

Financial Accounting Standards Board

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ROBERT H. HERZ
Chairman

VIA EMAIL

June 22, 2004

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515-6115

Dear Representative Dingell:

Thank you for your letter of June 18, 2004, that raises a number of questions concerning H.R. 3574, the "Stock Option Accounting Reform Act" ("HR 3574").

The Financial Accounting Standards Board ("FASB" or "Board") is an independent private-sector organization. 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 United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, comparable, and unbiased information to make decisions.

HR 3574 appears to address issues relating to the Board's current project to improve the accounting for equity-based compensation. In connection with that project, in March of this year, the Board issued for public comment an Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* ("Proposal"). Following the end of the Proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the Proposal. Only after carefully evaluating the input at public meetings and potential improvements to the Proposal will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year. The attachment to this letter includes a brief summary of the project.

Consistent with the FASB's mission, our technical expertise is limited to financial accounting and reporting matters. We, therefore, do not have expertise relating to the US federal securities laws or statutory or legislative interpretation generally. Thus, the responses to your questions that follow are subject to that limitation.

1. What is the practical effect of this bill on accounting for stock options by (i) the top five executives at SEC-registered companies, (ii) other option recipients at SEC-registered companies, and (iii) option recipients at private companies?

As explained below, the practical effect of HR 3574 on the accounting for stock options would appear to be that SEC-registered companies would be required to significantly understate the total amount of compensation cost relating to stock options in their financial reports. HR 3574, therefore, would appear to result in a distortion of those companies' reported earnings, profitability, and other key financial metrics.

HR 3574 would appear to prohibit the Securities and Exchange Commission ("SEC") from recognizing any final standard (or any existing standard relating to the expensing of stock options) unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.¹

HR 3574 also would appear to require that only stock options granted after December 31, 2004, to the chief executive officer and the four other most highly compensated employees of certain SEC-registered companies be reported as a compensation expense in those companies' financial reports.² Thus, if an SEC-registered company grants stock options to employees other than the top five executives, that compensation cost would not be reported in the company's income statement. There, however, is no accounting or economic theory that would support such a result. As the Congressional Budget Office recently concluded in its analysis of the accounting for stock options, "If 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."³

HR 3574 also would appear to require that for purposes of determining the fair value of the stock options granted to the top five executives the assumed volatility of the underlying stock shall be zero.⁴ It is generally accepted that a large part of a stock option's fair value is the result of volatility of the underlying stock price.⁵ Thus, if an SEC-registered company grants stock options to the top five executives, the amount of

¹ HR 3574, the "Stock Option Accounting Reform Act," 108th Congress, 2d Session (as reported by the Committee on Financial Services), Section 3(a)(3).

² HR 3574, Section 2(m).

³ Congressional Budget Office, "Accounting for Employee Stock Options," (April 2004), Section 2 of 3, page 1 of 2.

⁴ HR 3574, Section 2(m)(3)(B).

⁵ Testimony of Robert C. Merton, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, "Hearing on H.R. 3574, the Stock Option Accounting Reform Act" (March 3, 2004), page 2 of 2. In general, the higher the volatility of the underlying stock, the higher the option's value will be—because of the greater chance that the market price of the stock will rise above the strike price of the option before the term of the option expires.

that compensation cost reported in the company's income statement would be significantly understated.

A recent *Washington Post* editorial commented on the "top five executives" provisions of HR 3574, stating:

The second problem with the bill is its illogical content. In the past, opponents of expensing options have claimed that the value of options is unknowable. But the House bill abandons that claim by requiring that companies include in their profit-and-loss statements the value of options for their top five executives. Having conceded that, however, the bill goes on to say that the cost of options granted to employees outside the top circle should be left out, implying that they cost nothing. But they do not cost nothing. In high-tech companies, which grant options generously to middle-ranking employees, the top five executives get only a small fraction of the total – less than 5 percent in the case of Intel Corp. or Cisco Systems Inc.

