Accounting for Stock Compensation

As widely reported in the media in recent weeks, there have been a number of developments regarding the accounting for stock-based compensation. Specifically:

- The International Accounting Standards Board (IASB) continues to make progress on its project on the accounting for share-based payments that began in July of 2001. The IASB recently reached preliminary agreement on a proposed model for accounting for share-based payments that would require all share-based payments to employees, including employee stock options, to be measured at fair value on the grant date.

- In recent months, and in particular in the last two weeks as proposed legislation dealing with oversight of the accounting profession was discussed, there has been significant discussion in the U.S. Senate about the accounting for stock options.

- As a result of the above activities and continued concerns about the accuracy and transparency of reported financial information, several companies recently announced that they will adopt the fair value recognition and measurement provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, for awards to employees, and other companies have announced they are considering changing their accounting for stock-based compensation granted to employees. Until these announcements were made, only two companies among the Fortune 500 used Statement 123’s fair value method to account for employee stock-based compensation.

The following is a discussion of the IASB’s and Congress’ initiatives and a summary of Statement 123 (including the significant differences between the recognition provisions of Statement 123 and APB Opinion No. 25, Accounting for Stock Issued to Employees).

**IASB’s Project on Share-Based Payments**

The International Accounting Standard’s Board (“IASB”) is a newly reconstituted standard setter (successor to the International Accounting Standards Committee) with the mission of developing a set of international accounting standards that could be followed by companies throughout the world. In July of 2001, the IASB agreed that a project on share-based payments would be among the first it would add to its agenda, notwithstanding warnings about the controversial nature of the project.

In July 2002, the IASB reached a package of tentative decisions (without a single dissenting vote among its 13 members) that would require stock-based compensation to be measured on the grant date at fair value, similar to the recognition and measurement requirements of Statement 123. The IASB has made additional tentative decisions about the application of the proposed model, some of which differ from the accounting described in Statement 123, which are described in greater detail in the project summary available on the IASB’ website (www.iasb.org.uk).
The IASB’s current plan is to issue an Exposure Draft in the fourth quarter of 2002, and a final standard late in 2003. Based on a review of comment letters received by the IASB to date, while many financial statement preparers continue to oppose a fair value recognition approach, it appears that many financial statement users (e.g., investment analysts) are supportive of the fair value approach (which was not the case when the FASB issued its exposure draft on the accounting for stock-based compensation in June of 1993). With some companies in the US voluntarily adopting the fair value method of Statement 123, the Congressional activities described above, and the changing views of at least some constituents, it seems likely that the IASB ultimately will issue a standard that requires compensation expense for stock options and other stock-based compensation to be measured at fair value.

The FASB has not formally announced its intent to take any action on stock-based compensation. However, the new Chairman of the FASB, Bob Herz, has indicated that he expects the FASB to examine any standard issued by the IASB on share-based payments and consider what action, if any, to take at that point. Given the FASB’s stated goal of international harmonization of accounting standards and the current controversy over accounting standards, many believe that the FASB ultimately will follow the lead of the IASB and require that a fair value method be used to measure and recognize compensation expense resulting from grants of stock-based compensation to employees.

Congressional Activity Related to Stock Options
Earlier in the year, Senators John McCain and Carl Levin sponsored legislation entitled the “Ending the Double Standards for Stock Options Act.” (S. 1940) Under current tax law, a company obtains a tax deduction equal to the intrinsic value of a non-qualified stock option measured on the date of exercise (and the employee generally has taxable [ordinary] income of the same amount). The proposed legislation would limit the amount of that tax deduction to the amount of compensation expense recognized for GAAP financial reporting purposes (interestingly, adoption of Statement 123 would not ensure a full deduction as Statement 123 requires that compensation be measured on the grant date, not the exercise date). There has been no activity on this proposed legislation, although Senator McCain unsuccessfully proposed an amendment to the recently passed legislation dealing with oversight of the accounting profession to include the change proposed in S. 1940.

