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October 31, 2002

Letter of Comment No: 33  
File Reference: 1101-001  
Date Received: 11/4/02

Ms. Suzanne Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P. O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference No. 1101-001 – Exposure Draft – Accounting for Stock-Based Compensation—Transition and Disclosure, an Amendment of FASB Statement No. 123.**

Dear Ms. Bielstein:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)<sup>1</sup> is pleased to comment on the Financial Accounting Standards Board's (FASB) Exposure Draft, *Accounting for Stock-Based Compensation—Transition and Disclosure, an Amendment of FASB Statement No. 123*. The FAPC is a standing committee of AIMR charged both with maintaining liaison with standard setters who develop financial accounting standards and regulate financial statement disclosures and with responding to new regulatory initiatives. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

### General Comments

Although this Exposure Draft (ED) does not address the issue, the FAPC believes that the *only* appropriate method of accounting for stock-based compensation is the recognition of the fair value of such compensation as an expense in the income statement. The ED indicates that the FASB intends to reconsider the provisions of FASB Statement No. 123 once the IASB has issued its proposals on stock-based compensation. We strongly urge the Board to do so. When all

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companies are required to expense the fair value of compensation awarded, regardless of the form, their reported earnings will better reflect the economic reality of operations, and investors will have a more consistent and comparable basis for making informed investment decisions. The needs of investors for timely, relevant, and transparent information should supersede other considerations.

The FAPC believes that the FASB should permit only a single transition method, retroactive restatement, for those companies choosing to adopt the preferred accounting method, fair value recognition. The arguments provided in the ED for permitting preparers to choose from among three transition methods are not persuasive to the FAPC.

The FAPC strongly supports the proposal to require interim financial statement reporting of share-based compensation. For many companies, stock-based compensation is a highly material cost and investors need to receive timely information about its effect on the company's operating performance.

Finally, the FAPC supports requiring those companies which continue to report some or all unvested stock-based compensation under the intrinsic value method to present disclosure of both the amount of the related compensation expense recognized in income, if any, and the fair value of all such compensation expense. However, we believe that these amounts should be reported *before tax*, with additional disclosure of the related tax effects. Our preference is for disclosure of these amounts on the face of the income statement. We found the argument provided in the ED for not prescribing disclosure on the face of the financial statements to be unpersuasive.

## Specific Comments

### *Amendments to Transition Provisions*

The FAPC believes that the FASB should permit only a single transition method, retroactive restatement, for those companies choosing to adopt the preferred accounting method, fair value recognition. Paragraphs A3, A4, A9, and A11 of the Exposure Draft make the following points:

*Prior to the issuance of Statement 123, companies had not been gathering the necessary information or making the necessary assumptions to measure the fair value of employee stock options.*

*...[T]he Board acknowledged that the "ramp-up" effect created by the prospective transition method was undesirable...*

*...[T]he Board decided to require prospective application because retroactive application would have required preparers of financial statements to make numerous assumptions relevant to the valuation of previously issued stock-based awards.*

*In 2002, however, seven years after the issuance of Statement 123, **historical information necessary for retroactive application of the recognition provisions of Statement 123 is available.***

*A number of companies [who] have recently elected to adopt the fair value recognition provisions of Statement 123...as well as financial statement users...[have] expressed concern to the Board about the **lack of comparability and consistency of reported results between periods caused by the requirement to adopt the fair value method prospectively.***

*Board **members agreed that retroactive application maximizes consistency between periods and comparability among companies.***

*The Board further acknowledges that the existence of **multiple transition methods will impair comparability of reported results.** [Emphasis added]*

In summary, (1) the Board acknowledged at the time that Statement 123 was drafted that the ramp-up effect was undesirable; (2) the method was chosen for pragmatic reasons alone: the historical information needed to prepare fair values for the stock option awards was not available; (3) currently both preparers and users have expressed concerns that the ramp-up method results in a lack of comparability and consistency, and the Board agrees that retroactive application maximizes consistency and comparability; (4) now seven years of the necessary historical data are available; and (5) the Board agrees that the promulgation of multiple methods will impair comparability of reported results.

Given that the Board believes it necessary to move at this time from the single method, the admittedly flawed ramp-up transition requirements of Statement 123, and that the reason for the adoption of that method in the first place no longer exists, we are challenged to understand why the Board would choose not only to retain that method, but to permit preparers to choose from among three transition methods, including the method that the Board acknowledges to be superior, retroactive restatement.