Moreover, the House bill stipulates that companies should use an unorthodox method for valuing options that minimizes their worth. If the bill became law, the options granted by Intel last year would force it to deduct a modest \$3.5 million from its reported profit – compared with the hefty \$991 million it would have to deduct under the proposed FASB reform. Cisco, for its part, could report \$1.1 billion more in profit if the House bill passed. Small wonder that Intel and Cisco have led the lobbying charge in favor of the legislation.⁶

HR 3574 also would appear to exempt certain SEC-registered companies that are "small business issuers" from having to report any compensation expense for stock options granted.⁷ Similarly, HR 3574 would appear to exempt certain SEC-registered companies from having to report any compensation expense for stock options granted to employees for three years after an "initial public offering."⁸ In both cases, to the extent that a qualifying SEC-registered company grants stock options to its employees, the amount of compensation cost would be understated in the company's income statement.

Finally, HR 3574 would not appear to address the accounting for stock options by private companies. Thus, those companies would continue to account for stock options under

⁶ "High-Tech Holdup," *The Washington Post* (June 10, 2004), page A18.

⁷ HR 3574, Section 2(m)(4)(A).

⁸ HR 3574, Section 2(m)(4)(B).

existing accounting standards. Those standards (and the standards for SEC-registered companies) are proposed to be changed as a result of the FASB's current project to improve the accounting for equity-based compensation.

2. Ford Motor Company, General Motors, Citigroup, Microsoft Corporation, and more than 500 other companies, large and small, have voluntarily begun expensing stock options under the fair value method, and I commend them for doing so. Is it true, as I have been advised by counsel, that this bill, especially when read against Rule 4-01(a)(1) of Regulation S-X, would make it illegal for companies to continue to voluntarily expense stock options?

As explained below, HR 3574 would appear to prohibit SEC-registered companies from continuing to voluntarily expense stock options.

Rule 4-01(a)(1) of Regulation S-X states:

Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.

As indicated above in response to Question 1, HR 3574 would appear to prohibit the SEC from recognizing any accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.

Existing accounting standards prescribe as the preferable method of accounting for employee stock options a grant date fair value measurement approach.⁹ Those more than 575 companies that have begun voluntarily expensing all employee stock options are required to follow the preferable method.¹⁰ That method does not encompass an exercise or other settlement date measurement approach as would appear to be required by HR 3574. Thus, the existing voluntary expensing of all employee stock options would appear to be prohibited.

⁹ Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 11.

¹⁰ *Id.*; Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Accounting Issues: 576 Companies Have Voluntarily Adopted Option Expensing Under the Fair Value Method," Bear Stearns (April 29, 2004).

3. The bill provides that “the assumed volatility of the underlying stock shall be zero” under whatever pricing model is used. Is it true that this would allow companies to ignore reality and show near zero value for their option plans? Absent this provision, what economic considerations would determine the assumed volatility of the underlying stock?

As explained below, the zero volatility assumption contained in HR 3574 would appear to require that SEC-registered companies significantly understate the stock option compensation costs for their top five executives. In some cases, the amount of the understatement would be 100 percent because the compensation cost would be zero. The Proposal provides guidance for determining the expected volatility of the underlying stock when determining the fair value of employee stock options.

As indicated above, in response to Question 1, HR 3574 would appear to require that for purposes of determining the fair value of the stock options granted to the top five executives the assumed volatility of the underlying stock shall be zero (often referred to as the “minimum value approach”). It is generally accepted that a large part of a stock option’s fair value is the result of volatility of the underlying stock price. Thus, if an SEC-registered company grants stock options to the top five executives, the amount of that compensation cost reported in the company’s income statement under the minimum value approach would be significantly understated.