The Senate last week blocked an amendment proposed by Senator Levin calling on the FASB to review the issue of accounting for stock options within a year, although we understand that Senator Majority Leader Tom Daschle has indicated that the issue will be considered by the Senate in the future. Recently, current Federal Reserve Chairman Alan Greenspan, and former Federal Reserve Chairman Paul Volker, both urged Congress to refrain from legislative interference with the FASB. Given the controversial nature of the issue, the recent adoption of Statement 123 by several public companies, and the IASB’s activities, we do not expect Congress to take any actions with respect to stock options at this time. However, as recent events have indicated, it is difficult to predict what actions Congress will take.
Adoption of Statement 123

List of Adopters
As widely reported in the media, several companies recently have announced their intention to adopt the recognition and measurement principles of Statement 123 in accounting for employee stock-based awards. The following is a list of public companies that we have been able to identify as of July 22, 2002 that recently have adopted the fair value recognition and measurement principles of Statement 123 for employee stock-based awards:

- AMB Property Corporation
- Banc One Corp.
- Coca-Cola Co.
- Dole Food Co.
- Sovereign Bancorp
- Valley National Bancorp
- Wachovia Corp.
- Washington Post Co.

A complete list of companies that account for stock-based awards granted to employees using Statement 123’s fair value method is available in the EY/A&A Developments database, and will be updated regularly.

Summary of Statement 123

The following is a brief summary of the recognition and measurement requirements of Statement 123 and includes a description of the significant differences between the Statement 123 recognition model and the Opinion 25 model. A more detailed discussion of those requirements is included in our Financial Reporting Developments publication, Accounting and Disclosure of Stock-based Compensation.

Most companies currently account for stock options and other stock-based awards pursuant to Opinion 25. Under Opinion 25’s intrinsic value method, compensation expense is determined on the measurement date (the first date on which both the number of shares the employee is entitled to receive, and the exercise price, if any, are known). Compensation expense, if any, is measured based on the award’s intrinsic value (the excess of the market price of the stock over the exercise price on the measurement date). For most stock options, the intrinsic value on the measurement date (which usually is the date of grant) is zero, and no compensation expense is recognized. However, if the number of shares or exercise price is not known on the grant date, the options are subject to “variable accounting” (i.e., continued remeasurement of compensation expense at each reporting date until the number of shares and exercise price become known). Variable accounting essentially causes a grantor to recognize additional compensation expense (in excess of the amount measured on the measurement date) because of increases in the stock price after the grant date.
The FASB issued Statement 123 in October 1995. Statement 123 describes a fair value method of accounting for all stock-based compensation, including stock options. While the FASB encouraged companies to adopt the fair value recognition provisions of Statement 123 (and made clear that this is the preferable approach), it permitted (as a result of intense pressure from constituents and Congress) continued application of Opinion 25’s intrinsic value method. Companies that elected not to adopt Statement 123’s fair value method for employee awards are required to provide pro forma disclosure of net income and earnings per share calculated as if all stock-based compensation were accounted for under Statement 123.

Companies that decide to adopt the fair value method of Statement 123 for recognition purposes generally will recognize compensation expense for options and other stock-based awards based on their fair value on the date of grant. The fair value of options granted by public companies is estimated using complex option pricing models (e.g., the Black-Scholes or binomial models) that originally were developed to value traded options. Nonpublic companies are permitted to use a simpler method known as the “minimum value” method. Unlike the requirements of Opinion 25, Statement 123 requires a grant date measurement of compensation expense even for awards for which the number of shares or exercise price is not known (variable awards under Opinion 25), with certain exceptions. Accordingly, while performance awards will result in a fair value charge under Statement 123, the amount of that charge is based on the stock price on the grant date and is not adjusted for subsequent changes in stock prices. Accordingly, Statement 123 eliminates much of the income statement volatility associated with performance awards under Opinion 25.

**Determining Fair Value**

The objective in determining the fair value of a stock option is to estimate the amount a willing buyer would pay a willing seller for the option on the grant date. Because employee stock options generally are not traded or sold, market quotes are not available. As a result, Statement 123 requires companies to estimate the fair value of an option using an option-pricing model.

