

Institute Comments to FASB on Stock Option Accounting Standards, August 2002

August 21, 2002

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Herz:

The Investment Company Institute¹ is writing to urge the Financial Accounting Standards Board to propose and adopt, as soon as practicable, a new accounting standard that would (1) require companies to treat stock options as an expense and (2) ensure uniformity in how stock options are valued for this purpose, in order to enable investors to meaningfully compare companies' earnings.

As investors in approximately \$4 trillion in securities (both equity and fixed-income) issued by U.S. corporations—on behalf of millions of individual investors—mutual funds and other investment companies believe it is imperative that the accounting principles that govern the financial statements of these corporations ensure full and fair disclosure of their financial results and condition. In furtherance of this end, we have concluded that the adoption by FASB of a uniform standard under which stock options would be treated as an expense is necessary.

As you know, FASB Statement No. 123 currently requires companies to disclose the pro forma effect of stock options on income and earnings per share in footnotes to their financial statements. As institutional investors, our members can and do rely on this disclosure in evaluating companies. Nevertheless, we believe that requiring the effect of stock options to be reflected directly in a company's financial statements on a uniform basis would be preferable, for a number of reasons.

First, there is currently no standard methodology for valuing the cost of stock options. The adoption of a standard approach by FASB would facilitate the ability of all investors to evaluate the effects of options upon earnings for all companies on a uniform basis.

Second, including the effect of options in financial statements, rather than in footnotes, will ensure that commonly reported items, such as earnings per share, have the same meaning for all companies. (This is a matter of increased importance, as a number of companies have announced that they will begin to treat stock options as an expense.) While, as noted above, our members and other institutional investors can utilize the information currently provided in footnotes, it is not clear that all market participants make use of this information. Consequently, the failure to reflect the cost of stock options in reported earnings per share could have the potential to distort the relative valuation of companies' securities.

Third, current accounting rules treat stock options differently than other forms of compensation. While stock option plans can, depending on how they are designed, have the benefit of aligning the interests of shareholders and management, they can also have the potential for encouraging management to focus on short-term results and transferring voting power and wealth from shareholders to management. We do not believe it is appropriate for stock options to be favored (or, for that matter, disfavored) as compared to other forms of compensation through the application of accounting standards.

Fourth and finally, we note that the International Accounting Standards Board plans to issue an exposure draft of a proposed standard that would require companies in countries that adhere to IASB standards to expense stock options beginning in 2004. The United States has long been considered to have the most rigorous accounting standards in the world. Recent events have tarnished that image. We believe that the adoption by FASB of a requirement that stock options be treated as an expense on a uniform basis—

together with the recent enactment of legislation providing for a new accounting oversight board and establishing new standards for auditor independence, and recent proposals by the SEC to enhance disclosures by public companies (e.g., of critical accounting policies)—will help ensure that U.S. accounting and disclosure standards are once again held out as a model.

We appreciate your consideration of our views, and would be pleased to assist FASB in any way as it continues to consider this issue.

Very truly yours,

Matthew P. Fink
President

cc: The Honorable Paul S. Sarbanes
The Honorable Phil Gramm
The Honorable Carl Levin
The Honorable Michael G. Oxley
The Honorable John J. LaFalce
The Honorable W.J. Tauzin
The Honorable John D. Dingell

The Honorable Harvey L. Pitt, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

Alan L. Beller, Director, Division of Corporation Finance
Paul F. Roye, Director, Division of Investment Management
Robert K. Herdman, Chief Accountant

U.S. Securities and Exchange Commission

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,928 open-end investment companies (“mutual funds”), 499 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.898 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.