The minimum value approach of HR 3574 would also appear to permit companies to structure their employee stock option grants to ensure stock option compensation costs of zero. As demonstrated by University of California-Berkeley, Haas School of Business, Professor Mark Rubinstein in the *Journal of Derivatives*, the minimum value approach can be easily manipulated to drive the reported value to zero or near zero.¹¹ This can be done by raising the exercise price and multiplying the number of options in order to maintain the real value of the grant while lowering its reported minimum value.¹²

The Proposal provides implementation guidance that illustrates the fair-value-based method of accounting for stock-based compensation arrangements with employees and elaborates on certain other aspects of the Proposal.¹³ That guidance includes the following economic considerations and other factors to consider in estimating the expected volatility of the underlying stock for purposes of determining the fair value of an employee stock option:

- a. The term structure of the volatility of the share price over the most recent period that is generally commensurate with (1) the contractual term of the option if a lattice

¹¹ Mark Rubinstein, “On the Accounting Valuation of Employee Stock Options,” *Journal of Derivatives*, fall 1995, page 21.

¹² *Id.*

¹³ Proposal, paragraph B1.

- model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used.
- b. The implied volatility of the share price determined from the market prices of traded options. Additionally, the term structure of the implied volatility of the share price over the most recent period that is generally commensurate with (1) the contractual term of the option if a lattice model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used.
 - c. For public companies, the length of time an entity's shares have been publicly traded. If that period is shorter than the expected term of the option, the term structure of volatility for the longest period for which trading activity is available should be more relevant. A newly public entity also might consider the volatility of similar entities. A nonpublic entity that elects the fair-value-based method might base its expected volatility on the volatilities of entities that are similar except for having publicly traded securities.
 - d. The mean-reverting tendency of volatilities. For example, in computing historical volatility, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid or a major restructuring. Statistical models have been developed that take into account the mean-reverting tendency of volatilities.
 - e. Appropriate and regular intervals for price observations. If an entity considers historical volatility or implied volatility in estimating expected volatility, it should use the intervals that are appropriate based on the facts and circumstances and provide the basis for a reasonable fair value estimate. For example, a publicly traded entity might use daily price observations, while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.
 - f. Corporate structure. An entity's corporate structure may affect expected volatility. For instance, an entity with two distinctly different lines of business of approximately equal size may dispose of the one that was significantly less volatile and generated more cash than the other. In

that situation, an entity would consider the effect of that disposition in its estimate of expected volatility.¹⁴

The Proposal's Notice for Recipients includes six issues seeking additional input on the measurement issues raised by the Proposal, including whether "the Board should require a specific method of estimating expected volatility."¹⁵ The input received on those issues and all other issues will be carefully considered by the Board, consistent with the FASB's Rules of Procedure, at public meetings prior to the issuance of any final standard.

4. How do international accounting standards deal with accounting for stock options?

As explained below, international accounting standards deal with the accounting for stock options in a manner that is substantially similar to the approach contained in the Proposal.

In February 2004, the International Accounting Standards Board issued International Financial Reporting Standard 2, *Share-based Payment* ("IFRS 2"). IFRS 2, effective in 2005, requires the expensing of all employee stock options based on a grant date fair value measurement approach that is similar in most respects to the approach contained in the Proposal.¹⁶ It is expected that companies in over 90 countries around the world will begin applying IFRS 2 beginning January of next year.

Similarly, in September 2003, the Canadian Accounting Standards Board issued *Stock-Based Compensation and Other Stock-Based Payments*, Section 3870 ("Section 3870"). Section 3870, effective in 2004, also requires the expensing of all equity-based compensation based on a grant date fair value measurement approach that is similar in most respects to the Proposal and IFRS 2.¹⁷

Of note, over 350 of the Canadian enterprises that implemented Section 3870, and hundreds of other foreign companies that will be soon implementing IFRS 2, are registrants under the US federal securities laws and, therefore, subject to the rules and regulations of the SEC.

¹⁴ Proposal, paragraph B25 (footnote references omitted).

¹⁵ *Id.*, pages *ii* and *iii*.

¹⁶ *Id.*, paragraph C48.

¹⁷ Letter from Paul Cherry, FCA, Chair, Accounting Standards Board to The Honourable Michael G. Oxley, United States House of Representatives (May 7, 2004), page 1.