In order to estimate the fair value of each option, a public company is required to make certain subjective assumptions about its stock and the timing of option exercise. Those assumptions, together with certain objective information about the option, are used in the option-pricing model to estimate the option’s fair value. Statement 123 requires that all six of the following inputs be used in the option pricing model:

- Current price of the underlying stock on the date of grant
- Exercise price of the option

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1. If the fair value of the stock-based award is not determinable on the date of grant, a measurement date does not occur until that fair value is determinable, which results in accounting similar to Opinion 25’s variable accounting.

2. While the language in paragraph 163 of Statement 123 is ambiguous and might be read to suggest that market prices for options, if available, could be used to determine the fair value of employee stock options, paragraph 19 of Statement 123 is clear that an option-pricing model must be used to estimate that fair value of employee stock options. If active markets in employee stock options were to develop, it is possible that the FASB would reconsider this requirement.
• Expected dividend yield of the stock over the option’s life
• Expected volatility of the stock over the option’s life
• Expected life of the option
• Risk-free interest rate during the life of the option

The input assumptions made on the grant date normally are held constant regardless of subsequent actual experience, and the fair value of each option would not be remeasured. Detailed guidance regarding the selection of assumptions is included in our Financial Reporting Developments publication, Accounting and Disclosure of Stock-based Compensation, which is available in the EY/A&A Developments database. Additionally, a summary of our survey of disclosures provided pursuant to Statement 123, including information about the six input assumptions described above, is included in our interpretive guidance white paper — 2000 Survey Of Key Assumptions And Disclosures Made Under Financial Accounting Standards No. 123, Accounting For Stock-Based Compensation.

As indicated in our past surveys, the overwhelming majority of companies use the Black-Scholes option-pricing model for determining the fair value of employee stock options. A small minority of companies uses the binomial pricing model.

E&Y has developed a software program, EY/Options, that can be used to calculate the estimated value of most stock-based awards. EY/Options can be used to estimate the fair value of options using either the Black-Scholes or Binomial option pricing models. Clients and other interested parties should contact their Ernst & Young service team for more information.

Expense Recognition
Under Statement 123’s approach, expense is recognized only for options that ultimately vest. Compensation expense is not recognized for options that are forfeited because employees fail to fulfill service requirements (e.g., if the employee terminates before reaching the vesting date). Compensation expense is not reversed for options that are cancelled or expire unexercised, even if the options turn out to be worthless because the stock price declines. These provisions are similar to the expense recognition provisions of Opinion 25.

Liabilities
In addition to equity awards such as stock options and stock appreciation rights payable in shares, Statement 123 also addresses accounting for what the FASB refers to as “liability awards.” Generally, these are awards that obligate the employer to make a cash payment based on the company’s stock price. For example, a stock appreciation right (SAR) that an employer must pay in cash, or would pay in cash at the employee’s election, is accounted for as a liability. Under Statement 123, such liabilities are remeasured over the period of the award up through the date the liability is satisfied so that the expense ultimately recognized over the exercise period equals the cash paid. This is consistent with the “variable” accounting for SARs payable in cash pursuant to Opinion 25 and its related interpretations.
Under Opinion 25 and its interpretive literature, providing a grantee with the right to put shares obtained upon option exercise back to the company at fair value on the put date normally does not result in an accounting consequence if the put right is not expected to be exercised within six months of the exercise of the stock option. Under Statement 123, such an arrangement would be subject to the accounting described in the previous paragraph. However, the FASB did provide an exception from this accounting for nonpublic companies that provide employees with the right to put shares back to the employer at fair value. For nonpublic companies, such a put right does not have an accounting consequence.

**Settlements of Awards**

Statement 123 provides that the cash paid to repurchase stock options (and other equity awards) should be charged to equity similar to a treasury stock transaction, provided that the amount paid does not exceed the fair value of the options on the date of repurchase. Amounts paid in excess of the fair value are expensed. Under Opinion 25, such a repurchase could trigger recognition of additional compensation expense if it occurs “shortly after issuance” of the shares (generally interpreted in practice as within six months). Under Statement 123, this six-month holding period is irrelevant, and employers generally could repurchase the shares at their fair value immediately upon awarding the shares without triggering additional compensation expense, provided they are not obligated to do so (and that such repurchases do not occur often enough to cause the plan to be treated substantively as a liability).

