Testimony of
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Chairman
and
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Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
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Full Text of Testimony

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is one of my fellow board members, George Batavick. George is heading up the FASB's newly established Small Business Advisory Committee ("SBAC"). The idea for the SBAC originated with Senator Enzi at a hearing he chaired late last year.

We are pleased to appear before you today on behalf of the FASB. We want to thank you for inviting us to participate in this very important and timely hearing.

The Board recognizes the importance of small businesses to job creation, entrepreneurialism, and our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost effective manner.

Our testimony includes a brief overview of (1) the FASB, including the importance of the Board's independence and the ability to conduct its work in a systematic, thorough, and objective manner, (2) the process the FASB follows in developing accounting standards, (3) the application of our standards to small businesses generally, (4) how the FASB identifies the concerns of small businesses about our activities; (5) how the FASB evaluates the input from small businesses as part of our public due process procedures; (6) the background and basis for the Board's unanimous decision to issue a proposal to improve the accounting for equity-based compensation, (7) the key provisions of the proposal, (8) the special provisions of the proposal applicable to small business, (9) how the proposal would improve financial reporting, (10) the current status of, and the FASB's plans relating to, the proposal, and (11) some observations about some of the more common arguments offered by some opponents of the proposal.

The FASB

The FASB is an independent private-sector organization.[1] We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses.[2] Those standards are essential to the

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[1] See Attachment 1 for information about the Financial Accounting Standards Board ("FASB" or "Board").
[2] See Attachment 2 for excerpts from recent materials about the importance of the FASB's independence and concerns about proposed legislation.

efficient functioning of the capital markets and the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[3] is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting standard is harmful to investors, creditors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[4]

The Policy Statement, consistent with the language and intent of the Act, also reemphasizes the importance of the FASB's independence described earlier.[5] It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of

[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

[4] "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

[5] Sarbanes-Oxley Act of 2002, Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

> issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[6]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"),[7] maintains active oversight of the FASB's activities.

What Process Does the FASB Follow in Developing Accounting Standards?

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including small businesses.

Our Rules of Procedure require an extensive and thorough public due process.[8] That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. As discussed further below, many of our due process activities include active outreach to, and participation by, users, auditors, or preparers of the financial reports of small businesses. The Board makes final decisions only after carefully considering and analyzing the input of all interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

[6] Policy Statement, Page 5 of 8.
[7] See Attachment 1 for information about the Financial Accounting Foundation.
[8] See Attachment 1 for information about the FASB's due process.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.[9] Over the past two years, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures. Some of those actions were intended to increase the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses. Those particular actions include the following:

- Consistent with a suggestion made by Senator Enzi, establishing a SBAC in order to increase involvement by the small business community in developing accounting standards.[10] The SBAC, whose members represent diverse perspectives and experiences, comprises 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.

- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

- Making our public Board meeting announcements available to interested parties more broadly through an email subscription service.

- Making our public Board meetings available to interested parties for monitoring via the telephone and, again, consistent with a suggestion made by Senator Enzi, via web cast on our website free of charge.

- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website.

[9] The Securities and Exchange Commission ("SEC") also recently reviewed the FASB's due process and concluded that "the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . ." Policy Statement, page 5 of 8.
[10] See Attachment 3 for press release and listing of members of the Small Business Advisory Committee.

Are Small Businesses Required to Comply with FASB Standards?

The US federal securities laws generally require that any enterprise, including any small business, that lists its shares on a national securities exchange or has $10 million or more in assets and 500 or more owners of any class of equity securities be deemed a "registrant."[11] All registrants generally are required to file periodic reports with the SEC.[12]

The SEC has required, since the FASB's inception in 1973, that the preparation of the financial statements contained in the periodic reports comply with generally accepted accounting principles ("GAAP"), including FASB standards.[13] As indicated above, the SEC recently reevaluated and reaffirmed that requirement as a result of the provisions of the Act.[14]

Excluding those small businesses that are SEC registrants, there is generally no federal law requiring that small businesses file financial reports or comply with GAAP. Thus, for most small businesses, the use of FASB standards is a private choice.

Some small businesses may choose to comply with GAAP at the request or demand of current or potential lenders, suppliers, customers, or other contracting parties, or at the request of State regulators. Other small businesses may choose to comply with GAAP because they are funded by venture capital firms with the goal or expectation of becoming a public enterprise. In any event, the decision by one or more of those parties to require that the financial reports of a small business comply with GAAP instead of another basis of accounting is presumably dictated by the quality of FASB standards versus the other available alternatives.

How Does the FASB Identify the Concerns of Small Business about FASB Activities?

The FASB actively solicits the views of all interested parties, including the views of users, auditors, and preparers of financial reports of small businesses. Some of the ways in which the FASB currently attempts to identify the concerns of representatives of small businesses include the following:

- Establishing the SBAC to obtain more active involvement by the small business community in the development of financial accounting and reporting standards.

[11] 15 U.S.C. Section 781(g).
[12] 17 C.F.R. Section 249.310.
[13] Policy Statement, page 2 of 8.
[14] *Id*.

- Including representatives of small businesses on the UAC, the Financial Accounting Standards Advisory Council ("FASAC"), the Emerging Issues Task Force ("EITF"), and other project task forces and working groups.[15] Both the UAC and FASAC are formal parts of our independent structure and have responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, and other matters as may be requested by the FASB. The mission of the EITF is to assist the Board in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. Several current members of the UAC, FASAC, and EITF are primarily users, auditors, or preparers of the financial reports of small businesses.

- Participating in liaison meetings with representatives of small businesses. The FASB holds annual liaison meetings with several such organizations, including the Technical Issues Committee of the American Institute of Certified Public Accountants Private Companies Practice Section and the Accounting Practices Committee of the Risk Management Association. FASB members or staff also frequently meet less formally with other organizations and individuals representing small businesses upon request or at the initiation of the FASB members or staff.

- Participating at conferences and other speaking engagements that are sponsored by or primarily attended by representatives of small businesses. For example, FASB members or staff annually participate at dozens of State CPA society conferences across the country.

How Does the FASB Evaluate the Input from Small Business as Part of Its Due Process Procedures?

The FASB's conceptual framework guides the Board in its development of financial accounting and reporting standards. That framework states that the objectives of financial reporting are to provide information (1) that is useful to present and potential users, i.e., investors and creditors, in making investment and credit decisions; (2) to help the users to assess amounts, timing, and uncertainties

[15] See Attachment 1 for information about the Financial Accounting Standards Advisory Council and the Emerging Issues Task Force.

of prospective cash flows from their investments; and (3) about the economic resources of and claims against enterprises, and the effects of transactions changing such resources and claims.[16]

The Board has long recognized that those objectives are not static and that since the reporting by nonpublic or small businesses caters to a different set of users, the same objectives, defined identically, may mean different things. For many small businesses, the relevant financial statement users include both current and potential lenders, suppliers, and customers. Some of those users may focus more heavily on an enterprise's ability to meet its debt or performance obligations. Their needs may vary in some respects from the needs of other users of financial reports.

