cc: Board, TSL, JTB, DM, Upton, Stock Comp Team (letter)

Financial Accounting Standards Board
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DENNIS R. BERESFORD
Chairman

March 31, 1994

The Honorable John F. Kerry
United States Senate
Russell Senate Office Building
Room 421
Washington, DC 20510-2102

Dear Senator Kerry:

I read your March 10 remarks on the Senate floor with interest. You challenged the FASB to explain and justify our proposed accounting for stock-based compensation in simple English. That is a reasonable challenge (accountants too often speak accounting instead of English) and I welcome the opportunity to respond. I have attached a short article prepared by two members of the FASB staff. The article is a concise, "plain English," discussion of the issues and I recommend it to your attention. I will not repeat the article here, but I would like to respond to several points included in your remarks.

Is the FASB proposal prompted by concerns over excessive CEO compensation?
No, it is not. The project was added to our agenda in 1984, at the express request of major CPA firms, the American Institute of Certified Public Accountants, and the Securities and Exchange Commission. Those groups raised concerns over the inconsistency between accounting for different types of stock-based compensation. They also raised concerns over the inconsistency between accounting for employee stock options and every other free-standing equity instrument. The project was not dormant, as some have suggested. It was moving through our normal, deliberate, and often slow process. I have attached a history of the project to this letter.

Is the FASB proposal the best way to establish the value of employee stock options?
That remains to be seen. The Exposure Draft, *Accounting for Stock-based Compensation*, is a *proposal* for new accounting, and there are more steps in our due process from this stage to publication of any final standard. We do not issue an Exposure Draft until we have reached a considered judgment on every proposed requirement in the draft. Our Exposure Drafts are not "trial balloons." They expose our conclusions for public comment and encourage all interested parties to challenge our conclusions and reasoning. But, until we issue a final standard, all conclusions are tentative.

We have analyzed hundreds of comment letters received in response to the Exposure Draft; we have summarized the results of a field test of the proposal that involved over 25 companies; and we have recently completed six days of public hearings. In April, we are planning a roundtable meeting with investment bankers, academics, and others interested in option valuation to discuss the measurement of employee stock option value. All of these steps take place before the Board's reconsideration of all the issues in the Exposure Draft in working toward a possible final statement. This extensive due process involves constituent input at every step.

Many of the comment letters have raised concerns about the measurement methods proposed in the Exposure Draft, a point raised in your March 10 remarks. The Board is especially interested in those concerns. Accountants have wrestled with the problem of accounting for stock options for over 45 years, and measurement has always been one of the most troublesome issues. The valuation models proposed in the Exposure Draft are used every day to manage billions of dollars of financial transactions. The Board understands the differences between employee stock options and other financial instruments. It may be that the adjustments included in the Exposure Draft do not adequately compensate for those differences. We expect to consider that point in depth, beginning with the April meeting described above.

You suggested that the choice between models and the necessary assumptions "introduces uncertainty into the financial reporting process." While I understand your concern, an amount of uncertainty is always present in financial reporting. Many, if not most, of the numbers in a financial statement involve estimates about uncertain future events. Accounting standards strive to describe a clear objective and to guide accountants in the proper means to meet that objective. However, differences between companies make detailed, cookbook, standards impossible. Indeed, companies usually criticize the Board for providing too much guidance in too much detail.

How will the proposed accounting benefit the investing public?
People who use financial statements reasonably expect certain characteristics in financial reporting. First, they reasonably expect that financial statements will be complete--that all of an entity's transactions will be included, within the bounds of what is material and feasible. Second, they reasonably expect similar transactions will receive similar accounting.

The current accounting fails both of those expectations. Today, a company that provides a pension plan to employees recognizes an expense. A company that provides stock options instead of a pension plan does not recognize an expense. Yet, many agree with your observation that, "Employees forego salary and benefits in return for stock options." Today, a company that gives stock options in exchange for celebrity endorsements recognizes an expense (advertising cost). A company that gives the same options to employees does not recognize an expense. One need not be an accounting purist to see the inconsistency.

Some of the Board's critics assert that financial statement users oppose the proposed accounting. Perhaps the critics draw that conclusion from the very public positions of the Council of Institutional Investors. However, other groups of financial statement users support recognition of an expense for employee stock options. I have attached comment letters from the Association for Investment Management and Research (AIMR, investment analysts and portfolio managers), Robert Morris Associates (commercial bank loan officers), and the Boston Security Analysts.

