Submission of Materials by
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Financial Accounting Standards Board
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Full Text of Statement

Chairman Enzi, Senators Allen and Boxer, and the other roundtable participants, I am Robert H. Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is G. Michael Crooch, one of my fellow Board members. We are pleased to be here today.

We are here mainly to listen to and learn from the discussion. I, however, have a brief opening statement, and I would respectfully request that the full text of my statement and my entire submission of materials be made a part of the Roundtable record.

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. Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors and other users 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,[2] is fundamental to our mission because our work is

[1] See Attachment 1 for information about the Financial Accounting Standards Board.
[2] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

technical in nature, designed to provide investors and the capital markets with the most accurate possible ruler to measure and report upon the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent FASB to maintain the integrity of an accurately designed ruler in order to obtain the financial information necessary to properly assess and implement the public policies they favor. While bending the ruler to favor a particular outcome may seem attractive to some in the short run, in the long run a bent ruler (or a biased accounting standard) is harmful to investors, the capital markets, and the 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.[3] The SEC, together with the private-sector Financial Accounting Foundation,[4] maintains active oversight of the FASB's activities.

[3] 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).
[4] See Attachment 1 for information about the Financial Accounting Foundation.

Background on Accounting for Stock-Based Compensation

APB Opinion 25

US accountants and accounting standard setters have long debated the issue of the best way to report 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.[5] 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 options) are not reported as an expense. All other options and all other forms of stock-based transactions result in expenses to be included in the financial statements consistent with the general principle.

[5] 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

Statement 123

Many agreed that the Opinion 25 exception was not the best approach to transparent financial reporting for 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. 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 of 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 of issues that usually leads

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.

> 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.
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> 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*.[6]

Last year, 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.
>
> 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 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*

[6] Paragraphs 61 and 62 (emphasis added).

> *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.*[7]

<u>Statement 148</u>

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

Over the past year, however, following the highly publicized bankruptcies of Enron Corp., Global Crossing Ltd., and WorldCom, Inc., many investors and other users of financial statements began questioning companies' accounting and reporting for stock options. Moreover, many companies began considering whether to voluntarily expense all stock-based compensation consistent with the requirements of Statement 123.

In July 2002, as a number of US companies began announcing their intention to switch to the fair value method of reporting stock-based compensation, the FASB, in response to requests from some of those companies and other constituents, decided to add a limited-scope project to its agenda to address issues related to the transition and disclosure

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[7] 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).

provisions of Statement 123.[8] In December 2002, the FASB issued Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure.*

Statement 148 provides alternative methods for transition for a voluntary change to the fair value method of accounting for stock-based compensation. In addition, that Statement amends the required disclosures of Statement 123 to provide for more prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results.

International

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

After a year of thorough deliberations by the IASB, like the FASB decided almost 10 years ago in developing Statement 123, it proposed that the appropriate accounting for stock options is to measure compensation for the fair value of the options at the date

[8] As of April 28, 2003, 244 companies expense or intend to expense stock options using the grant date fair value method. See Attachment 6 for a list of those companies.

granted and to recognize the cost over the period the option vests.[9] And, also like 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 are somewhat different from those under the fair value method developed by the FASB in Statement 123. There also are some other important differences between the IASB's proposal and the Statement 123 approach. Nevertheless, the fundamental conclusions are the same.

The IASB has begun discussing at public meetings the issues raised by constituents in response to its proposal. Of note, a majority of commentators from industry indicated full or qualified support for treating all stock-based compensation as expenses and for measuring them at their fair value. The IASB currently plans on issuing a final standard in the fourth quarter of 2003.

Other national standard setters of countries with major capital markets are also in the process of developing similar improvements to the accounting for stock-based compensation.

Invitation to Comment

As the IASB released its exposure draft in November 2002, the FASB issued an Invitation to Comment that explains in detail the similarities and differences between the

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[9] IASB Proposed IFRS, *Share-based Payment* (November 2002); FASB Exposure Draft, *Accounting for Stock-based Compensation* (June 1993).

IASB proposal and the existing US standards and that solicits comments on those differences.[10] 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 stock-based compensation and (2) to assist constituents that were planning to respond to the IASB's proposal.

