of companies that continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in Statement 123, the Board believes such transactions should be accounted for using the fair-value-based method.

c. **Simplifying U.S. GAAP.** This proposed Statement would simplify the accounting for share-based payments. The Board believes that U.S. GAAP should be simplified whenever possible. Requiring the use of a single method of accounting for share-based payment would result in the elimination of Opinion 25's intrinsic value method and the many related detailed and form-driven rules.

d. **International convergence.** This proposed Statement would result in greater international comparability in the accounting for share-based payment. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by enterprises in many countries throughout the world, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. IFRS 2 requires that all enterprises recognize an expense for all employee services received (and consumed) in exchange for the enterprise's equity instruments. The IASB concluded that share-based compensation transactions should be accounted for using a fair-value-based method that is similar in most respects to the fair-value-based method established in this proposed Statement. Converging to a common set of high-quality financial accounting standards on an international basis for share-based payment transactions with employees improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both U.S. GAAP and international accounting standards.

The Board believes that this proposed Statement addresses users' and other parties' concerns by requiring enterprises to recognize an expense in the income statement for employee services received (and consumed) in exchange for the enterprises' equity instruments, thereby reflecting the consequences of the economic transaction in the financial statements. By requiring the fair-value-based method for all public companies, this proposed Statement would eliminate an alternative accounting method and the accounting guidance associated with that method; consequently, similar economic transactions would be accounted for similarly. Finally, requiring the use of Statement 123's fair-value-based method is convergent with IFRS 2.

Differences between This Proposed Statement and Current Practice

This proposed Statement would affect current practice in a number of ways, but chief among them is that it would eliminate the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments, based on the grant-date fair value of those instruments (with limited exceptions).

This proposed Statement would affect current practice in other ways, including the measurement attribute for nonpublic entities, the pattern in which compensation cost would be recognized, the accounting for employee share purchase plans, and the accounting for income tax effects of share-based payment transactions. Paragraphs 6–15 of this proposed Statement summarize those as well as other differences.

How This Proposed Statement Would Improve Financial Reporting

This proposed Statement would require the recognition of compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer. Recognizing compensation cost in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the impact that share-based compensation arrangements have on an enterprise's financial condition and operations.

This proposed Statement also would improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and would also thereby simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions are accounted for similarly.

How the Conclusions in This Proposed Statement Relate to the FASB's Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing information about the costs incurred by the employer to obtain employee services in the marketplace.

With respect to the notion of *comparability,* FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* states that information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly. That will improve the usefulness of financial information. Neutrality is another important characteristic of accounting information. Establishing that method also eliminates the accounting bias toward using employee share options for compensation, which results in accounting that is neutral for different forms of compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. Thus, to faithfully represent the total cost of employee services to the enterprise, compensation cost relating to valuable equity instruments issued by the employer to its employees in exchange for their services should be recognized in the employer's financial statements.

Concepts Statement 6 defines *assets* as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services cannot be stored and are received and used simultaneously. Those employee services are assets of an enterprise only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the enterprise. When an employer exchanges its valuable equity instruments for employee services, the receipt of those employee services creates an asset that should be either capitalized as part of another asset of the enterprise (as permitted by U.S. GAAP) or expensed when consumed.

Costs and Benefits

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this proposed Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members, valuation experts, compensation consultants, and numerous other constituents. Based on the findings of those cost-benefit procedures, the Board concluded that this proposed Statement will sufficiently improve financial reporting to justify the costs it will impose. Paragraphs C40–C47 provide a discussion of the Board's cost-benefit assessment with respect to this proposed Statement.

The Effective Dates of This Proposed Statement

This proposed Statement would be applied to public entities prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting. Nonpublic entities that had adopted the fair-value-based method of accounting for recognition or pro forma disclosures would use the same transition and effective date as public entities. All other nonpublic entities would apply this proposed Statement prospectively for fiscal years beginning after December 15, 2005.

Testimony of
Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
April 28, 2004

Attachment 5

Excerpts from Recent Materials about the Proposal and Small Business

Excerpts from Recent Materials about the Proposal and Small Business

Many new and growing companies genuinely need to be able to grant options to attract talent. I have no problem with that, and I think it is a great way to build a company. Nonetheless, these companies must take the cost of doing so on the chin, and not hide it in the footnotes.

If they take the risk of paying too much for talent, they need to account for the cost of that risk in the financial statements. Options should be treated like any other business expense.