5. The Energy and Commerce conferees were appointed by the Speaker to the House-Senate conference committee for consideration of Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 (SOX) which dealt with, among other things, the standards for Securities and Exchange Commission (SEC) recognition of “accounting standards established by a standard setting body” and the annual accounting support fee for that standard setting body, in order to strengthen the independence of FASB and the integrity of its standard setting process. I understand that these provisions have been implemented. What effect would this bill have on these sections of SOX and the rules implemented thereunder?

As explained below, HR 3574 would appear to have results that are inconsistent with the language and intent of Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 (“SOX”) and the related SEC actions implementing those provisions.

The legislative history of SOX is clear that Sections 108 and 109 were intended to enhance the independence of the FASB to assist it in achieving its mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises.¹⁸ In implementing Sections 108 and 109 of SOX, the SEC, in April 2003, issued a Policy Statement.¹⁹ The Policy Statement, consistent with the language and intent of SOX, reemphasizes the importance of the FASB’s independence:

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 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.²⁰

Section 108 of SOX also indicates that Congress intended that the Board act more promptly in making changes to accounting principles.²¹ The Policy Statement, consistent with that view, stated that the Commission expects the FASB to “improve the timeliness with which it completes its projects.”²²

¹⁸ Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

¹⁹ “Policy Statement: Reaffirming the Status of the FASB as Designated Private-Sector Standard Setter,” Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

²⁰ Policy Statement, page 5 of 8.

²¹ Sarbanes-Oxley Act of 2002, Section 108(b)(1)(A)(iv).

²² Policy Statement, page 4 of 8.

Finally, Section 108 of SOX indicates that Congress supported the FASB's ongoing efforts to promote "international convergence on high quality accounting standards."²³ The Policy Statement contains nearly identical language.²⁴

As indicated above in response to Question 1, HR 3574 would appear to prohibit the SEC from recognizing any FASB standard unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted. The former condition suggests that the quality of financial accounting and reporting for stock options should be subjugated to the protection of certain specified public policy goals. The latter condition prescribes a measurement approach that is generally inconsistent with the measurement approach contained in (1) existing US accounting standards, (2) IFRS 2 and Section 3870, and (3) the Proposal. Mandating either condition through legislation appears inconsistent with the language and intent of SOX and the Policy Statement.

Many preparers, auditors, and users of financial reports (including Members of the Congress and federal regulators) agree that HR 3574 is inconsistent with the language and intent of SOX and the Policy Statement because it would appear to weaken the independence of the FASB, harm the integrity of the standard-setting process, and have an adverse impact on achieving international convergence of high-quality accounting standards.²⁵ In recent testimony before Congress, The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, stated:

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

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

"Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet

²³ Sarbanes-Oxley Act of 2002, Section 108(b)(1)(A)(v).

²⁴ Policy Statement, page 4 of 8.

²⁵ Testimony of Robert H. Herz, Chairman, and George J. Batavick, Board Member, Financial Accounting Standards Board, before the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services, hearing on "The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs" (May 4, 2004), Attachment 5.

the need, in a world of globalized finance, for a common set of international accounting standards?”²⁶

6. What practical effect would this bill have on the issue of the setting of accounting standards by FASB with respect to accounting for stock options? In answering this question, do you believe that Section 5 of the bill has any practical effect?

As explained below, the practical effect of HR 3574 would appear to be to delay the implementation of, and thereafter severely constrain the content of, any FASB accounting standard relating to expensing stock options. Section 5 of HR 3574 does not appear to obviate that result.

Section 5 of HR 3574 states that “[n]othing in this Act shall be construed to limit the authority over the setting of accounting principles by any accounting standard setting body whose principles are recognized by the Securities and Exchange Commission.” As indicated above in response to Question 5, the Policy Statement issued to implement Section 108 of SOX reaffirmed that the SEC would continue to recognize as “generally accepted” the accounting standards established by the FASB.²⁷

Notwithstanding the provisions of Section 5 of HR 3574 and the Policy Statement, as indicated above in response to Question 1, Section 3 of HR 3574 would appear to prohibit the SEC from recognizing any FASB accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted. The latter condition prescribes a measurement approach that is generally inconsistent with the measurement approach contained in (1) existing US accounting standards, (2) IFRS 2 and Section 3870, and (3) the Proposal.