The Board's conceptual framework also describes the qualitative characteristics of accounting information.[17] In the hierarchy of accounting qualities, the FASB conceptual framework rates "decision usefulness" as the most important quality, and "relevance" and "reliability" as the two primary qualities necessary to provide such usefulness, subject always to the constraints of a cost-benefit evaluation.[18]

In applying the above concepts to the financial accounting and reporting of nonpublic or small businesses, the Board has generally differentiated between financial information appearing on the face of the financial statements and the additional, analytical, and collateral information appearing in the footnotes to those statements.[19] With respect to the former, the Board has generally concluded that all enterprises, including nonpublic and small businesses, should be subject to

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[16] Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978), paragraphs 32-54.

[17] Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (May 1980).

[18] *Id*. paragraphs 32-110, 133-44. The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small enterprises because of their limited accounting resources and need to rely on outside professionals. "FASB Analyzes Small Business Concerns about Accounting Standards," FASB *Status Report,* No. 181 (November 3, 1986).

[19] Statement of Financial Accounting Standards No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (December 1996), paragraph 10 (stating that in considering the costs and benefits of a new standard the Board has a commitment to consider potential disclosure differences between small and large companies on a case-by-case basis).

the same recognition and measurement requirements.[20] That conclusion has been generally supported by the stated needs of users of financial reports of nonpublic or small businesses. The Board, however, has on a number of occasions provided deferred effective dates for nonpublic enterprises to alleviate the costs and other burdens that may be associated with the more rapid implementation of new requirements.[21]

With respect to the latter information disclosed in the financial statement footnotes, the FASB has on a case-by-case basis decided in some circumstances to reduce[22] or eliminate[23] the disclosure requirements for nonpublic enterprises. Those decisions have generally been the result of input from users, auditors, or preparers of financial reports of nonpublic or small businesses indicating that the users of those reports did not need some or all of the disclosures[24] or that the cost of preparing the disclosures outweighed the usefulness of the information to those users.[25]

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[20] FASB *Status Report*, No. 181, page 4. There have been some limited exceptions. As discussed further in the text of this testimony, in the October 1995 standard to improve the accounting for stock-based compensation, the Board permitted nonpublic enterprises to use the minimum value method for measuring stock-based compensation because of the difficulties of estimating expected volatility. Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 20. Another example is in the November 2002 Interpretation to improve the accounting and disclosure for guarantees. The Board provided a scope exception for the initial recognition and measurement of guarantees issued between parents and subsidiaries and certain other related parties. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002), paragraph 7. One of the reasons given for the scope exception was to alleviate nonpublic enterprises' concerns about the cost of complying with the new requirement. *Id.* paragraph A29.

[21] Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (December 1991), paragraph 79 (concluding that allowing smaller enterprises additional time to comply with the provisions of the Statement will reduce their costs of compliance); Emerging Issues Task Force Topic No. D-1, "Implications and Implementation of an EITF Consensus" (May 15, 2003), page 4965A, footnote 2 (establishing operating procedures that provide nonpublic enterprises a later effective date than public enterprises).

[22] Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Retirement Benefits* (February 1998), paragraphs 57-59 (concluding that a reduced disclosure set would be appropriate for nonpublic enterprises as a result of comments by users of financial statements of nonpublic enterprises about the usefulness of the disclosures).

[23] Statement of Financial Accounting Standards No. 141, *Business Combinations* (June 2001), paragraph B201 (concluding that nonpublic enterprises should continue to be exempt from pro forma disclosure requirements because of arguments by preparers and auditors that costs of the information exceed the benefits); Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997), paragraph 115 (concluding to continue to exempt nonpublic enterprises from the requirement to report segment information because few users of nonpublic enterprises' financial statements have requested that those enterprises provide segment information); Statement 126, paragraph 14 (concluding that certain nonpublic enterprises should be exempt from fair value disclosure requirements because of the likely limited utility of the disclosures to certain users).

[24] Statement 132, paragraphs 57-59.

[25] Statement 141, paragraph B201; Statement 131, paragraph 115; and Statement 126, paragraph 14.

The FASB and its constituents have over the years periodically examined the issue of whether financial accounting and reporting standards should be different for small businesses.[26] Some of the reasons frequently cited in opposition to a so-called Big GAAP/Little GAAP approach to financial accounting and reporting include:

- Similar economic transactions and events should be reported consistently regardless of the size of the reporting enterprise.
- Differential standards for enterprises of different sizes would reduce the benefits to users of financial reports by impairing comparability more than they would reduce the costs of financial statement preparation.
- It would be virtually impossible for an accounting standards-setting body to decide which economic transactions and events should be permitted to be recognized and measured differently by large versus small businesses.
- Dual standards would represent additional costs to preparers, accountants, advisors, and others in the areas of continuing education, authoritative resources, and quality control systems.[27]

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[26] *Status Report*, No. 181, page 4 (concluding that the most constructive effort to alleviate the concerns of small businesses regarding generally accepted accounting principles ("GAAP") is to ensure that the views of privately held companies and smaller certified public accounting firms are adequately included in the Board's consideration of specific accounting issues); FASB Research Report, A. Rashad Abdel-khalik, *Financial Reporting by Private Companies: Analysis and Diagnosis* (August 1983), page 1 (stating that surveyed bankers that are users of the financial reports of private companies do not believe that a special set of GAAP would be beneficial for private companies considered to be small in size); FASB Invitation to Comment, *Financial Reporting by Private and Small Public Companies* (November 20, 1981) (soliciting input on several concerns about the existing financial reporting by private and small public companies); "Report of Task Force on GAAP Requirement of Concern to Small or Closely Held Businesses, to Small Business Advisory Committee, Financial Accounting Advisory Council" (December 1978), page 3 (finding that most individuals surveyed reported that there were no areas of particular concern to them with respect to current reporting requirements of small or closely held businesses); Abraham M. Stanger & Samuel P. Gunther, Article, "Big GAAP—Little GAAP: Should There Be Different Financial Reporting for Small Business?" N.Y.U. L. Rev. 1209 (Nov. – Dec. 1981) (concluding that different disclosure requirements, but not recognition and measurement standards, should apply to small businesses, but that there should remain a unitary system of GAAP).

[27] J. E. McCahey & A. L. Ramsay, "Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its Resolution," Australian Accounting Research Foundation (June 26, 1989), pages 10-11, 12-13.