The FASB received over 290 comment letters in response to the Invitation to Comment. Most commentators from industry that made general observations about the accounting for stock-based compensation, many of whom were from the high-technology industry, were generally against mandatory expense recognition of all stock-based compensation. Those commentators raised a number of issues including (1) whether mandated expensing of employee stock options has a clear or widely accepted rationale; (2) whether the real cost of issuing employee stock options is potential dilution of existing shareholders' equity interests; (3) whether the cost of employee stock options is already reported in corporate financial statements; (4) whether existing option pricing models, including Black-Scholes and binomial models, even when adjusted, produce inaccurate and misleading information; (5) whether expensing stock options is likely to lead to an even more distorted picture of a company's financial performance and condition; and (6)

[10] 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).

whether mandated expensing of employee stock options will destroy broad-based plans and the productivity, innovation, and economic growth they generate.

In contrast, most commentators that were users of financial statements, including individual investors, pension funds, mutual funds, creditors, and financial analysts, were generally supportive of mandatory expense recognition of all stock-based compensation.[11] 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., 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.
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> *Kenneth F. Broad, CFA, Portfolio Manager, Transamerica Investment Management, LLC, 1/31/03*

[11] Attachments 4 and 7 include excerpts and letters, respectively, from some of those constituents who responded to the Invitation to Comment.

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, 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 funds 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

> 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. 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.
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> *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 stock-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*

> 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*

> 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! . . .
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> *David and Nancy Gabrielsen, Beavercreek, Oregon, 2/11/03*

Current FASB Project on Improving the Accounting and Reporting for Stock-Based Compensation

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to stock-based compensation.[12] That decision was based largely on three reasons: (1) the high level of public concern expressed by individual and institutional investors, pension funds, mutual funds, creditors, financial analysts, and other users of financial statements about the need to improve the financial accounting and reporting for stock-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists for fixed plan options,[13] (2) the noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting stock-based compensation that has been magnified by the recent trend of enterprises to adopt the voluntary fair value provisions of Statement 123,[14] and (3) the opportunity to achieve convergence to a common, high-quality international accounting standard on stock-based compensation.

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[12] See Attachment 3 for a summary of the project on stock-based compensation.
[13] See Attachment 4 for excerpts from investors and other users expressing concerns about the existing accounting for stock-based compensation.
[14] Of the 244 companies that have adopted or will adopt fair value expensing of stock options, 89 (37%) are S&P companies. The 89 companies from the S&P 500 represent 35% of the index based on market capitalization. See Attachment 6 for a list of companies (alphabetical and by state) that currently expense or intend to expense stock options using the fair value method.

At the April 22, 2003, Board meeting, the Board began its initial public deliberations of issues related to the recognition and measurement of stock-based compensation. The Board tentatively decided:

- Goods or services received in exchange for stock-based compensation result in a cost that should be recognized in the income statement as an expense when the goods or services are consumed by the enterprise.

- The measurement attribute for an exchange involving stock-based compensation is fair value.

- With respect to stock-based compensation transactions with employees:

    - The economic event being measured is the exchange of goods or services received for stock-based compensation.

    - The measurement objective for equity-settled awards is to determine the fair value of the goods or services received in the exchange, which should be based on (1) the fair value of the goods or services received or (2) the grant-date fair value of the stock-based compensation given, whichever is more reliably measurable.

In the coming weeks and months, at public meetings, the Board will continue its deliberations of issues relating to the project. The Board has divided the project into two distinct phases. In phase one, the Board will address issues relating to improving the accounting for employee stock-based compensation. In phase two, the Board will address issues relating to improving the accounting for nonemployee stock-based compensation and stock-based compensation arising from employee stock ownership plans and employee stock purchase plans.

The Board currently expects to hold at least six public meetings to discuss the following issues in connection with developing a proposed standard for public comment for phase one of the project:

- Measurement methods
- Option valuation
- Attribution methods
- Modification and settlements
- Income taxes
- Disclosures
- Transition
- Effective date.

The Board's public deliberations of those issues will be systematic, thorough, and objective. The deliberations will benefit from the FASB staff's ongoing review and analysis of the vast amount of research and other literature in this area.[15] The Board's deliberations also will benefit from the advice of leading valuation and compensation experts that the FASB will consult with throughout the entire process.