**Modifications of Awards**

After granting an award, a company may modify the terms of the award in a way that increases its fair value on the date of the modification. For example, a company may extend the term of a stock option or reduce its exercise price. Statement 123 treats such a modification as an exchange of the original award for a new award. This approach requires the company to measure the fair value of the new award and the old award (immediately before the modification) and recognize the difference as compensation. Compensation expense previously recognized for the original award is not reversed.

This approach is significantly different from the approach under Opinion 25. Under Opinion 25, a change to the exercise price, number of shares or expiration of an award results in a new measurement date (with compensation measured as the intrinsic value of the option on that date). As a result, a modification that has a small impact on the value of an option (e.g., reducing the exercise price by 1%) could result in significant incremental expense if the company’s share price has risen since the grant date. In addition, under Opinion 25 if the exercise price is reduced or the number of shares is increased, the change results in variable accounting for the award. Under Statement 123, such a modification is accounted for as described in the preceding paragraph, resulting in a fixed measure of incremental compensation expense. There is no “variable accounting” concept in Statement 123 except for awards that are accounted for as liabilities or for awards for which fair value is not reasonably estimable at the grant date.
Changes to terms other than the number of shares, exercise price, or expiration normally do not result in an accounting consequence under Opinion 25. However, any such change that increases the fair value of the option would result in incremental compensation expense under Statement 123. The FASB did not explicitly address the accounting for decreases in fair value resulting from a modification, because an employer normally could not unilaterally modify an award to decrease its value, and the accounting for such a transaction would depend on all of the facts and circumstances.

**Noncompensatory Plans**

Under Opinion 25, plans that meet four criteria are considered “noncompensatory plans” and result in no compensation expense, even though stock may be issued under such plans at a discount from market. For example, Employee Stock Purchase Plans (ESPP), frequently referred to as “423 Plans” (in reference to the section of U.S. Internal Revenue Code that describes that federal income tax implications of such plans), typically do not result in compensation expense under Opinion 25, even though stock may be sold with a discount up to 15 percent and the period that the employee has to make the purchase decision can extend up to 5 years. Statement 123 includes a similar noncompensatory concept and similar criteria. However, two of the criteria are interpreted much more strictly under Statement 123 than Opinion 25. Specifically:

- The plan incorporates no option features other than the following:
  - Employees may be permitted a short period of time (not exceeding 31 days) after the purchase price has been fixed to enroll in the plan.
  - The purchase price may be based solely on the stock’s market price at the date of purchase, and employees may be permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid, such as those paid by payroll withholdings.
- The discount from market price does not exceed the greater of (i) a per share discount that would be reasonable in a recurring offer of stock to shareholders or others or (ii) a per share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. However, a “safe-harbor” discount of 5% is allowed. Note that if a company allows employees a discount greater than 5% and cannot justify that discount under these criteria, the entire discount is treated as compensation expense—not just the incremental portion above 5%.

Section 423 plans often provide the employee the right to purchase shares at 85% of the lesser of fair market value of the stock on the first day or the last day of a defined period (e.g., six months). Such plans do not qualify as noncompensatory under Statement 123 because of the significant discount offered to employees and because the look-back price feature is, in effect, an option to the employee. Therefore, those plans are subject to the same fair value recognition model as stock options and other stock-based awards. Appendix B of Statement 123 provides a rather complex example of its accounting for Section 423 plans with a look-back option feature.
Balance Sheet Presentation of Awards
Opinion 25 does not provide explicit guidance on the balance sheet presentation of unvested stock-based awards for which compensation is recognized. Two methods are commonly used in practice: (1) recognize an equity instrument equal to the measured compensation and recognize offsetting deferred compensation as a reduction of equity (the “gross method”) or (2) recognize in equity only an amount equal to recognized compensation expense (the “net method”). Under Statement 123, an equity instrument is not considered to be issued until it vests and, accordingly, companies recognizing compensation using Statement 123’s fair value method must use the net method.

Earnings Per Share Implications
Under FASB Statement No. 128, *Earnings per Share*, stock options, nonvested stock (i.e., restricted stock), and similar equity instruments issued to employees are treated as common stock equivalents in computing EPS. That requirement and the requirement to use the “treasury stock method” do not differ whether Opinion 25 or Statement 123 is used to measure and recognize compensation expense.