Significantly, the users of small business financial reports have historically been generally supportive of uniform accounting standards for both nonpublic or small businesses and larger public enterprises.[28]

Notwithstanding this history, the Board recognizes the continuing interest by some parties in the Big GAAP/Little GAAP approach. The Board plans to utilize the SBAC to again consider issues raised by that approach.

What Are the Background and Basis for the Board's Unanimous Decision to Issue a Proposal to Improve the Accounting for Equity-Based Compensation?

A Brief History of the Accounting for Equity-Based Compensation

APB Opinion 25

US accountants and accounting standard setters have long debated the issue of the best way to report employee stock options. In 1972, the Accounting Principles Board ("APB"), the predecessor of the FASB, issued APB Opinion No. 25, *Accounting for Stock Issued to Employees.* Partly because techniques to estimate the value of stock options did not yet exist, the drafters of Opinion 25 created an exception to the normal financial reporting model.[29] That model encompasses the general principle that all of an enterprise's costs should be included in the enterprise's financial statements; otherwise, the enterprise's income is overstated.

Under the Opinion 25 exception, only stock options granted to employees that meet certain specified criteria (so-called fixed plan employee stock options) are not reported as an expense. All other options and all other forms of equity-based transactions result in expenses to be included in the financial statements consistent with the general principle.

[28] FASB Research Report, A. Rashad Abdel-khalik, page 1. Of note, the FASB's counterpart internationally, the International Accounting Standards Board ("IASB") recently added a project to its agenda to develop IASB accounting standards for small or medium-sized entities ("SME"). Under the IASB planned approach there would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles of International Financial Reporting Standards for SME standards. Similar to the general approach taken by the FASB, the IASB approach would generally be limited to disclosure modifications. As part of its international convergence efforts, the FASB will be closely monitoring the IASB project.

[29] Opinion 25 measures stock issued to employees using the "intrinsic value based method." Under that method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Opinion 25, paragraph 10. The consequence of using the intrinsic value based method is that stock options are frequently issued with the quoted market price of the stock at grant date equal to the amount an employee must pay to acquire the stock and, thus, no expense is reported in the financial statements.

Statement 123

Many parties agreed that the Opinion 25 exception was not the best approach to transparent financial reporting for employee stock options, and, in 1984, the FASB undertook a project to reconsider the issue. In 1993, after several delays in the project, the FASB issued an Exposure Draft, *Accounting for Stock-based Compensation*, for public comment. The Exposure Draft proposed to replace Opinion 25 and require recognition of compensation cost for all awards that eventually vest, based on their fair value at the grant date. For nonpublic enterprises, the Board decided to permit those enterprises to omit expected volatility from the fair value determination (so-called minimum value method) because "estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible."[30]

In 1995, however, when the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation*, it permitted companies to continue to apply Opinion 25, while also requiring annual footnote disclosures of the fair values (or minimum value for nonpublic enterprises) of fixed plan employee stock options otherwise omitted from the financial statements. The following paragraphs of Statement 123 summarize the basis for the Board's decision to only *encourage*, rather than *require*, that all stock-based compensation be measured at fair value at date of grant and reported as an expense in determining an enterprise's net income:

> The Board continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments. . . . However, in December 1994, the Board decided that the extent of improvement in financial reporting that was envisioned when this project was added to its technical agenda . . . was not attainable because the deliberate, logical consideration

[30] Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 174.

> of issues that usually leads to improvement in financial reporting was no longer present. Therefore, the Board decided to specify as preferable and to encourage but not to require recognition of compensation cost for all stock-based employee compensation, with required disclosure of the pro forma effects of such recognition by entities that continue to apply Opinion 25.
>
> The Board believes that disclosure of the pro forma effects of recognizing compensation cost according to the fair value based method will provide relevant new information that will be of value to the capital markets and thus will achieve some but not all of the original objectives of the project. However, the Board also continues to believe that disclosure is not an adequate substitute for recognition of assets, liabilities, equity, revenues, and expenses in financial statements. . . . *The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting*.[31]

In 2002, in Congressional testimony before the Committee on Banking, Housing and Urban Affairs, Dennis R. Beresford, who was the FASB chairman at the time Statement 123 was issued, shared his views about that Statement and the reasons for the Board's decision:

> As many of you may recall, the FASB had proposed that companies account for the expense represented by the fair value of stock options granted to officers and employees. The business community and accounting firms strongly opposed this proposal and a number of corporations engaged in a lobbying effort to stymie the FASB's initiative.
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> Certain members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB's proposal. The legislation would have prohibited public companies from following any

[31] Statement 123, paragraphs 61 and 62 (emphasis added).

> final FASB rule on this matter. More importantly, the legislation would have imposed requirements that the SEC repeat the FASB's process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a footnote to the financial statements but not record the expense in the income statement.[32]

Pertinent Events Following the Issuance of Statement 123

For many years following the issuance of Statement 123, only a handful of companies elected to adopt the fair value method of reporting employee stock options as an expense in the income statement. In addition, few investors and other users of financial statements expressed significant concerns with that practice.

Beginning in 2001, however, following the highly publicized bankruptcies of several major enterprises including Enron Corp., Global Crossing Ltd., and WorldCom, Inc., many investors and other users of financial statements began questioning enterprises' accounting and reporting for employee stock options. Moreover, many enterprises began considering whether to voluntarily expense all equity-based compensation consistent with the requirements of Statement 123. As of March 2003, when the Board added the project on equity-based compensation to its agenda, 179 public companies had adopted or announced their intention to adopt the fair-value-based accounting method in Statement 123.[33]

In 2001, the FASB's international counterpart, the International Accounting Standards Board ("IASB") took up the subject of the accounting for stock options. It needed to do so, not only because of the growing use of employee stock options around the world, but also because there was no existing literature in the international standards on this topic.

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[32] Prepared statement at a hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles (February 26, 2002), page 5 (emphasis added).
[33] FASB Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraph C5.

In November 2002, it proposed, as the FASB decided almost 10 years ago in developing Statement 123, that the appropriate accounting for employee stock options is to measure compensation for the fair value of the options at the date granted and to recognize the cost over the period the option vests.[34] And, also as the Board decided in developing Statement 123, the IASB proposed that the best way to measure the fair value at grant date is to use established option-pricing models and then make certain adjustments for the unique features of employee stock options. However, the IASB's particular set of adjustments and allocation methods were somewhat different from those under the fair value method developed by the FASB in Statement 123. There also were some other important differences between the IASB's proposal and the Statement 123 approach. Nevertheless, the fundamental conclusions were the same.

As the IASB released its exposure draft, the FASB issued an Invitation to Comment that explained in detail the similarities of and differences between the IASB proposal and the existing US standards and that solicited comments on those differences.[35] The purpose of the Invitation to Comment was twofold: (1) to solicit comments on certain issues that the Board would discuss when, in accordance with its objectives of improving US financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, it considered whether it should propose any further improvements to the US accounting standards on equity-based compensation and (2) to assist constituents that were planning to respond to the IASB's proposal.

