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Financial Accounting Standards Board
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Re: Exposure Draft, Share-Based Payment: An Amendment to SFAS Nos. 123 and 95 (File Reference No. 1102-100)

In this letter, I provide input on the above-referenced exposure draft. I understand that this submission will be part of the Board's consideration of this proposed standard and will serve as background for my participation in a constituent round-table. As a member of a committee of the American Accounting Association, I have provided input to the Board on prior standards (e.g., SFAS No. 123; SFAS No. 140). The positions presented in this submission are my own.

Support for the ED

I support the provisions of this exposure draft (ED). The cost of stock-based compensation should be recognized as an expense in company financial statements. Not expensing stock options has led to a lack of transparency in the stock market as executives try to (or are perceived to) hide total compensation cost from the public. Furthermore, options are an expense just as cash compensation is an expense. Goods and services received in exchange for stock options result in a cost and should be recognized as such in the financial statements. Because a valuable financial instrument (or another asset, the value of which is based on a financial instrument) is being exchanged for employee services, fair value, as proposed in the ED is the most relevant measure of the compensation cost to be recorded. Although some uncertainty in measurement will always be present, sufficiently reliable estimates can be determined. Academic research supports this position. Finally, attributing the cost to the period of service by employees, and taking into consideration expected vesting of awards, will result in a more accurate measure of the cost of services exchanged in equity-based arrangements. This provision, combined with use of a consistent measurement and recognition framework for both equity- and liability-type awards will result in reported information that is (1) representationally faithful to the economic substance of stock-based compensation

arrangements and, (2) will increase the comparability of information reported about stock-based and cash compensation plans.

Now is the Time

Ten years ago, I joined other academics in support of the FASB in issuing a standard to require expensing of stock-based compensation, based on a fair value model. Others opposed expensing, and following extensive lobbying and political pressure, some of which threatened its very existence as a standard-setter, the FASB issued a standard that permitted choice as to the recognition of stock-based compensation expense. For the same reasons I support the current ED, I felt that the expensing provisions of SFAS 123 would improve financial reporting by recognizing the cost of the compensation, based on fair value. While I continue to believe that the fair-value-measurement and expense recognition framework in SFAS 123 is appropriate, the proposed standard embraces and improves on the SFAS 123 model in a number of ways. For example:

- Like SFAS 123, the ED requires that expense will be measured based on the grant date fair value of the equity instruments. And while the estimates should be computed using an option-pricing model, the ED does not require use of a particular model. Importantly, the ED indicates a preference for so-called lattice models, which can better accommodate features of employee stock options that affect expected vesting. Such methods were not well understood when SFAS 123 was deliberated; use of such methods will result in more relevant and reliable measures of fair value, and thereby more accurately measure the costs associated with equity-based compensation plans.
- The ED contains comprehensive and improved attribution provisions for recognizing compensation expense over the life of the plan. The attribution methods are general, in that they can be consistently applied to measure the fair values for both equity- and liability-type plans. The provisions also adjust the compensation expense for changes in expected vesting. Such provisions will increase the comparability of information reported for various compensation plans and will greatly streamline the accounting guidance in this area. For some companies, these provisions will result in less compensation expense recognized compared to SFAS 123.
- The ED makes appropriate allowances for cost/benefit considerations for both public and non-public companies. It permits use of alternative fair value methodologies, depending on the terms of the compensation plan. And allowances are made for non-public companies with respect to transition provisions and in the use of intrinsic value measurement, when it is impractical to estimate fair value.

- The ED addresses the inconsistent treatment of cash flows arising from excess tax benefits of stock option exercises in the statement of cash flows. Currently these benefits are recorded as cash flow from operations. Under the ED, the tax benefits will instead be reported as a cash inflow from financing activities. While this provision will likely have a significant impact on many companies' reported cash flow from operations, it better represents the nature of the cash inflows – arising from the financing activity of issuing shares to employees. This will increase the comparability of information reported in cash flow statements.

Other Considerations

Beyond the conceptual merits of the proposed accounting in the ED, which reflect improvements on the provisions in the prior standard, changes in the economic and financial reporting environments in the past 10 years also reinforce the need for an enhanced standard:

- Recent business and accounting failures -- During the late 1990s, we witnessed numerous business, auditing, and accounting failures, which raised new concerns about, and demand for, high quality and transparent accounting practices. To many, the accounting for stock-based compensation is an example of less than transparent accounting, by omitting from financial statements an important cost of business. Indeed, beginning in 2002, a number of companies began to voluntarily switch to the fair value method for recording compensation expense related to stock options; by March of 2004 over 500 public companies were using the fair value method. A major reason for this change was to show the investing community that these companies believed in fair and transparent financial reporting, particularly in the aftermath of the many financial reporting scandals. However, because some companies include stock-based compensation expense in income and others only disclose the pro-forma effects, comparability concerns have been raised.
- Increased Fair Value Acceptance – Since the promulgation of SFAS 123, the application of fair value as a measurement attribute has been further established in the accounting literature and in practice. This evolution has been facilitated by the development of more sophisticated valuation technologies with attendant application of fair value concepts in the accounting literature. For example, fair value concepts have been applied and accepted in recent standards involving derivatives (SFAS 133), transfers of financial assets and liabilities (SFAS 140), intangible assets and goodwill (SFAS 142), and asset retirement obligations (SFAS 143). The FASB has issued a concept statement related to expected cash flow measurement (when such measures are used to approximate fair value) and the FASB and IASB have ongoing projects to address the use of fair values in financial reporting. Compared to the environment at the time of promulgation of SFAS 123, these developments have increased the acceptance and understandability of fair value as a

measurement attribute in general, and especially in the case of financial instruments, such as stock options.

- International Convergence -- The International Accounting Standards Board (IASB) has recently issued a standard on the accounting for stock-based compensation, which requires expensing options using fair values. As a result, in the interest of international convergence it is important that the FASB also addresses the issue. Not surprisingly, since the FASB and IASB collaborated in developing their share-based payment proposals, the accounting in the ED is in substantial agreement with IASB standard. Thus, adoption of the ED will contribute to the international convergence of accounting standards.

Thus, I support the proposed ED on Share-Based Payment. The FASB's decision to require stock option expensing in 2005 will strengthen investor confidence in the financial statements of all companies, thereby lowering their cost of capital. The efficient allocation of capital to the most economically valuable business activities depends on high quality accounting. The accounting proposed in the ED on Share-Based Payment will contribute to the body of high quality accounting rules.

At the same time I oppose efforts by some in Congress to thwart the FASB in establishing accounting standards in this area. I have voiced concerns on this front directly to members of Congress but will reinforce a couple of those concerns here. In general, these bills either delay or partially apply the provisions in the ED. These legislative efforts are a bad idea for two fundamental reasons:

- They undermine the authority of the FASB at a time when it is essential that we restore faith in our financial reporting system, and
- The measures generally do not reflect the economic substance of equity-based compensation transactions and provides a political, rather than an economic answer to an important accounting problem.

I hope that the FASB can withstand Congressional pressure and not abandon the position it has developed based on careful due process. Indeed, I believe that political pressure on the development of accounting standards, and in particular, assailing the FASB's role as an independent body, have contributed to the

chain of events that led to the corporate scandals of the last several years.¹ It is important to understand that transparent financial reporting -- by recognizing stock-based compensation expense -- should not be criticized because companies will report lower income. We may not like what the financial statements say, but we are always better off when the statements are representationally faithful to the underlying economic substance of transactions. While the ED deals with this issue, various legislated proposals (such as H.R. No. 3574) do not. The apparent motivation for these bills is support for the position of a minority of companies that want to keep all or part of stock-based compensation expense out of income and buried in the notes to financial statements, implying that the cost is zero.

Such reporting is biased – it may be in the interests of managers of some companies but does not serve financial reporting or our capital markets well. Biased reporting not only raises concerns about the credibility of these companies' reports, but also the credibility of financial reporting in general. Consider companies that do not use stock options. Why should they be made to look worse because they use a different form of compensation? As we have learned from Enron, WorldCom, Xerox, MicroStrategy, Lucent, and other recent failures, credibility of financial reporting is fundamental to the efficient operation of our capital markets. And even good companies get tainted by biased reporting of a few “bad apples.”

An additional source of bias in financial reporting arises when political interests attempt to circumvent the due process in the setting of accounting standards in the private sector. All relevant issues related to stock option accounting have been studied and given full consideration by the FASB and the SEC (and international standard-setters) both recently and in the prior round of deliberations in the early 1990s. I hope that Congress stays out of accounting standard-setting and allows the FASB to serve the interests of our markets within its due process.

Thank you for considering my views on the Share-Based Payment ED, as part of this due process.

Sincerely,

Terry Warfield, PhD

¹ Congress reacted to these events with the Sarbanes-Oxley Act of 2002. The Act affirmed the role of the FASB as independent private sector accounting standard setter and called for a study of principle- versus rule-based standards in order to address the role of accounting standards in the recent scandals. By streamlining the accounting guidance for stock-based compensation, with a focus on the concepts underlying its accounting, the ED arguably embraces a principles-based approach. However, recent actions by Congress undermine the Act's support for independent accounting standard-setting by the FASB.