Statement 128 also provides that any measured but not yet recognized compensation expense should be included as “proceeds” in applying the treasury stock method. Because Statement 123 generally results in higher compensation expense than Opinion 25, such assumed proceeds likewise will be higher and more shares will be considered “repurchased” in the EPS calculation. This effect will help mitigate the higher expense charge in the numerator.

Because Statement 128 limits the amount of tax benefits included in the proceeds in the treasury stock calculation to those that would be credited to paid-in capital (because the tax deduction exceeds the amount of recognized compensation expense), the amount of tax benefit added to the proceeds in the treasury stock calculation will be reduced under Statement 123. Of course, this effect is mitigated by the fact that the tax benefit will increase net income and, therefore, the numerator in the EPS calculation.

A detailed example of the application of the treasury stock method to stock options accounted for using Statement 123’s fair value method is included in Chapter 6 of our Financial Reporting Developments publication, *Accounting and Disclosure of Stock-based Compensation*.

Transition
The recognition provisions of Statement 123 must be applied to all stock-based compensation granted to employees during the year of adoption (i.e., it must be applied as of the beginning of a fiscal year). Accordingly, if Statement 123 is adopted after the first quarter of a fiscal year, prior interim financial statements for that fiscal year must be restated if any stock-based awards were granted during the year. Application of the recognition principles of Statement 123 to awards granted prior to the year of adoption is prohibited except to the extent that those awards are modified or settled. It should be noted that once a company adopts the provisions of Statement 123, it cannot change back to the Opinion 25 intrinsic value method. Appendix B of Statement 123 describes
how to account for modifications of awards when the original award was accounted for under Opinion 25.

Because Statement 123 prohibits accounting for employee stock options granted before the year of adoption using the fair value method, the statement of operations during the year of adoption most likely will not include the full impact of the employee stock-based compensation expense. For example, assume that each year a company grants its employees stock options with a fair value of $3 million subject to three year cliff vesting. During the year of adoption, the company will recognize only $1 million in compensation expense from stock option grants (it will recognize compensation for awards granted during that year only, and will not recognize compensation for prior awards that continued to vest during the fiscal year). However, if the company had adopted the recognition provisions of Statement 123 two years earlier, it would recognize $3 million of compensation expense from stock options during the current year (options granted in the prior two years would contribute $2 million in expense to the current year’s operating results). In this circumstances, companies should disclose the fact that stock option expense has not yet ramped up, and refer financial statement readers to the pro forma disclosures required by Statement 123, which will include the effects of application of the fair value recognition method to the prior grants in our example. In addition, until compensation expense has ramped up for all periods presented, the pro forma disclosures required by Statement 123 must continue to be provided (i.e., they must be provided until pro forma net income and reported net income are the same).

Opinion 20 Disclosures

APB Opinion No. 20, *Accounting Changes*, requires the following disclosures regarding a change in accounting principle that is affected prospectively from the beginning of the year of adoption. These disclosures should be provided in the first financial statements that include the effects of the change in accounting principle whether those financial statements are for an interim period or a complete fiscal year, and should continue to be provided in financial statements that include any period in which the new accounting principle is not applied.

1. The nature of and justification for a change in accounting principle and its effect on income. The justification for the change should explain clearly why the newly adopted accounting principle is preferable (in this case, because paragraph 11 of Statement 123 clearly states the FASB’s view that the fair value method is preferable).

2. The effect of adopting the new accounting principle on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change.

3. Income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected.
Regarding item 3, above, the pro forma amounts computed in accordance with Opinion 20 technically could differ from the pro forma disclosures previously provided pursuant to paragraph 45 of Statement 123. The Statement 123 pro forma disclosures reflect only pro forma compensation with respect to awards granted during or after the fiscal year beginning after December 15, 1994 (1995 for calendar year companies). However, the disclosures required by Opinion 20 include no such limitation. Accordingly, the Opinion 20 pro forma disclosures technically should include compensation expense with respect to all awards that were unvested at the beginning of the first period presented in the statement of operations. However, paragraph 25 of Opinion 20 provides an exception from this requirement if it is not possible to compute those amounts and appropriate disclosures are provided. Given the FASB’s view described in paragraph 270 of Statement 123 that the “Board decided that requiring retroactive application would be excessively burdensome,” we believe it would be reasonable to disclose Opinion 20 pro forma amounts that are consistent with those presented for purposes of the Statement 123 disclosures as long as appropriate disclosure is provided.