The FASB received 302 comment letters in response to the Invitation to Comment. Most commentators from industry that made general observations about the accounting for equity-based compensation, many of whom were from the high-technology industry, were generally against mandatory expense recognition of all equity-based compensation. Those commentators raised a number of issues including (1) whether mandated expensing of fixed plan employee stock options has a clear or widely accepted rationale; (2) whether existing option pricing models, including Black-Scholes and binomial models, even when adjusted, produce inaccurate and misleading information; and (3) whether mandated expensing of fixed plan employee stock options will discourage broad-based compensation plans.

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[34] IASB Proposed IFRS, *Share-based Payment* (November 2002); FASB Exposure Draft, *Accounting for Stock-based Compensation* (June 1993).
[35] FASB Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment (November 2002).

In contrast, most commentators that were users of financial statements, including creditors, individual investors, pension funds, mutual funds, and financial analysts, were generally supportive of mandatory expense recognition of all employee stock options. Some representative examples include the following:

> Stock options have become a disgrace insofar as accurate reporting of expenses is concerned for corporation[s].
>
> I <u>strongly recommend</u> that there be a requirement for stock options to be expensed.

Benham M. Black, Partner, Black, Noland & Read, PLC, and Director, Virginia Financial Group, Inc. (an independent bank holding company with total assets of $1.04 billion), 1/31/03

> [A]s a fiduciary, I continue to be infuriated with the tech industry . . . and their blatantly self-serving position on stock options. Options have contributed mightily to the current crisis of confidence that we have in the stock market, and I view the expensing of options as a long-overdue and necessary step towards restoring both confidence and rationality in the market. . . . The tech industry has been masterful at marshalling their shareholders own capital against them, given their vociferous lobbying against the proper accounting treatment of options, but the time has come to treat options for what they are—compensation—and force them to be treated on par with all other forms of compensation.

Kenneth F. Broad, CFA, Portfolio Manager, Transamerica Investment Management, LLC (a registered investment adviser managing $12.5 billion in equity and fixed-income assets for mutual funds, funds for funds, separately managed accounts, retirement plans and various for-profit and nonprofit enterprises), 1/31/03

CPF . . . supports the view that stock options are compensation, have a cost, and that those costs should be included on reported income statements.

Michael R. Fanning, Chief Executive Officer, Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of over 150,000 participants of the CPF), 1/23/03

Investors support the core conclusions by the IASB and the FASB that stock based compensation should be recognized as an expense and that the amount of compensation expense should be based on the fair value of stock-based awards at grant date.

James E. Heard, Chief Executive Officer, Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide), 1/31/03

The Institute urges the Board to move forward with a reconsideration of Statement No. 123 as soon as practicable. We continue to believe that accounting standards should (1) require the issuers to treat the fair value of stock options granted to employees to be recognized as expense in the income statement and (2) ensure uniformity in how stock options are valued for this purpose.

Gregory M. Smith, Director – Operations/Compliance & Fund Accounting, Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies and 6 sponsors of unit investment trusts; its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders), 1/31/03

> <u>The Council supports the principles outlined in the IASB's exposure draft, and we urge the Financial Accounting Standards Board to propose and approve similar rules</u>. The IASB proposal is in line with the Council policy on the issue, which states that since stock options granted to employees, directors and non-employees are compensation and have a cost, companies should include these costs as an expense on their reported income statements and disclose their valuation assumptions.
>
> *Sarah A. B. Teslik, Executive Director, Council of Institutional Investors (an association of more than 130 corporate, public and union pension funds with more than $3 trillion in pension assets), 1/21/03*

In addition, the Board received many letters and emails from individual investors and other members of the general public from around the country urging the Board to mandate expense recognition for all equity-based compensation. Representative examples include the following:

> I strongly recommend that employee stock options be mandated as an expense on corporate financial statements. As long as these options can be passed out like funny money, thereby encouraging those on the receiving end to manipulate the financial records to their advantage – people like me will stay away from the market.
>
> *John S. Clauss, Jr., Glendale, California, 2/10/03*
>
> We encourage you to . . . require employee stock options to be counted as an expense. If you don't take this action who do you think will make these greed-monger's start accounting for their massive profits? Do the RIGHT THING, Damn it! . . .
>
> *David and Nancy Gabrielsen, Beavercreek, Oregon, 2/11/03*
>
> Companies are not required to expense options, which means they can give out as many as they want.

> I urge the FASB to require employee stock options to be counted as an expense. . . .
>
> *Rob Rocco, Avon Lake, Ohio, 2/12/03*

FASB's Current Project to Improve the Accounting for Equity-Based Compensation

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to equity-based compensation. That decision was based largely on three reasons.

The first reason was the high level of public concern expressed by creditors, individual and institutional investors, pension funds, mutual funds, financial analysts, and other users of financial statements about the need to improve the financial accounting and reporting for equity-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists *only* for fixed plan employee stock options. Those users of financial statements that have been urging the FASB to eliminate the exception for fixed plan employee stock options include:

- The Council of Institutional Investors (an association of more than 130 corporate, public, and union pension funds with more than $3 trillion in pension assets)

- Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide)

- The Office of the State Comptroller of New York (an investor, shareholder, and sole trustee of the nation's second largest pension fund at approximately $100 billion in assets)

- Moody's Investor Services

- The Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of more than 150,000 participants of the CPF)

- The Teachers Insurance and Annuity Association College Retirement Equities Fund (a financial services company with approximately $262 billion in assets under management, serving nearly 3 million education and research employees at 15,000 institutions)

- The Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies, and 6 sponsors of unit investment trusts; its mutual fund members have assets of about $6.539 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders)

- The Association for Investment Management and Research (a nonprofit professional organization of 61,600 financial analysts, portfolio managers, and other investment professionals)[36]

- The American Federation of Labor and Congress of Industrial Organizations (representing 13 million of America's workers in 65 member unions)

- The Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Peterson, chairman of the Blackstone Group, former Secretary of Commerce and chairman of the Federal Reserve Bank of New York, and John W. Snow, (former) chairman, CSX Corporation and former chairman, Business Roundtable).

As indicated above, fixed plan employee stock options are the *only* form of employee stock options that *are not* required to be reported as an expense in the income statements of the enterprises that grant them. All other forms of employee compensation, including cash salaries, bonuses, fringe benefits, restricted stock, stock warrants, performance-based stock options, indexed-based stock options, employee stock ownership plans, are (and have long been) required to be reported as an expense. Moreover, when equity-based grants of any form are issued to nonemployees for goods or services, they also are (and have long been) required to be reported as an expense. The exception for fixed plan employee stock options is clearly an anomaly in today's financial accounting and reporting.