Rick Ashburn, La Jolla Light, April 8, 2004

A survey of institutional investors indicates that a vast majority back the proposal issued recently by the Financial Accounting Standards Board (FASB) that would require all public companies to list stock options as an expense in the income statement.

By a four to one margin, the 302 buy side portfolio managers and research professionals surveyed . . . said they believe the FASB proposal will improve transparency in financial reporting . . . .

More than three quarters (77%) of respondents said the FASB proposal should not be modified. . . .

An overwhelming majority -- 90% -- of respondents said they are opposed to any exemptions from the options expensing rule for "start-ups" or technology companies.

Broadgate Consultants, Inc., April 7, 2004

But do we really want to preserve the practices that led to the internet-stock bubble? How many of those pie-in-the-sky start ups attracted employees with visions of options-based fortunes that never materialized? We should not be using accounting gimmicks to encourage the formation of companies that have virtually no hope of success.

Jeff Brown, The Philadelphia Inquirer, April 4, 2004

I am deeply troubled by . . . assertion[s] that the proposed FASB standard on equity-based compensation imposes great costs on small businesses. I have a hard time seeing just how this could be true. The vast majority of small, privately-held businesses– . . . should be totally unaffected by this pronouncement for the simple fact that they do not usually issue stock options. There may be facts available from the Bureau of Labor Statistics that bear this out; but in my experience, stock option plans simply do not exist in these kinds of firms.

Jack T. Ciesielski, President, R.G. Associates, Inc., April 21, 2004

ARGUMENT 4: THE ECONOMIC CONSEQUENCES OF MANDATORY EXPENSING WILL ADVERSELY AFFECT SMALL FIRMS AND INNOVATIVE FIRMS. . . . We agree that the expensing of stock options could cause a change in capital allocation, but the role of accounting is to report the underlying economic substance of transactions. Once investors understand the economic substance of a firm's transactions, they can decide how to efficiently allocate their capital.

Michael B. Clement, Global Equity Research, Goldman Sachs Group, Inc., April 7, 2004

Experience has also shown that it is unnecessary for firms to overstate their net income in order to raise capital. Investors that perceive opportunities for growth in a firm's revenue and earnings have shown themselves willing to invest despite a less-than-outstanding current income statement. Furthermore, many companies in the start-up phase of their operations turn to venture capitalists and private equity firms for fund-raising. Those organizations are made up of skilled investors who will be able to look past the stock options' expense to see the firm's potential.

Congressional Budget Office, April 2004

. . . [A] study by Towers Perrin, a consulting firm, found that the share prices of 300 firms that had chosen to treat stock options as an expense were not affected by the change—a sign that the stockmarket may weigh options efficiently. Venture capitalists, who make their living from financing start-up companies, might also be expected to see past the cost of stock options.

The Economist, April 10, 2004

It is also important to remember that most U.S. employers, including many private companies, small businesses, and partnerships, don't offer stock option compensation to their employees; a nationwide survey by the Bureau of Labor Statistics in 2000, a banner year for stock options, found that only 1.7 percent of non-executive U.S. workers actually received any options that year. In short, honest accounting does not hurt average workers.

The Honorable Carl Levin, United States Senate, April 20, 2004

[Phillips Smith, Chairman of Taser], just like a long line of folks who oppose expensing, is using the argument that a change in measurement is going to change his (and thousands of start-up companies') behaviors. Isn't it a sign of what this is really about that a noneconomic change will alter their behavior? If options are so valuable to companies, if they are so necessary to attract talent, then why in the world would they *dare* change their behavior unless there is a real, tangible economic impact?

We're talking about measurement, folks. Not taking food out of the mouths of babies, not ending entrepreneurship as we know it. Not stealing from the working class. Measurement, and making accounting fair.

Bill Mann, The Motley Fool, April 21, 2004

Fiction: Expensing will depress the earnings of start-up companies, make it difficult for high-tech companies to raise capital, and hurt the economy.

. . .

Economic studies show that there is no effect on stock value of firms that voluntary switch to expensing of employee stock options. There is no evidence to support the notion that start-up companies and high-tech firms need to misrepresent themselves in order to raise capital. Capital markets are highly sophisticated and already factor in stock option expense in their valuations. This is particularly true for venture capitalists who supply funding for start-ups.

The Honorable Pete Stark, Ranking Member, Joint Economic Committee, United States Congress, April 20, 2004

Testimony of
Robert H. Herz
Chairman
and
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Financial Accounting Standards Board
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Committee on Small Business and Entrepreneurship
April 28, 2004

Attachment 6

Materials Excerpted in Attachments 2 and 5

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