Preferability

Item 601(b)(18) of Regulation S-K requires that a letter from a registrant’s independent auditors be filed as an exhibit in the first periodic report (Form 10-K or Form 10-Q) filed subsequent to any accounting change, which letter would indicate whether or not the change is preferable under the circumstances. However, Item 601(b)(18) of Regulation S-K indicates that a preferability letter is not needed when a change is made “in response to a standard adopted by the Financial Accounting Standards Board that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle.” [Emphasis added]

Paragraph 11 of SFAS 123 states: “The Board encourages entities to adopt the fair value based method of accounting, which is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under APB Opinion No. 20, Accounting Changes.” [Emphasis added]

Given that the FASB clearly articulated its preference for the “fair value based method” of accounting for stock-based compensation, we believe that a preferability letter is not required for a change in accounting for employee stock-based compensation from the Opinion 25’s intrinsic value method to Statement 123’s fair value method (we have confirmed our view with the SEC staff). Further, once a company adopts the fair value method for recognition of employee stock-based compensation, it cannot change back to the Opinion 25 intrinsic value method under any circumstances.

Auditors Report

If a company adopts the recognition and measurement provisions of Statement 123 with respect to employee awards, not all of the reporting periods presented in the financial statements will be prepared on a consistent basis when presenting financial statement for the initial year of adoption and the subsequent year. As a result, we refer to the change in an explanatory paragraph to our report following the opinion paragraph (and after required explanatory paragraphs, if any, for going concern uncertainties). The
explanatory paragraph identifies the nature of the accounting change, indicates the period in which the change occurred, and refers to the note in the financial statements that discusses the change and its effects. For example:

As discussed in Note X to the financial statements, in 20X2, the Company changed its method of accounting for stock-based employee compensation granted.
Accounting & Auditing Guidance on Ernst & Young Online

Ernst & Young Online, Ernst & Young’s password-protected web site for clients and friends, is powered with accounting and auditing guidance that has been developed for Ernst & Young professionals and the clients they serve. See the summary of online options below, or contact your Ernst & Young client service team to learn more about Ernst & Young Online.

Accounting & Reporting Digest

- **Weekly Update** summarizes FASB deliberations, SEC regulatory pronouncements, and other activities.
- **Financial Reporting Developments** provide Ernst & Young’s analyses and implementation guidelines on important financial reporting matters.
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Audit Committee Library

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- **Audit Committee Toolkit** includes reference materials, questionnaires, and other resources to help prepare for meetings with management and independent auditors.
- **Commentary & Guidance** is provided from a variety of organizations committed to providing best practices, and establishing standards for functioning audit committees.

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Accounting & Auditing Toolkit

The A&A Toolkit bundles together a variety of U.S. GAAP related knowledge resources. Key components include:

- **Accounting & Auditing Developments Database** tracks Standard Setter projects, meetings (FASB, EITF, SEC, AcSEC, etc.), exposure drafts, and recent pronouncements.
- **Ernst & Young Accounting & Auditing Research Tool (EY/AART)** is your primary research resource, including U. S. GAAP literature, International Accounting Standards, and Ernst & Young Interpretive Guidance.
- **Online GAAP Checklist** enables a thorough review of relevant disclosure considerations and online submission to your engagement team.

}*The A&A Toolkit is available on an annual subscription basis.*

Multinational A&A Tools

The following are available on a subscription basis:

- **Global GAAP Comparison** includes a subject-by-subject comparison of U.S., U.K., International, Swedish, German, Belgian, Dutch, and Swiss GAAP.
- **UK & International GAAPplus** provides a comprehensive guide to UK and International GAAP, including Standards, exposure drafts, and illustrative financial statements.