Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services
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Statement

Chairman Baker, Ranking Member Kanjorski, 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 subject to oversight by the United States ("US") Securities and Exchange Commission ("SEC"). Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the US economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased information to make rational resource allocation decisions.

Our work is designed to provide investors and the capital markets with the most useful possible yardstick to measure and report on the underlying economic transactions of business enterprises. Congress and other policy makers also need an independent and objective FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to properly assess and implement public policies. While bending the yardstick or preempting the independent accounting standard setting process to favor a particular outcome may seem attractive to some in the short run, in the long run a crooked yardstick (in the form of a biased accounting standard) is harmful to investors, the capital markets, and the US economy.

In March of this year, at a public meeting, the Board unanimously decided to add a project to its agenda to address issues relating to improving the financial accounting and reporting for stock-based compensation. That decision was based largely on three factors:

First, the high level of public concern expressed by individual and institutional investors, pension funds, mutual funds, creditors, financial analysts, and other users of financial statements, as well as trade unions, consumer groups, the Conference Board's Commission on Public Trust and Private Enterprise, and the major accounting firms, about the need to improve the reporting for stock-based compensation, in particular the need to eliminate the exception for so-called fixed plan employee stock options, which are the only form of stock-based compensation that is not currently reported as an expense in the financial statements.

Second, the noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting stock-based compensation which has been magnified by the recent trend of major US companies (sometimes as the result of shareholder resolutions and votes) to adopt the voluntary expense recognition provisions of our 1995 standard.

Third, the opportunity to achieve convergence to a common, high-quality international accounting standard for stock-based compensation.

There is no subject on our current agenda on which we have received so many strong and heartfelt calls to action. The concerns raised go beyond the abuses of excessive executive pay to the view that the current accounting is just "flat wrong."

In April, the Board began its initial public deliberations to consider improvements to the recognition, measurement, and disclosure of stock-based compensation. We have to-date held four public meetings and we have reached tentative decisions on certain issues.

In the coming weeks and months, at public meetings, the Board will continue its deliberations of the many issues relating to this project, including the measurement issues and issues relating to private companies and start-ups. The Board's public deliberations of the issues will be systematic, thorough, and objective. The deliberations will benefit from our review and analysis of the vast amount of research and other literature in this area. The deliberations also will benefit from the ongoing input of our constituents, including the advice of leading valuation and compensation experts that we will consult with throughout the entire process.

The Board currently plans to be in a position to issue a proposed standard for public comment in the fourth quarter of this year. Any proposal must be approved by an affirmative vote of the majority of the Board. The proposal will be exposed for an ample public comment period so that all interested constituents will have the opportunity to provide detailed responses. The Board also will consider whether to hold public roundtables or public hearings to solicit additional input on the proposal.

Prior to making any final decisions on any changes to the accounting for stock-based compensation, the Board would consider, at public meetings, all of the input received in response to the proposal. The Board will not issue any final standard until it has carefully considered, at public meetings, the views of all constituents. Like any proposal, any final standard must be approved by an affirmative vote of a majority of the Board.

We have reviewed H.R. 1372, the "Broad-Based Stock Option Plan Transparency Act of 2003" ("HR 1372"). We note that, if enacted, HR 1372 would impose a more than three-year moratorium on any FASB improvements to the financial accounting and reporting for stock-based compensation. The FASB strongly opposes HR 1372 for a number of reasons.

First, the moratorium would unduly intervene in the Board's independent, objective, and open process to make unbiased decisions on the substance and timing of improvements to the accounting for stock-based compensation. Such intervention would be in direct conflict with the expressed needs and demands of many investors and other users of financial reports. Such intervention would also appear to be inconsistent with the language and intent of the Sarbanes-Oxley Act of 2002 ("Act") and the related and recently issued SEC Policy Statement reaffirming the FASB as the nation's accounting standard setter.

Second, the moratorium would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality international accounting standards on stock-based compensation. The FASB is actively working with the International Accounting Standards Board and other national standard setters in an effort to achieve convergence in this important area and in other areas. The moratorium would likely hamper those efforts, and again appears inconsistent with the language and intent of the Act and the related SEC Policy Statement, both of which encourage international convergence efforts.

Finally, and perhaps most importantly, the moratorium would establish a potentially dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to intervene in accounting standard setting. That signal would likely prompt others to seek political intervention in the future activities of the FASB.

We all have witnessed the devastating effects and loss of investor confidence in financial reporting that have resulted from companies intentionally violating or manipulating accounting requirements. What impact then on the system, and on investors' trust in financial reports, might there be if it were perceived that accounting standard setting was being biased toward the pursuit of objectives other than those relating to fair financial reporting or that the FASB was being blocked from pursuing improvements in financial reporting?

For all of these reasons, we strongly oppose HR 1372 and any other legislation that would undermine and impair the Board's independent, objective, and open standard setting process.

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