Also as indicated above, creditors, investors, and other users of financial reports have urged the Board to address the exception for fixed plan employee stock options. Many have pointed to the negative impact that exception has had on promoting excessive awards of such options, particularly to corporate executives, and the negative behavioral aspects that it has had on corporate responsibility.[37]

[36] A 2001 survey conducted by the Association for Investment Management and Research found that more than 80 percent of financial analysts and portfolio managers responding to the survey believed that stock options granted to employees are compensation and should be recognized as an expense in the income statements of the enterprises that grant them. AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows" (November 19, 2001).

[37] The Conference Board, "Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation" (September 17, 2002), page 10.

Clearly, many creditors, investors, and other users of financial reports want this issue addressed and resolved in the near term.[38]

In 2002, President Bush announced a ten-point plan to improve corporate responsibility.[39] That plan including the following statement: “The authors of accounting standards must be responsive to the needs of investors.”[40] There is no other issue on the Board’s agenda on which investors have been clearer about the need for an improvement in the existing accounting standards.

The second reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was because of the complexity and noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting equity-based compensation. That lack of transparency has been magnified by the recent trend noted above of enterprises adopting the voluntary fair value provisions of Statement 123. Some of those enterprises, including Citigroup Inc. and J.P. Morgan Chase & Co., have requested that the Board mandate the expensing of all employee stock options. It is also interesting to note some of those enterprises, including Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that adopting fair value expensing for all employee stock options will not result in a curtailment of those programs.[41]

The third reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was the opportunity to achieve convergence to a common, high-quality international accounting standard in this area. As noted earlier, the IASB issued a proposal in November 2002 that would require that all stock options be expensed at their fair value at grant date. To maximize the opportunity for international convergence, the FASB concluded that it needed to consider the US accounting requirements for equity-based compensation concurrently with IASB’s consideration of its proposal.

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[38] The major US accounting firms also are generally supportive of expensing of all employee stock options. Letter from Jack A. Weisbaum to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski (March 19, 2004); Letter from Dennis M. Nally, Eugene O’Kelly, James H. Quigley, and James S. Turley to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski (March 17, 2004); Letter from Edward Nusbaum to the Honorable Richard H. Baker (March 17, 2004); “Big Four Shift View on Expensing Options,” *Financial Executive’s News* (May 1, 2003).

[39] Ten-Point Plan to Improve Corporate Responsibility and Protect America’s Shareholders (March 7, 2002).

[40] *Id*.

[41] News from Carl Levin, U.S. Senator, Michigan, “Stock Option Roundtable Dismissed as One-Sided” (May 8, 2003), page 2; Reed Hastings, “Expense It!” *The Wall Street Journal* (April 5, 2004).

The FASB has long been committed to actively working with the IASB and other national accounting standard setters to promote international convergence of accounting standards concurrent with improving the quality of financial reporting.[42] Both the Act[43] and the Policy Statement[44] indicate the support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

Since March 2003, the Board has held 38 public meetings to discuss the project. Preparations for those meetings included thousands of hours of research on issues relating to the project, including the review of the results of many research studies on the topic.

In addition, the Board and staff have participated in public and private discussions about the project with hundreds of individuals, including members of the FASAC, the UAC, the Option Valuation Group,[45] and other groups and organizations representing preparers, auditors, and users of financial reports. The Board also has conducted field visits with a variety of enterprises of various sizes, including small businesses, covering a range of industries to discuss issues relating to the project.

In February 2004, at a public meeting, the Board unanimously agreed to the issuance of a proposal for public comment. That proposal was issued on March 31, 2004.[46]

What Are the Key Provisions of the Proposal?

Scope

The scope of the proposal is very broad addressing the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services, including employee stock purchase plans. 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. The proposal does not change the accounting for similar transactions involving parties other than employees or the 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.

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[42] FASB, *Rules of Procedure* (December 1, 2002, as amended), page 2.
[43] Act, Section 108(a)(2).
[44] Policy Statement, page 4 of 8.
[45] The Board established the Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of stock options. Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, paragraph C37.
[46] See Attachment 4 for a summary of the proposal.

Recognition

For public enterprises, the proposal would require that the cost of employee services received in exchange for equity instruments 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.

Measurement

The proposal would require that the grant-date fair value of employee stock options and similar instruments be estimated using existing option-pricing models adjusted for the unique characteristics of those options and instruments.

Disclosures

The proposal would require that the footnotes to financial statements of both public and nonpublic enterprises disclose the information that users of financial information need to understand the nature of the equity-based compensation transactions and the effects of those transactions on the financial statements.

Transition and Effective Date

The proposal would be applied to public enterprises prospectively for fiscal years beginning after December 15, 2004, as if all equity-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting.

What Are the Special Provisions of the Proposal Applicable to Small Business?

Consistent with the requirements of its mission and due process, when the Board developed the proposal it evaluated whether the proposal would fill a significant need and whether the costs imposed to apply the provisions of the proposal, 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 the proposal on nonpublic enterprises (most small businesses are nonpublic enterprises).

The Board noted that the available statistical data about small businesses and employee stock options appears to indicate that very few small businesses operate stock option plans and, therefore, are unlikely, to be affected by the proposal.[47] For those small businesses, however, that do operate such plans the Board concluded that the proposal should include special provisions that mitigate the incremental costs those enterprises would incur in complying with the proposal's provisions.

Those special provisions include permitting most small businesses to (1) use a simpler, less costly method to measure compensation cost; (2) use a simpler, less costly method to transition to the new requirements; and (3) have a delayed effective date.

Simpler, Less Costly Measurement Approach

Most nonpublic enterprises would be permitted (and public enterprises, in the limited circumstances where it is not possible to reasonably estimate the fair value of an equity instrument at the grant date, would be required) to measure compensation cost using a simpler "intrinsic value method," rather then the fair-value-based method that would be required for other enterprises.[48]

Under the intrinsic value method, the compensation cost for any reporting period would be measured based on the difference between any excess of the fair value of the enterprises' stock and the exercise price of the employee stock options granted, with final measurement of compensation cost at settlement date. The total amount of compensation expense reported under the intrinsic value method would generally be equivalent to the total amount of income tax deduction for option grants presently reported by those enterprises.