Commenting on the practical effect of HR 3574, Robert Denham, Chairman and President of the Financial Accounting Foundation, the nonprofit corporation that appoints members of the FASB and oversees its process, stated:

H.R. 3574 preempts and overrides the FASB’s ongoing effort to improve accounting for equity-based compensation through public due process. . . . Once Congress starts setting accounting standards through its

²⁶ Testimony of The Honorable Paul A. Volcker, before the Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs, United States Senate, “Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board” (April 20, 2004), page 2 of 2.

²⁷ Policy Statement, page 5 of 8.

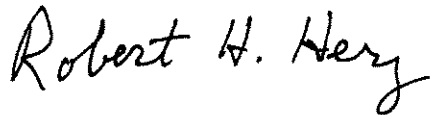
political process, the integrity of accounting standard setting in this country will be dangerously compromised.

If enacted, H.R. 3574 would also severely impede the important ongoing efforts by the FAF and FASB to achieve international convergence of high-quality accounting standards. . . . Because the International Accounting Standards Board has recently issued a final standard requiring the recognition of compensation cost for the fair value of employee stock options, Congressional action would result in a major difference between US and international standards, thus undermining the movement toward international convergence previously encouraged by Congress in the Sarbanes-Oxley Act, by the Securities and Exchange Commission, and by many investors and other market participants.²⁸

* * * *

Thank you again for your letter and your long-time and continuing support of the independence of the FASB. If you have any further questions or comments, please feel free to contact me directly or our Washington, DC representative, Jeff Mahoney (703-243-9085).

Yours Truly,



Attachment

²⁸ Financial Accounting Foundation News Release, "Financial Accounting Foundation Chairman Responds to House Subcommittee's Action on 'The Stock Option Accounting Reform Act'" (May 17, 2004).

A BRIEF SUMMARY OF THE FINANCIAL ACCOUNTING STANDARDS BOARD'S PROJECT TO IMPROVE THE ACCOUNTING FOR EQUITY-BASED COMPENSATION

Under existing United States (“US”) generally accepted accounting principles (“GAAP”), only stock options granted to employees that meet certain specified criteria (so-called fixed plan employee stock options) are not required to be reported as a compensation expense in the income statements of those companies 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, and employee stock ownership plans, are, and have long been, required to be reported as an expense. Similarly, when stock-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 model in the US.

In March 2003, at a public meeting, the Board decided by unanimous vote to add a project to its agenda to address issues relating to improving the accounting for equity-based compensation. The project was in response to the high level of public concern expressed by many individual and institutional investors, financial analysts, the major accounting firms, study groups such as the Conference Board Commission on Public Trust and Private Enterprise, and many other parties, including a number of Members of Congress, about the need to improve the accounting for equity-based compensation. More specifically, many expressed support for eliminating the fixed plan employee stock option anomaly.

Many believe that the anomaly results in significant distortions in reporting of earnings, operating results, and operating cash flows of an enterprise—distortions that cannot be remedied solely by improvements in footnote disclosures. Others believe that the anomaly and related reporting distortions were a contributing factor to the stock market bubble, the severity of the subsequent crash, and some of the recent high-profile corporate reporting scandals and subsequent bankruptcies.

Others believe that the anomaly encourages enterprises to issue an excessive amount of fixed plan employee stock options resulting in an opaque transfer of economic value from shareholders to employees. Some studies have shown that in order to maintain their stock price in the face of such dilution, companies expend large amounts of cash on stock buybacks that have absorbed much of their free cash flow. The result is that there is less

cash available for other purposes, such as research and development, employee training, or other corporate activities, which may be more beneficial to the long-term value of the company and its shareholders.