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[15] Some of the relevant published and unpublished research papers and other materials issued just since January 2003 include: Bettis, Bizjak, and Lemmon, "The Cost of Employee Stock Options," working paper, Social Science Research Network (May 2003); Bodie, Kaplan, and Merton, "For the Last Time: Stock Options Are an Expense," *Harvard Business Review* (March 2003); Finnerty, *Valuing Employee Stock Options: A Comparison of Alternative Methods* (Morristown, N.J.: Financial Executives Institute Research Foundation, 2003); Gooch and Lipe, "An Empirical Comparison of Grant-Date and Exercise-Date Measurements in Employee Stock Option Accounting," School of Accounting, University of Oklahoma (February 2003); Mollen, Rodney, Harper, and Jones, *Does the Black-Scholes Model Predict*

The Board currently plans to be in a position to issue a proposed standard for public comment on phase one of the project in the fourth quarter of this year. Prior to making any final decisions on any changes to the accounting for stock-based compensation, the Board would consider, at public meetings, all of the input received in response to a proposal. The Board will not issue any final standard until it has carefully considered the views of all constituents.

Roundtable Questions

Do fixed employee stock options represent a corporate cost at the time they are granted in the traditional sense that they should be deducted from earnings, or are they a potential shareholder level cost that should be reflected in diluted earnings per share when they are exercised?

As indicated above, at the public Board meeting on April 22, 2003, the Board tentatively decided by a unanimous vote that goods and services received from any party in exchange for stock-based compensation should result in a cost that is recognized in the financial statements. The tentative decision would eliminate the existing exception that permits certain fixed plan employee stock options to avoid expense recognition in the financial statements.

The basis for the Board's tentative decision is that the Board agreed that all employee stock options, including fixed plan stock options, have value and that valuable financial instruments given to employees give rise to compensation cost that is properly included

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the Value of Employee Options? (New York: Sibson, 2003); Olagues, "Wrestling with the Value of Your in measuring an enterprise's net income. Employee stock options provide the 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 such options and warrants to outside parties to acquire goods and services and in connection with acquisitions and financing transactions. 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 argument made by some constituents that stock-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 stock based-compensation, other than fixed plan stock-based compensation, 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 stock-based compensation transactions. [16]

In addition to potential dilution, stock-based compensation transactions also impact the amount of the enterprise's employee compensation costs. Under existing accounting

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Employee Stock Options," *SFO Magazine* (April 2003).

standards, all forms of stock-based compensation, except for fixed plan stock-based compensation, are reported as part of an enterprise's employee compensation costs.

The Board believes that all compensation costs, including fixed plan stock-based compensation costs, must be reported as an expense and deducted from earnings in order to provide investors with credible information about an enterprise's net income.

Does a method exist to accurately value the cost to the corporation of issuing stock options at the time they are granted, so that financial statements will be more accurate, transparent and reliable if stock options are expensed at that time?

In its current project, the Board has not yet deliberated issues relating to the method of determining the fair value of stock-based compensation. In response to the Invitation to Comment, the FASB received significant input from constituents on over two dozen issues relating to determining the fair value of stock-based compensation.[17] Some of those constituents questioned whether existing pricing models, including Black-Scholes and binomial models, even when adjusted, could produce an accurate and reliable fair value for stock-based compensation. As indicated above, the Board will systematically, thoroughly, and objectively deliberate those issues at future public meetings.

From a historical perspective, it should be noted that in the development of Statement 123 almost 10 years ago, when the valuation and measurement of complex financial

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[16] 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).

instruments was less advanced and far less routine than in today's environment, the Board unanimously concluded that the value of employee stock options could be estimated within acceptable limits for recognition in financial statements. The basis for the Board's conclusion included the following:

> [U]ncertainties inherent in estimates of the fair value of employee stock options are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pension and other postretirement benefit obligations. All estimates, because they are estimates, are imprecise. Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing nothing—which is what Opinion 25 accounting recognizes for most employee stock options. Zero is not within the range of reasonable estimates of the value of employee stock options at the date they are granted, the date they vest, or at other dates before they expire, with the possible exception of deep-out-of-the-money options that are near expiration. Even those latter options generally have nominal value until very shortly before expiration.
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> The Board continues to believe that use of option-pricing models, as modified in this Statement, will produce estimates of the fair value of stock options that are sufficiently reliable to justify recognition in financial statements. Imprecision in those estimates does not justify failure to recognize compensation cost stemming from employee stock options. That belief underlies the Board's encouragement to entities to adopt the fair value based method of recognizing stock-based employee compensation cost in their financial statements.[18]

More recently, in the development of the IASB proposal, the IASB unanimously decided that ". . . estimated fair value of employee share options at grant date can be measured

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[17] Paragraph B1.
[18] Paragraphs 111 and 117.

with sufficient reliability for the purposes of recognising employee share-based payment transactions in the financial statements."[19] The basis for the IASB's decision included the following:

> The Board noted that there is evidence to support a conclusion that it is possible to make a reliable estimate of the fair value of employee share options. First, there is academic research to support this conclusion (eg Carpenter 1998, Maller, Tan and Van Ed Vyver 2002). Second, users of accounts regard the estimated fair values as sufficiently reliable for recognition in the financial statements. Evidence of this can be found in a variety of sources, such as the comment letters received from users of accounts who responded to the Discussion Paper. Users' views are important, because the objective of financial statements is to provide high quality, transparent and comparable information to help users make economic decisions. In other words, financial statements are intended to meet the needs of users, rather than preparers or other interest groups. The purpose of setting accounting standards is to ensure that, wherever possible, the information provided in the financial statements meets users' needs. Therefore, if the people who use the financial statements in making economic decisions regard the fair value estimates as sufficiently reliable for recognition in the financial statements, this provides strong evidence of measurement reliability.
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> In summary, if expenses arising from grants of options to employees are omitted from the financial statements, or recognised using the intrinsic value method (which typically results in zero expense) or the minimum value method, that means that there is a permanent error embedded in the accounts. So the question is, which accounting method is more likely to produce the smallest amount of error and the most relevant, comparable information—a fair value estimate, which might result in some understatement or overstatement of the associated expense, or another measurement basis, such as intrinsic value, that will definitely result in substantial understatement of the associated expense?[20]

[19] Paragraph BC294.
[20] Paragraphs BC291 and BC293 (footnote omitted).

Relevance and reliability are the two primary qualities that make accounting information useful for decision making.[21] The balancing of those two qualities is a key element of the Board's objective decision-making process in each and every project it undertakes.

The nature of financial accounting and reporting requires that enterprises utilize numerous methods, estimates, and judgments in the application of accounting standards to their particular economic transactions. Those methods, estimates, and judgments often have a significant impact on the resulting information reported in the enterprise's financial statements.[22]

At upcoming public meetings the Board will continue its systematic, thorough, and objective deliberation of issues, including those relating to the method or methods of accurately valuing the fair value of stock-based compensation. Those deliberations will

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[21] FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (May 1980), paragraph 90.

[22] The SEC has provided cautionary advice about public companies' disclosure of critical accounting policies used in financial statements (Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Releases Nos. 33-8040; 34-45149; FR-60 [December 12, 2001]). The required disclosures identify methods, estimates, and judgments that companies' use in applying those accounting policies that have a significant impact on the results reported (page 2 of 3). As one example, Intel Corporation's ("Intel") critical accounting policies disclosure contained in their Form 10-K for the fiscal year ended December 28, 2002, describes methods, estimates, or judgments used in its accounting for goodwill, nonmarketable equity securities, inventory, long-lived assets, and income taxes (Intel, 2002 Form 10-K, pages 29-31). Some companies have disclosed critical accounting policy estimates in over 12 separate areas (See Jack T. Ciesielski, "Ignorance Is Not Bliss: Critical Accounting Policies in the S&P 100," *The Analyst's Accounting Observer* [April 23, 2003]).

benefit from enterprises' seven years of experience in valuing and reporting the fair value of stock-based compensation in their audited financial statements; the ample existing research and other literature on the issue; and the advice and expertise of leading valuation and compensation experts that the FASB will consult with throughout the entire process.

What are the likely economic impacts of an accounting standard that requires the expensing of all employee stock options at the time they are granted?

As indicated earlier, the mission of the FASB is to set accounting and reporting standards to benefit investors and other users of financial information. Those users rely heavily on credible, transparent, comparable, and unbiased information for effective participation in the capital markets.

The FASB's Rules of Procedure explicitly require that the Board be objective in its decision making to ensure the neutrality of information resulting from its standards.[23] The notion of neutrality is a fundamental element of our standard-setting process. To tolerate financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermines the credibility and value of that information and the proper functioning of the capital markets by impairing investors' capital allocation decisions. The SEC's recently issued Policy Statement

[23] See Attachment 2 for information about the importance of the FASB's neutrality.

reaffirms its support of the FASB and the importance of the Board's independence:

> [T]he FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investment communities.[24]

In the development of Statement 123, the FASB addressed the argument that ". . . a requirement to recognize [stock-based] compensation would have adverse economic consequences. . . ."[25] The Board stated:

> The Board's operating precepts require it to consider issues in an even-handed manner, without intentionally attempting to encourage or to discourage specific economic actions. That does not imply that improved financial reporting should not have economic consequences; a change in accounting standards that makes available more relevant and representationally faithful financial information often will have economic consequences. For example, the availability of the new information resulting from application of this Statement may lead an entity to reassess the costs and benefits of its existing stock option plans.[26]