The Board believes that applying the intrinsic value method described above lessens incremental costs that nonpublic enterprises may incur in applying the proposed requirements. The Board noted that nonpublic enterprises must

[47] Beth Levin Crimmel and Jeffrey L. Schildkraut, "Stock Option Plans Surveyed by NCS," *Compensation and Working Conditions* (Spring 2001), Table 3, page 11 (referencing 1999 survey indicating that 2.1 percent of enterprises with 100 employees or fewer offered stock options); Andrew Pendleton, Joseph Blasi, Douglas Kruse, Erika Poutsma, and James Sesil, "Theoretical Study on Stock Options in Small and Medium Enterprises," Final Report to the Enterprise-Directorate General, Commission of the European Communities (October 2002), page 45 (indicating that the incidence of any form of share scheme among small and medium size businesses is very low).

[48] The International Accounting Standards Board's International Financial Reporting Standard (IFRS) 2, *Share-based Payment* (February 2004), paragraph 24, does not permit the use of the intrinsic value method for nonpublic or public enterprises, but does require that that method be used by nonpublic or public enterprises in the rare circumstance that the fair value of the equity instrument cannot be estimated reliably.

currently calculate the intrinsic value method whenever employee stock options are granted (for financial reporting purposes) and whenever employee stock options are exercised (for income tax deduction purposes). The Board also noted that most nonpublic enterprises only prepare audited financial reports once a year. Finally, to the extent that a nonpublic enterprise is funded by a venture capital firm, the Board noted that those firms are required to determine the fair value of their investments for financial reporting purposes.

After considering the input from users, auditors, and preparers of nonpublic enterprises' financial reports, the Board concluded that the intrinsic value method provided more meaningful information than other alternatives, including the minimum value method alternative permitted in Statement 123.[49] In rejecting the minimum value method alternative, the Board noted that that method ignores a key element of what makes options valuable, that is the ability of the holder for a potentially lengthy period of time to capture the appreciation in the value of the underlying stock.[50] As such, it results in a measurement that is not representationally faithful to the underlying economics of the transaction. It also was noted that the minimum value method could be easily manipulated to result in zero compensation expense being recognized.[51]

Simpler, Less Costly Transition Approach

All nonpublic enterprises would apply the proposed standard prospectively and not be required (as other enterprises) to apply the requirements to any nonvested portion of awards that were granted before the date of adoption of the proposed standard.

Delayed Effective Date

The effective date of the proposed standard for most nonpublic enterprises would be delayed for one year (fiscal years after December 15, 2005), as compared with the proposed effective date for other enterprises (fiscal years after December 15, 2004).

[49] Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, paragraphs C68-C72.
[50] *Id.* paragraph C72.
[51] Mark Rubinstein, "On the Accounting Valuation of Employee Stock Options," *Journal of Derivatives* (Fall 1995), page 21.

Solicitation of Comments on Special Provisions

The Board specifically highlighted the special provisions applicable to small businesses in the following issues contained in the proposal's Notice for Recipients ("Notice") to encourage respondents to provide further input on those issues:

> *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?

> . . . .
>
> *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 Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?[52]

Also as noted above, the Board plans to discuss the views of individuals representing small and medium-sized businesses regarding the above issues and other aspects of the proposal at the inaugural meeting of the SBAC.

The Board will carefully consider during its public redeliberations of the proposal the input received from users, auditors, and preparers of small business financial reports and carefully consider whether the proposed requirements are cost effective and meet the demands of those parties and the marketplace.

How Would the Proposal Improve Financial Reporting?

The proposal would improve financial reporting by requiring for the first time the recognition of all compensation cost incurred as a result of receiving services in exchange for valuable equity instruments issued by the employer. Recognizing all compensation cost relating to equity-based compensation 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 reports understand the impact that equity-based compensation arrangements have on an enterprise's financial condition and operations.

That Board view was confirmed in a recent survey of 302 buy-side portfolio managers and research professionals, who by a four-to-one margin indicated that they believe the proposal, will improve transparency in financial reporting.[53] **That same survey found that "an overwhelming majority -- 90% -- of respondents said they are opposed to any exemptions from the options expensing rule for 'start-ups' or technology companies."**[54]

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[52] Proposed Statement of Financial Accounting Standards, *Share-Based Payment*, pages iii and iv; see Attachment 4 for the complete Notice for Recipients.

[53] Broadgate Consultants, Inc., "Institutional Investors Support FASB Options Expensing Proposal" (April 7, 2004).

[54] *Id.;* See Attachment 5 for additional excerpts from materials about the proposal and small business.

In addition, a recent survey of 30 institutional technology investors found that more than 90 percent support the Board's effort to require firms to report employee stock option expense in their income statements.[55] **That same survey also found that nearly 70 percent of technology investors opposed exceptions from the proposal for "newly public companies."**[56]

Both surveys are consistent with a 2001 survey of more than 18,000 analyst and portfolio managers in which 83 percent of respondents agreed that employee stock options are compensation and should be recognized as an expense in the income statements of the enterprises that grant them.[57]

The proposal also would improve comparability by eliminating one of the two different methods of accounting for equity-based compensation transactions that were available to most enterprises (the Opinion 25 method) and would also thereby simplify existing US GAAP. The existing accounting for equity-based compensation had been specifically identified by many parties, including the SEC, as an example of a "rules-based standard" that has "fueled the demand for increased guidance" and that has led to further complex, detailed, and form-driven rules.[58] Eliminating different methods of accounting for the same transaction leads to improved comparability of financial statements because similar economic transactions are accounted for similarly. That should, in turn, result in accounting information that is more decision useful to creditors and investors.

The proposal also results in greater international comparability in the accounting for equity-based compensation. In February 2004, the IASB issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment.*[59] Converging to a common set of high-quality financial accounting standards on an international basis for equity-based compensation improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both US GAAP and international accounting

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[55] Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment (February 3, 2004), page 7.
[56] *Id.* page 11 (emphasis added).
[57] AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows."
[58] Staff of the US 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" (July 25, 2003), pages 24 and 25.
[59] Of note, in September 2003, the Accounting Standards Board ("AcSB") of Canada issued *Stock-Based Compensation and Other Stock-Based Payments,* Section 3870. Section 3870, consistent with IFRS 2 and the FASB proposal, requires the expensing of all equity-based compensation. Significant concerns in Canada about the inadequacies of the existing accounting for equity-based compensation led the AcSB to take the unusual action of requiring that Section 3870 become effective in 2004, prior to completion of the related FASB project and prior to the effective date of IFRS 2.

standards. As indicated above, both the Act and the Policy Statement indicate support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

What Is the Current Status of, and the FASB's Plans Relating to, the Proposal?

As indicated above, the Board issued the proposal for public comment on March 31, 2004. Also as indicated above, the proposal includes a Notice that highlights and describes twenty-two specific issues (three of which are related to small businesses) that respondents might wish to consider in developing their comments.[60] The comment period ends on June 30, 2004.

