Testimony
Before the Subcommittee on Commerce, Trade, and Consumer Protection, House Committee on Energy and Commerce

FINANCIAL ACCOUNTING STANDARDS

Accounting for Stock Options and Other Share-Based Payments

Statement of David M. Walker
Comptroller General of the United States
Dear Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss with the subcommittee GAO’s perspective on the process for establishing accounting standards for private-sector entities and then, more specifically, the current proposals for accounting for stock options. We recognize that accounting for stock options is a complex and controversial issue on which reasonable people can and do disagree. As a result, in light of the Financial Accounting Standards Board’s (FASB) current proposed standard for accounting for stock options and other share-based compensation, there has been a renewed interest for the Congress to possibly legislate accounting rules for stock options. On June 28, 2004, we sent a letter to FASB commenting on its proposed standard and a letter discussing the accounting standard-setting process to the Senate Committee on Banking, Housing, and Urban Affairs.¹

FASB is a non-governmental organization empowered to establish financial accounting and reporting standards for private-sector entities. Although this function legally resides with the Securities and Exchange Commission (SEC) for public companies as part of its mandate to administer and enforce the provisions of the federal securities laws, the SEC has traditionally relied on FASB since 1973 to fulfill this function. The U.S. capital markets depend on a system of continuously improving financial information about the underlying economic activities of companies. This information is fostered and framed by independently established financial accounting and reporting standards, collectively referred to as generally accepted accounting principles (GAAP).

On March 31, 2004, FASB issued an exposure document on a proposed Statement, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95*, which addresses the accounting for compensation to employees in the form of stock options and other forms of equity. The FASB’s proposed Statement would generally eliminate the ability for public companies to account for share-based services using the intrinsic method (which generally results in no expense being recognized) and would require instead the use of a fair-value-based method, which would generally result in companies treating stock options granted to employees as an

expense based on their fair value when granted. It is important to note that in 1995, when issuing the current standard that is in place, FASB clearly stated that the fair market value is the preferable method. The current standard also includes guidance to that effect and requires that if the fair market value method is not used, then disclosure must be made of pro forma net income and earnings per share presented as if the fair market value method had been used.

We support the concepts behind FASB’s current proposed Statement requiring companies to use the fair market value method, which essentially results in companies recording stock options and other share-based arrangements as an expense. In our view, stock options and other forms of share-based payment have economic value and represent a form of compensation expense. Therefore, we believe that the economic substance of such transactions should be reflected as compensation expense in the calculation of a company’s net income to accurately portray its financial results. The current standard, which permits companies to choose between the intrinsic and fair value methods, allows companies to select the impact on net income. It also creates a barrier to comparable financial information, both domestically and internationally, because the choice of methods used will result in differences in reported amounts across companies due to the different methods of accounting. We believe that a requirement to expense stock options and other share-based payment will provide additional transparency, clarity, and comparability in financial reporting.

We also support the four principal reasons FASB cited for issuing the new proposal: (1) addressing concerns of users and others that the use of the intrinsic value method results in financial statements that do not faithfully represent economic transactions and can distort the financial condition and operations of the issuer; (2) improving the comparability of reported financial information through the elimination of alternative accounting methods; (3) simplifying U.S. generally accepted accounting principles by requiring the use of a single method of accounting for share-based payment; and (4) enabling international convergence and greater international comparability in the accounting for share-based payment.

The proposed standard would permit nonpublic companies to measure compensation costs based on the intrinsic method of accounting at each reporting date until options are exercised or otherwise settled.
Notwithstanding our and others’ views on the merits of various accounting methods for stock options, we believe that the principle of independence, both in fact and in appearance, is essential to the credibility of and confidence in any authoritative standard-setting processes. With respect to the role of FASB in this and other areas, we support its efforts, as the SEC’s designated independent non-governmental standard-setting body, to identify issues for consideration, prepare exposure documents, conduct outreach efforts and solicit comments on exposure documents, and consider the resulting comments in finalizing and issuing new accounting standards. FASB, in carrying out its standard-setting activities, has an established process in place to obtain and consider feedback from its constituent groups, including financial statement preparers, auditors, and users such as individual investors, institutional investors, lenders, creditors, professional analysts, and various other parties. These processes were established in order to balance the competing interests and demands of the various groups while providing standards that promote transparent, credible, and comparable financial information. This time-tested and proven deliberative process has served to strengthen financial reporting and ensure general acceptance of the nation’s accounting standards. This process is especially important given the complexity and controversial nature of some accounting standards, including the accounting for stock options and other share-based payments.

We believe it is critical that FASB complete its analysis of comments received on its exposure document on share-based payment and finalize its proposed Statement in accordance with its established independent standard-setting process. In enacting the Sarbanes-Oxley Act of 2002, the Congress recognized the importance of having an independent standard-setting process that facilitates accurate and effective financial reporting and protects investors. As a safeguard, the Act specified criteria for the SEC to use for determining whether a private-sector accounting standard setter’s principles will be considered as generally accepted. The SEC determined that FASB met the statutory criteria established in the Sarbanes-Oxley Act of 2002. In our opinion, the FASB’s independent standard-setting process, subject to SEC oversight, should be allowed to proceed in its consideration of accounting for stock options.

I would like to add that GAO is involved in setting government auditing standards and accounting standards for federal agencies. We have also implemented deliberative processes to obtain and consider the perspectives of affected parties on exposure drafts of proposed standards. Standard setting is, by its nature, an iterative process and the standard
setter needs a high degree of independence to make decisions on what represents the best standard in the public interest.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions you or other members of the subcommittee may have at this time.

For further information regarding this testimony, please contact Jeanette M. Franzel, Director, Financial Management and Assurance, at 202-512-9471 or franzelj@gao.gov. Michael C. Hrapsky also made key contributions to this testimony.
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