Similarly, in the development of the IASB proposal, the IASB addressed the argument that the required recognition "of employee share-based payment would have adverse economic consequences. . . ."[27] The IASB noted:

> [T]he role of accounting is to report transactions and events in a neutral manner, not to give 'favourable' treatment to particular transactions to encourage entities to engage in those transactions. To do so would impair the

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[24] Page 5 of 8 (footnote omitted).
[25] Paragraph 83.
[26] Paragraph 84.
[27] Paragraph BC53.

> quality of financial reporting. If expenses are omitted from the income statement, profits are overstated. The financial statements are less transparent. Comparability is impaired, given that expenses arising from employee share-based payment transactions vary from entity to entity, from sector to sector, and from year to year. More fundamentally, accountability is impaired, because the entities are not accounting for transactions they have entered into and the consequences of those transactions.[28]

The Board is aware that some commentators, like the International Employee Stock Options Coalition, believe that requiring the expensing of all stock-based compensation will likely have a negative economic impact because in their view it "will destroy broad-based plans and the productivity, innovation and economic growth they generate."[29]

Others, like the Conference Board Commission on Public Trust and Private Enterprise, have indicated that requiring the expensing of all stock compensation will likely have a positive economic impact, in part, because the existing accounting treatment discourages the use of "grants of actual stock and other forms of stock options more closely related to performance."[30]

Many other constituents have explicitly commented on the economic impact of requiring the expensing of all stock-based compensation. One example is Federal Reserve System Chairman Alan Greenspan. Chairman Greenspan stated:

> There is a legitimate question as to whether markets see through the current nonexpensing of options. If they do, moving to an explicit recognition of option expense in

[28] Paragraph BC55.
[29] Letter from International Employee Stock Options Coalition to the FASB (January 30, 2003), page 4 of 29.
[30] The Conference Board, "Commission on Public Trust and Private Enterprise. Findings and Recommendations, Part I: Executive Compensation" (September 17, 2002), page 6. See Attachments 4 and 7.

> reported earnings will be a nonevent. The format of reports to shareholders will change somewhat, but little more will be involved. Making an estimate of option expense requires no significant additional burden to the company.
>
> If, however, markets do not fully see through the failure to expense real factor inputs, market values are distorted and real capital resources are being diverted from their most efficient employment. This *would* be an issue of national concern.
>
> Clearly then, the greater risk is to leave the current accounting treatment in place. If markets have seen through the accounting, required expensing of option grants will have no effect on the nation's capital allocation. If, however, expensing does affect market values, a continuation of current accounting practice could be costly to capital efficiency.[31]

Another example is the Republican Senate Staff of the Joint Economic Committee. Their Economic Policy Research Report on "Understanding the Stock Option Debate," concluded:

> Commentators differ greatly on the practical impacts of stock option expensing. Opponents believe it would discourage firms from granting options, reduce investor willingness to invest in option granting companies, and confuse investors. Proponents, however, believe that it would improve the quality of reported earnings, improve the investment decisions of investors who rely on reported earnings, and increase public confidence in financial reporting. *In evaluating these competing claims, policy should focus on one goal: informing investors so they allocate their capital as effectively as possible. Accounting policies should not be designed to favor or disfavor particular forms of compensation or types of companies. Although some arguments can be made for both sides, the weight of evidence appears to favor a switch to stock option expensing*.[32]

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[31] 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. See Attachments 4 and 7.

[32] Joint Economic Committee, Republican Senate Staff, Economic Policy Research, "Understanding the Stock Option Debate," Report 107-04 (July 9, 2002), page 18 (emphasis added). See Attachments 4 and 7.

Conclusion

I want to again express my appreciation for inviting Mike and me to participate at this Roundtable. We will carefully consider what we learn from today's discussion.

Let me assure you, Chairman Enzi, Senators Allen and Boxer, and other participants at this Roundtable, that consistent with the FASB's Rules of Procedure, the Board's open and thorough due process and independent and objective decision making will be carefully and fully carried out in connection with our project to improve the accounting and reporting for stock-based compensation. Our capital markets, and the investors who participate in those markets, are demanding and deserve sound, transparent, and unbiased financial information. We at the FASB are committed to continuing to fulfill our mission to respond to that need in a timely and objective manner.

Thank you, Chairman Enzi.