The Board plans to hold public roundtable meetings with interested users, auditors, preparers, and compensation and valuation experts to discuss the issues related to the proposal. Those roundtable meetings are scheduled to take place on June 24, 2004, in Palo Alto, California, and June 29, 2004 in Norwalk, Connecticut. The Board plans to seek participants for each meeting that represent a wide variety of users, preparers, and auditors of financial reports, and compensation and valuation experts. The Board also plans to discuss the views of interested parties representing small and medium-sized businesses regarding the proposal at the inaugural meeting of the SBAC to be held on May 11, 2004, in Norwalk, Connecticut.

Following the end of the comment period, the Board will redeliberate at public meetings the issues raised by the proposal. Those public redeliberations will be thorough and objective.

The redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal and will include careful consideration of the input received by all parties. The redeliberations also will benefit from the FASB staff and Board's ongoing discussion of the key issues with interested parties from a broad range of perspectives, including valuation and compensation experts that the FASB has been consulting with and will continue to consult with throughout the entire process.

Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

[60] See Attachment 4 for the Notice for Recipients.

The Board's current plans are to issue a final standard in the fourth quarter of this year. As with all of the FASB's activities, the FAF and the SEC will closely monitor and oversee the Board's due process on this important project.

Some Observations about Some of the More Common Arguments Offered by Some Opponents of the Proposal.

Four of the more common arguments made by some of the opponents of the Board's proposal to improve the financial accounting and reporting for equity-based compensation are (1) employee stock options do not represent a cost and, therefore, should not be required to be expensed, (2) the cost of employee stock options cannot be reliably estimated, (3) mandatory expensing of employee stock options will eliminate broad-based stock option plans, and (4) mandatory expensing of fixed plan employee stock options will have negative economic consequences, including harmful implications to US technology leadership and job creation. The following presents some observations about each of those arguments.

Employee Stock Options Do Not Represent a Cost

In connection with the development of the proposal, the Board, after public deliberations, decided by a unanimous vote that goods and services received from any party in exchange for equity-based compensation should result in a cost that is recognized in the financial statements. That decision led to the proposed elimination of the existing exception that permits fixed plan employee stock options to avoid expense recognition.

The basis for the Board's proposed decision is that the Board agreed that all employee stock options, including fixed plan stock options, have value and those valuable financial instruments given to employees give rise to compensation cost that is properly included in measuring an enterprise's net income. Employee stock options provide an employee a valuable right to buy an enterprise's stock for a fixed price during a fixed time period. Similar rights are bought and sold in organized markets by speculators and other parties.

Furthermore, companies issue similar options and warrants to outside parties to acquire goods and services and in connection with acquisitions and financing transactions (and the fair value of those exchanges are always reported on the face of the financial statements without exception). If such rights were not valuable, employees, speculators, and other parties would not purchase them. Because employees purchase those rights with services, those consumed services represent an expense that is properly included in measuring an enterprise's net income.

The Board also discussed and disagreed with the related argument made by some parties that equity-based compensation should not be reported as a cost and deducted from earnings, but instead should only be reflected in diluted earnings per share when the options are exercised. The Board noted that the argument ignores the fact that all equity-based compensation, other than fixed plan employee stock options, is currently reported as a cost and deducted from earnings.

The Board believes that information about dilution from stock and stock option issuances is relevant information for investors. Diluted earnings per share, however, do not reflect all of the effects of equity-based compensation transactions.[61]

In addition to potential dilution, equity-based compensation transactions also affect the amount of the enterprise's employee compensation costs. As noted earlier, under existing accounting standards, all forms of equity-based compensation, except for fixed plan employee stock options, are reported as part of an enterprise's employee compensation costs.

The Board believes that all compensation costs, including fixed plan employee stock options costs, must be reported as an expense and deducted from earnings in order to provide investors with sound, fair, and credible information about an enterprise's net income. As the Congressional Budget Office recently concluded in its paper analyzing the accounting for employee stock options, **"[i]f firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' reported net income will be overstated."**[62] More recently, in expressing support for the proposal in testimony before the Joint Economic Committee last week, Federal Reserve System Chairman Alan Greenspan commented that **not expensing employee stock options gives a distorted view of profitability**.[63]

<u>The Cost of Employee Stock Options Cannot Be Reliably Estimated</u>

In its public deliberations leading to the development of the proposal, the Board did not find persuasive the argument that the estimated fair value of employee stock options based on currently available valuation techniques would be so unreliable as to impair the credibility and comparability of financial statements.

[61] Of note, the diluted earnings per share calculation takes into account only those stock options that are in-the-money and ignores the potential dilutive impact of options that are either at- or out-of-the-money. FASB Statement No. 128, *Earnings per Share* (February 1997), paragraphs 20-23.

[62] Congressional Budget Office, "Accounting for Employee Stock Options," Summary, Section 2 of 3, pages 1 and 2 (emphasis added).

[63] Stephen Taub, "Greenspan Endorses Expensing Options," *CFO.com* (April 22, 2004).

To the contrary, the Board believes that use of the Opinion 25 intrinsic value method has and would continue to impair not only the relevance and reliability, but also the credibility, of financial statements by omitting a potentially significant component of the total cost of employee services.

The Board notes that thousands of public enterprises have been estimating the fair value of employee stock options, generally consistent with the approach contained in the proposal, and have been reporting those amounts in their audited financial statement footnotes for eight years. Moreover, 483 enterprises, 113 of which represent 41 percent of the S&P 500 index based on market capitalization, have estimated and reported or will soon estimate and report all of their employee stock options as an expense in their audited and certified financial statements generally consistent with the proposal's approach.[64]

In addition, many valuation experts and many other parties, including the Congressional Budget Office, agree that employee stock options can be reliably valued.[65] It is widely acknowledged that far more complicated financial instruments, including long-dated and complex derivatives, and convertible bonds containing embedded long-dated options, are valued in the marketplace daily and that value is routinely reported by enterprises.[66]

Uncertainties inherent in estimates of the fair value of equity-based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations.[67] For those items, as well for many other items in accounting involving the use of estimates, enterprises are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements.[68] Few accrual-based accounting measurements can claim absolute

[64] Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Options Using the Fair Value Method," Bear Stearns (February 12, 2004).

[65] Congressional Budget Office, "Accounting for Employee Stock Options," Summary, Section 2 of 3, page 2, and Section 3 of 3, pages 5 and 6.

[66] Hearing on "H.R. 3574: Stock Option Accounting Reform Act," Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004).

[67] Michael B. Clement, "Accounting: The Case for Expensing Stock Options," Goldman Sachs Global Equity Research (April 7, 2004), page 1.