The FAPC has applauded the decisions of those companies that have elected voluntarily to follow the preferred fair value expense alternative in Statement 123. It is not clear to us that the interests of those companies would be impaired, nor would they be inconvenienced, nor would they incur significant additional costs to move to the retroactive restatement method. Indeed, they would then be fully compliant with the method that is agreed to be preferable. Moreover, the Board acknowledges that some of these preparers have “expressed concern” about the effects of using the prospective method.

Now that all companies with stock option awards have had to present fair value expense information in disclosures for seven years, it is also not clear to the FAPC that companies currently using the intrinsic value method would be deterred from voluntary adoption of the fair value method merely because they would be required to use the retroactive restatement transition method rather than one of the two prospective methods.

The FAPC does not agree with the suggestion in Paragraph A9 that retroactive restatement in order to achieve higher quality financial reporting, greater consistency across time periods, and enhanced comparability across companies causes credibility problems. Reporting standards that provide better information or clarify conflicting reporting typically may require restatement—SAB 101 on Revenue Recognition comes to mind as well as EITF conclusions on reporting revenues and expenses gross as opposed to net. Indeed, improved financial reporting should lead to greater credibility, not less.

If more than one stock option recognition method is to continue to be permitted, at least for the near term, the FAPC believes that the clear distinction should be between companies that continue to use the intrinsic value method and those that use the preferable fair value method with retroactive restatement. We could speculate that among the reasons many companies have chosen recently to adopt the fair value method is that in the current environment of concern about financial reporting, use of this method has come to be regarded as a “litmus test” of quality financial reporting. Narrowing the choices to the two methods, (1) full and complete fair value method expense recognition for all years presented, and (2) no expense recognition under the intrinsic value method, may well throw the companies’ choices and their implications under a strong spotlight, and may even encourage companies to adopt the fair value method voluntarily.

### ***Amendments to Disclosure Provisions***

The FAPC concurs with the Board’s observation in Paragraph A17 that “[D]isclosure is not an adequate substitute for recognition of items that qualify for recognition in financial statements...” Additionally, the FAPC believes that the financial statements would be more relevant and representationally faithful if the estimated fair value of stock options were included in net income. We believe that this uniquely differentiates the pro forma effects of the option adjustments from other “as if” adjustments. Therefore, we believe that at a minimum, this disclosure should be provided on the face of the income statement.

Despite our strong preference for a single method, fair value recognition in the income statement, the FAPC supports the proposal to require those companies using the intrinsic value method to present disclosure of both the amount of such compensation recognized in income, if any, and the fair value of all such compensation. However, we believe that these amounts should be reported *before tax*, with additional disclosure of the related tax effects. We prefer that these amounts be presented on the face of the income statement, with the full disclosure of these amounts plus net income and earnings per share amounts provided in the tabular presentation, as

proposed. Investors should not have to search through the notes to financial statements to find operating expenses.

Consistent with our view that the only acceptable accounting method for stock options is fair value expense recognition in the income statement and retroactive restatement, investors should be provided with the information needed to fully adjust the statements of those companies that continue to use the intrinsic value method so that they will be comparable to those of companies that have adopted the preferred method. For many companies, stock option compensation is a highly material expense with a major effect on operating performance. Thus, in order to make the statements fully comparable, analysts and other investors must be able to adjust all of the components of income, not merely the bottom line net income. The tax effects related to the stock option expense should also be reported.

Companies possess this information and would not incur significant costs to provide it to investors. Consequently, this additional disclosure will not prove burdensome to them but will greatly enhance the usefulness of the disclosures to investors.

### ***Interim Disclosures***

The FAPC strongly supports the proposal to require interim financial statement reporting of share-based compensation. For many companies, stock-based compensation is a highly material cost and we agree with the Board's conclusion that investors need to receive timely information about the effect of such compensation on the companies' operating performance.

### ***Concluding Remarks***

The Financial Accounting Policy Committee appreciates the opportunity to express its views on the Board's proposed statement: *Accounting for Stock-Based Compensation—Transition and Disclosure*. If the Board or staff have questions or seek amplification of our views, please contact Rebecca McEnally at 1-434-951-5319 or at [rebecca.mcenally@aimr.org](mailto:rebecca.mcenally@aimr.org). We would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

/s/ Jane Adams

/s/ Rebecca Todd McEnally

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Jane Adams  
Chair, Financial Accounting Policy Committee

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Rebecca McEnally, Ph.D., CFA  
Vice-President, Advocacy, AIMR

**DRAFT:** AIMR FAPC Letter to Ms. Suzanne Bielstein  
Re: Accounting for Stock-Based Compensation—Transition and Disclosure  
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cc: AIMR Advocacy Distribution List  
Patricia Doran Walters, Senior Vice-President  
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