AIMR stated its position succinctly in its recent publication, *Financial Reporting in the 1990s and Beyond.*[1]

> First, we strongly believe that stock options have value, that they are used to compensate managers, and that they should be recognized and measured as compensation expense in the financial statements, if practicable. We asserted earlier in this report that financial statements should be complete and that disclosure is not an acceptable substitute for recognition and measurement.

Aren't employee stock options already included in earnings per share?
Options issued "at the money," the most common form, have no dilutive effect and do not change earnings per share when granted. The dilutive effect comes later, if the market price of the stock rises. Some have suggested that this is enough accounting recognition and that anything more is double-counting. The Board disagrees, but I will turn again to financial statement users for an analysis:

> We are unable in this document to discuss fully the entire stock compensation issue. However, we can comment on the often-heard argument that the dilutive effect of stock options on earnings per share (EPS) makes redundant the measurement of compensation expense on the income statement. We disagree. EPS is not an accounting number; it is a financial ratio, a tool of financial analysis. The only reason its computation and disclosure is governed by an accounting standard is to produce EPS numbers that are comparable across enterprises and to preclude the egregious abuses that prevailed before the standard was issued. The calculation of EPS requires a numerator (earnings) and a denominator (shares). It is the business of accounting to measure and report earnings, the numerator. And, as we note above, the question of stock compensation is one of income determination. Only after that is settled need we turn our attention to the number of shares (actual or potential) over which those earnings are to be spread.[2]

[1]Association for Investment Management and Research. Charlottesville, Virginia, 1993. Pages 47-48.

[2]Ibid. Page 48.

Doesn't the FASB proposal disproportionately affect small and high-tech companies? It has never been clear to me exactly what the term "disproportionate" means in this context. Under the proposed Exposure Draft, a company that issues 10,000 options will report twice as much expense as a company that issues 5,000, all other things being equal. That seems a natural consequence of measuring and reporting compensation cost, just as a company with 100 employees has more compensation cost than a company with 50. I would observe that the **current** accounting is disproportionate, since both the 10,000 and the 5,000 share grants receive the same accounting measurement, zero.

I also would agree that every dollar of expense is more noticeable in the financial statements of a small company than in those of a larger company. That too is a consequence of reporting accounting information. The only way to avoid that consequence is to bend the rules and color the information to benefit one interest, companies that use stock options in this case, against companies that do not.

Some of the Board's critics seem to favor just this type of skewed accounting. They raise worthy public-policy objectives (in this case, competitiveness and high employment) and suggest pursuing those goals by slanting the accounting rules. They evidently believe that if they can have (or keep) accounting rules that show higher net income, investors will provide them with more capital than they would otherwise attract. Indeed some assert that the growth or even the viability of their companies is critically dependent on the accounting for stock options.

In a recent letter to Senator David L. Boren, SEC Chairman Arthur Levitt addressed concerns about the independence and neutrality of the FASB and the accounting standard-setting process. He stated:

> The existing process for setting accounting standards, with its emphasis on providing neutral, unbiased information to investors and policy makers, has been successful and should continue....
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> ....[T]he true role of accounting standards-setting bodies should not be to judge whether an economic goal or political or social policy is good or bad, but to create the means for communicating reliable and complete information to investors and to the public in general. This information should permit knowledgeable investment decisions, assist in public debates, and allow public policy makers to formulate well-informed and real solutions to problems....

Financial statements are a basic tool used for communicating information about economic events to capital markets. An efficient economy requires good financial information because investors, creditors, regulators, and others base decisions on information contained in financial statements. To make the best economic decisions, they must have financial statements that neither omit information nor color the message to influence behavior in a particular direction. The U.S. capital market system is well-developed and efficient because of users' confidence that the financial information they receive is reliable.

I appreciate your continued interest in this issue and the standard-setting process, especially the courtesy extended by Jonathan Winer of your staff. Members of the Board and staff are regularly in Washington, and we would be pleased to meet with you or your staff. Please feel free to contact me, Diana Willis, or Wayne Upton if you need more information or would like to discuss our proposal further.

Very truly yours,

Dennis R. Beresford

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