[68] As an example, Intel Corporation's ("Intel") Form 10-K for fiscal year ended December 27, 2003, includes a disclosure of "Critical Accounting Estimates" in Management's Discussion and Analysis of Financial Condition and Results of Operations. That disclosure describes "difficult and subjective judgments" in five specific areas that Intel acknowledges "have a significant impact on the results we report in our financial statements." Those five areas include goodwill, non-marketable equity securities, inventory, long-lived assets, and income taxes. Intel Form 10-K, pages 32-34.

reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing no amounts.[69]

Mandatory Expensing of Employee Stock Options Will Eliminate Broad-Based Stock Option Plans

If broad-based employee stock option plans are a good business decision, meaning that the benefits derived from those plans exceed their costs, mandatory expensing of fixed plan employee stock options should not lead to the elimination of broad-based stock option plans. Many other forms of compensation, including pension plans and Employee Stock Purchase Plans, have been and continue to be "broad-based" at many enterprises, notwithstanding that those and other forms of compensation, other than fixed plan employee stock options, are reported as an expense.

As indicated above, Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that voluntarily adopting fair value expensing for all employee stock options will not result in any curtailment of those programs. The CEO of Netflix Inc. recently commented:

> Thoughtful Silicon Valley CEO after CEO lines up to say that closing the stock option loophole will curtail the innovation economy as we know. But Amazon, Microsoft and my company, Netflix, all voluntarily converted last year to expensing, have continued to give broad-based equity incentives, and innovation continues unabated. Stock options may be the symbol of the Silicon Valley culture, but it is not the essence. We innovate because it thrills us, not because of some accounting treatment."[70]

[69] Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment, page 5.
[70] Reed Hastings, "Expense It!" *The Wall Street Journal*.

Mandatory Expensing of Employee Stock Options Will Have Negative Economic Consequences

Some opponents of the proposal argue that the recognition of compensation cost based on fair value may have undesirable economic consequences, including harmful implications for US technology leadership and job creation.[71] As indicated above, they often suggest that the required recognition of compensation cost from equity-based payment arrangements is likely to cause some enterprises to reduce, eliminate, or otherwise revise those arrangements. Some also contend that recognition of compensation cost for employee stock options will raise the cost of capital for enterprises that make extensive use of those options. All of those assertions seem to be based on the presumptions that (1) most, if not all, current equity-based arrangements are inherently desirable regardless of their cost and (2) Opinion 25's accounting requirements have only desirable economic consequences. The Board considers neither presumption to be either supportable or relevant in establishing accounting standards for equity-based payment arrangements.

The Board's operating precepts require it to consider issues in an evenhanded manner, without attempting to encourage or to discourage specific actions. That does not imply that improved financial reporting should have no economic consequences. To the contrary, a change in accounting standards that result in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences. For example, required recognition of compensation cost based on the provisions of the proposal would result in comparable accounting for all forms of employee compensation. The Board believes that any decision to reassess and modify existing equity-based payment arrangements would be based on information that better represents the costs and benefits of various forms of compensation.

Some investors and others have noted the dramatic increase in the number of stock options awarded to employees during recent years. The Board understands that the vast majority of stock options awarded to employees are fixed plan employee stock options for which enterprises that continued to use the accounting

[71] Some commentators have found it ironic that defending US jobs is used as an argument against the FASB proposal, when many high technology and venture capital enterprises are at the same time trying to convince Congress and other State legislators not to impose restrictions on outsourcing as they actively promote the movement of jobs overseas. Steven Milunovich and Richard Farmer, "Tech Stock Options—The Invisible Cash Flow Drain," Merrill Lynch Comment, page 6. Some recent articles discussing support of outsourcing by representatives of the high technology or venture capital industries include Don Clark, "Another Lure of Outsourcing: Job Expertise," *The Wall Street Journal* (April 12, 2004); Ann Grimes, "Venture Firms Seek Start-Ups That Outsource," *The Wall Street Journal* (April 2, 2004); and Karl Schoenberger, "Fears Over Offshoring Inflated, Says AeA," *Mercury News* (March 24, 2004).

requirements of Opinion 25 recognized no compensation expense. The accounting under Opinion 25 treats most fixed plan employee stock options as though they were a "free good," which implies that the services received in exchange for those options are obtained without incurring a cost. But employee services received in exchange for stock options are not free. Stock options are valuable equity instruments for which valuable consideration is received—consideration that should be recognized regardless of whether it is in the form of cash, goods, or services from employees or other suppliers. Accounting for fixed plan employee stock options as though they imposed no cost on the enterprise that issues them may encourage their substitution for other forms of compensation, such as stock options or other instruments with performance or market conditions that may be preferable in a particular situation. Requiring recognition of compensation cost based on fair value increases the neutrality of financial reporting and removes an accounting incentive for an entity to choose a form of incentive compensation—fixed plan employee stock options—that may not be the most advantageous in its circumstances.

Many would agree that an enterprise's expenditures for a broad range of items, such as pensions, education and training, environmental remediation, or occupational, health, and safety programs, are expenditures that should be encouraged. Those items, however, like all forms of employee compensation, are a cost of the enterprise and properly reported as expenses in financial reports.

Of note, the above observations have generally been supported by many economic experts who have reviewed the issue, including Federal Reserve Chairman Alan Greenspan,[72] former Federal Reserve Chairman (and current chairman of the Trustees of the International Accounting Standards Committee Foundation) Paul A. Volcker,[73] Nobel Prize winning economists Robert C. Merton[74] and Joseph E. Stiglitz,[75] the Financial Economist Roundtable,[76] the Republican Staff of the Joint

[72] Stephen Taub, "Greenspan Endorses Expensing Options," *CFO.com;* Federal Reserve System Chairman Alan Greenspan, Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (May 3, 2002), pages 5 and 6.
[73] Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Testimony of Paul A. Volcker (June 3, 2002), pages 3 and 4.
[74] Hearing on "H.R. 3574: Stock Option Accounting Reform Act," Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton.
[75] Joseph E. Stiglitz, "The Roaring Nineties" (October 2003), pages 115-139.
[76] Statement of Financial Economist Roundtable on the Controversy over Executive Compensation (November 24, 2003).

Economic Committee of the US Congress,[77] the Conference Board Commission on Public Trust and Private Enterprise,[78] and the Congressional Budget Office.[79]

Conclusion

In conclusion, let me assure you, Chair Snowe, Ranking Member Kerry, and Members of this Committee, that you, and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to actively solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties and that will lead to improving the transparency and credibility of financial reports and, thus, assisting in the strengthening of the US economy.

Thank you again, Chair Snowe. Bob and I would welcome the opportunity to respond to any questions.

[77] Joint Economic Committee, Republican Senate Staff, Economic Policy Research, "Understanding the Stock Option Debate," Report 107-04 (July 9, 2002), page 18.
[78] The Conference Board, "The Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation," page 6.
[79] The Congressional Budget Office, "Accounting for Employee Stock Options," Section 3 of 3, pages 4 and 5.