Others, including prominent compensation experts, believe that the anomaly discourages companies from utilizing other forms of equity-based compensation that may be more beneficial to the long-term value of the company and its shareholders and that may have better incentive properties in terms of attracting, motivating, and retaining employees, than fixed plan employee stock options. Examples often cited include performance-based options and restricted stock.

The ultimate goal of the current FASB project on improving the accounting for equity-based compensation is to develop and put in place a standard that results in reporting that more faithfully reflects the underlying economic effects of equity-based compensation arrangements and that brings about greater comparability of reporting in this important area. The project also provides an opportunity to achieve greater international convergence of accounting standards, an objective the FASB has been encouraged to pursue by the Sarbanes-Oxley Act of 2002 (“Act”), the US Securities and Exchange Commission (“SEC”), and many other parties.

On March 31 of this year, the Board issued, by unanimous vote, an Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (“Proposal”). The Proposal is the result of an extensive public due process that began in November 2002 before the project was added to the Board’s agenda. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, the review of relevant research studies, consultation with our advisory councils and valuation and compensation experts, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of the financial reports of small businesses, and active deliberations at 38 public Board meetings at which the provisions of the Proposal were carefully developed with consideration given to all interested parties.

Based on our extensive public due process to date, the Board believes that the Proposal would improve the financial reporting for equity-based compensation arrangements. We believe that by creating greater transparency, completeness, and a more level playing field in the accounting for different forms of equity-based compensation, the Proposal would enhance the comparability of reported results between enterprises that choose to compensate their employees in different ways. The Proposal would achieve that through a number of provisions, including by eliminating the existing anomaly for fixed plan employee stock options, which, as indicated above, are the only form of equity-based compensation that is not currently required to be reported as an expense in the financial statements. The Proposal also includes provisions that we believe would improve the transparency of the effects of equity-based compensation on reported cash flows.

The Proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such and that the existing anomaly for fixed plan employee stock options results in reporting that not only ignores the economic substance of those

transactions but also distorts reported earnings, profitability, and other key financial metrics. Thus, under current US GAAP, the greater the use of fixed plan employee stock options, the greater the distortion of reported results. In contrast, this distortion does not occur when enterprises use stock options, or similar instruments such as stock purchase warrants, for purposes other than compensating employees, for example, in acquiring goods or services or in financing or merger and acquisition transactions. In those cases, current US GAAP does require that stock options or warrants be valued and accounted for in the financial statements.

The Proposal would bring about greater comparability between the over 575 companies that have voluntarily opted to account for the cost of employee stock options and many others that have elected not to do so. It also would be responsive to the growing number of companies, including major technology companies, whose shareholders by a majority vote have approved nonbinding proxy resolutions mandating expensing of all employee stock options. Management of a number of those companies has indicated that it is awaiting completion of our project in order to respond to the demands of its shareholders.

The Proposal also would result in substantial convergence in the accounting for equity-based compensation between our standards and international accounting standards that will, beginning next year, be followed by companies in over 90 countries around the world. In addition, Canada, who often has followed the lead of the US in improving accounting standards, felt that it could not wait on this topic, and decided to mandate expensing of employee stock options beginning in January of this year. It is our understanding that implementation of their new standard has to date gone very smoothly.

Finally, and most importantly, improvements in accounting for equity-based compensation can have economic consequences. More credible, comparable, and transparent financial information about equity-based compensation transactions can enhance the efficiency of capital allocation in our markets. Efficient allocation of capital is critical to our nation's economy.

The Board continues to actively seek input about the Proposal from interested parties. For example, the Board discussed the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee on May 11. The Board also plans to hold public roundtable meetings with valuation and compensation experts, and users, auditors, and preparers of financial reports in the coming days to discuss a broad range of issues about the Proposal.

Following the end of the Proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the Proposal. Those redeliberations will include careful consideration of the ongoing input received from all interested parties.

Only after carefully evaluating the input and potential improvements to the Proposal at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.