Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
Before the
Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs
April 20, 2004

Prepared Statement

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises, including small businesses. Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002, is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises.

Like investors and creditors, Congress and other policy makers need an independent FASB to maintain and improve the integrity of accounting standards in order to obtain the financial information necessary to properly assess and implement the public policies that you favor. While current efforts by certain parties to block improvements to the accounting for equity-based compensation may seem attractive to some in the short run, in the long run biased accounting standards are harmful to investors, creditors, the capital markets, and the US economy.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all interested parties. The Board must balance the often conflicting perspectives of various parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of sound, fair, and transparent financial reporting.

On March 31, 2004, the Board issued a proposal for public comment to improve the accounting for equity-based compensation. That proposal was the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, consultation with our advisory councils, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of financial reports, and valuation and compensation experts, and active deliberations at 38 public Board meetings at which the provisions of the proposal were carefully developed with consideration given to the ongoing input received from all interested parties.

The Board believes the proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including eliminating the existing exception for so-called fixed plan employee stock options, which are the only form of equity-based compensation that is not currently required to be reported as an expense in financial statements. The proposal reflects the view that all forms of equity-based compensation should be properly accounted for as such, and that the existing exception for fixed plan employee stock options results in reporting that ignores the economic substance of those transactions. It is important to note that when enterprises use stock options and similar instruments such as stock purchase warrants for purposes other than compensating employees, for example to acquire goods and services or in financing transactions, they have long been required to value those instruments and properly account for them in the financial statements.

Eliminating the fixed plan employee stock option exception is also responsive to the demands and concerns expressed by individual and institutional investors, pension funds, creditors, financial analysts, the major accounting firms, and many other parties. It will provide greater transparency and consistency in the reporting of various forms of equity-based compensation. It also will provide greater comparability between enterprises that compensate their employees in different ways and between the nearly 500 enterprises that have voluntarily chosen to account for the cost of all of their employee stock options and the many others that have elected not to do so.

The proposal also has the secondary benefit of achieving greater international comparability in the area of accounting for equity-based compensation. International convergence of accounting standards in this important area improves the transparency of financial information around the globe, lowering the costs of domestic and international investors, creditors, enterprises, auditors, and regulators. In that regard, our international counterpart, the International Accounting Standards Board, issued a final standard in February of this year requiring the expensing of all equity-based compensation. The IASB standard will be followed by enterprises in over 90 countries beginning next year.

Our proposal includes a Notice for Recipients ("Notice") that highlights and describes over twenty specific issues that respondents might wish to consider in developing their comments to the Board. The Notice includes several issues focusing on the proposal's measurement approach and the special provisions in the proposal applicable to small business.

The Board plans to hold public roundtable meetings with interested users, auditors, and preparers of financial reports, and valuation and compensation experts, to discuss the issues raised by the proposal. The Board also plans to discuss the views of interested parties representing small and medium-sized businesses at the inaugural public meeting of our Small Business Advisory Committee.

Following the end of the comment period on June 30th, the Board plans to redeliberate, at public meetings, the issues raised in response to the proposal. Those redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal and will include careful consideration of the ongoing input received from all parties.

Only after carefully evaluating the input at public meetings will the Board consider whether to issue a final standard. The Board's current plans are to complete its redeliberations and be in a position to issue a final standard in the fourth quarter of this year.

I would like to conclude my statement by noting that we all have witnessed the devastating effects and loss of investor confidence in financial information that have resulted, at least in part, from companies intentionally violating or manipulating accounting requirements. Investors, creditors, and other consumers of financial reports are continuing to demand improvements in accounting and financial reporting. The existing accounting for equity-based compensation has been an area of great concern for years, and our proposal is intended to be responsive to that concern.

Let me assure you, Mr. Chairman, Ranking Member Akaka, and Members of this Subcommittee, that you, and investors, creditors, and other consumers of financial reports can have confidence that the FASB will resolve the concerns raised about the accounting for equity-based compensation in an open, thorough, and objective manner that will serve the interests of consumers of financial reports and, thus, assist in the strengthening of our capital markets and the US economy.

Thank you, Mr. Chairman. I would be happy to respond to any questions.