Testimony of
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Chairman
Financial Accounting Standards Board
before the
Commerce, Trade, and Consumer Protection Subcommittee
of the
Committee on Energy and Commerce
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Prepared Statement

Chairman Stearns, Ranking Member Schakowsky, and Members of the Subcommittee:

Good afternoon. 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 want to thank you for inviting me to participate at this very important and timely hearing.

I have brief prepared remarks and 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 general-purpose standards of financial accounting and reporting for both public and private companies. Those standards are essential to the growth and stability of the United States ("US") economy because creditors, investors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions. In other words, financial accounting and reporting is meant to tell it like it is, not to distort or skew information to favor particular industries, types of transactions, or particular political, social, or economic goals other than the goal of sound and honest reporting.

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 roundtables, field visits, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment.

In March of this year, the Board issued, by unanimous vote, a proposal for public comment to improve the accounting for a wide range of equity-based compensation arrangements. We understand the controversial nature of this project, but the Board felt it was important to address the accounting in this area based largely on three reasons: First, the high level of public concern expressed by investors, creditors, and other consumers of financial reports about the need to improve the accounting for equity-based compensation, in particular the need to address the exception from expense recognition that presently exists *only* for fixed plan employee stock options. Second, the complexity and noncomparability and, thus, lack of transparency created by the alternative accounting treatments presently available for reporting equity-based compensation. And finally, the opportunity to achieve convergence to a common, high-quality international accounting standard in this important area.

The FASB proposal is the result of an extensive public due process that began in November 2002 before the project was added to the Board's agenda. That process included the issuance of a preliminary document for public comment, the review of hundreds of comment letters, the review of relevant research studies, consultation with our advisory councils and valuation and compensation experts, field visits, public and private discussions with hundreds of individuals, including users, auditors, and preparers of the financial reports of small businesses, 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 interested parties.

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 not only ignores the economic substance of those transactions but also distorts reported earnings and other key financial metrics. As the Congressional Budget Office's recent analysis of this subject concluded, "[i]f firms do not recognize as an expense the fair value of employee stock options, measured when the options are granted, the firms' net income will be overstated." Thus, under current accounting standards, the greater the use of fixed plan employee stock options, the greater the distortion of reported results. I would note that, in contrast, this distortion does not occur when companies use stock options, or similar instruments such as stock purchase warrants, for purposes other than compensating employees, for example, in acquiring goods or services or in financing or merger and acquisition transactions. In those cases, current accounting standards do require that stock options or warrants be valued and accounted for in the financial statements.

In the public company arena, the proposal would bring about greater comparability between the over 575 companies that have voluntarily opted to account for the cost of employee stock options and many others that have elected not to do so. It also would be responsive to the growing number of companies, including major technology companies, whose shareholders by a majority vote have approved nonbinding proxy resolutions mandating expensing of all employee stock options. Management of a number of those companies has indicated that they are awaiting completion of our project in order to respond to the demands of their shareholders.

The proposal also would result in substantial convergence in the accounting for equity-based compensation of our standards and international accounting standards that will, beginning next year, be followed by companies, including many small businesses, in over 90 countries around the world. I also would note that our neighbor to the north, Canada, who often has followed the lead of the US in improving accounting standards, felt that it could not wait in this area, and decided to mandate expensing of employee stock options beginning in January of this year. I understand that implementation of Canada's new standard, which has been adopted by over 1,500 small businesses and 500 technology companies, has to date gone very smoothly.

Finally, I also would note, as indicated earlier, that improvements in accounting standards have economic consequences. More credible, comparable, and transparent financial information enhances the efficiency of capital allocation in our markets. Most agree that efficient allocation of capital is essential to the growth and stability of the US capital markets and the economy as a whole.

Since the issuance of the proposal for public comment in March, the Board has continued to actively solicit input in response to the proposal. In May, the Board discussed the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee. The discussion focused in part on the special provisions of the proposal that are intended to alleviate the cost and complexity of implementation for small businesses.

In June, the Board held four half-day public roundtable meetings relating to the proposal in Palo Alto, California, and in Norwalk, Connecticut. Over 70 individuals from a broad range of companies, including representatives from the high-technology industry, small businesses, valuation experts, compensation consultants, software developers, auditors, financial analysts, institutional investors, professional and trade associations, and academics participated.

To date, the Board has received thousands of comment letters in response to the proposal. The vast majority of those letters are form-like letters from employees of certain high-technology companies expressing opposition to the proposal, and from union employees and investors expressing support for the proposal. We also have received many letters from companies, accounting firms, valuation experts, compensation consultants, and trade and professional associations providing detailed comments and suggestions on one or more of the many technical issues raised by the proposal.

Beginning later this month, the Board plans to redeliberate, at public meetings, the issues raised by the proposal. Those redeliberations will be systematic, thorough, and objective and will include careful consideration of the input already received and the input that the Board will continue to solicit throughout the entire process.

Only after carefully evaluating at public meetings the input received, and reaching decisions on the issues raised, 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.

It is with great concern that I recently learned that the US House of Representatives is scheduled to soon take the extraordinary action of voting on H.R. 3574, proposed legislation, that if enacted would preempt and override the Board's current efforts to improve the accounting for equity-based compensation.

The Board strongly opposes H.R. 3574, consistent with the view of most investors, analysts, accountants, and many companies. That opposition is based on many conceptual and technical reasons, including:

- The proposed legislation is seriously flawed. By mandating the expensing of only those stock options held by the top five executives, and stipulating an unorthodox method for valuing the options that minimizes their worth, the proposed legislation violates fundamental concepts of economics and financial accounting and reporting and would legislate significant distortions in companies' reported earnings, profitability, and other key financial metrics.

- The proposed legislation, although titled the "Stock Option Accounting Reform Act," contains provisions that have exactly the opposite effect by largely preserving, protecting, and perpetuating the existing accounting for stock options that has resulted in an unlevel playing field favoring certain companies that are the greatest users of fixed plan employee stock options over other companies that have chosen to compensate their employees in different ways.

- The proposed legislation would be in direct conflict with the expressed needs and demands of many investors and shareholders and would appear to prohibit the voluntary expensing of all employee stock options that has been adopted by over 575 companies.

- The proposed legislation would strike a major blow to the FASB's efforts to achieve timely convergence of high-quality international accounting standards and, therefore, is inconsistent with the language and intent of both the Sarbanes-Oxley Act of 2002 and the related 2003 SEC Policy Statement reaffirming the FASB as the nation's accounting standard setter.

- The proposed legislation would raise a host of practical and implementation issues that would likely be very disruptive to companies, auditors, regulators, and the entire financial reporting system.

- And, finally and perhaps most importantly, the proposed legislation would establish a dangerous precedent in that it would send a clear and unmistakable signal that Congress is willing to directly intervene in the independent, objective, and open accounting standard-setting process based on factors other than the pursuit of sound and honest financial reporting.

For those and other reasons set forth in more detail in the full text of my testimony, I believe that H.R. 3574, if enacted, would result in a giant step backwards in the recent and ongoing efforts by Congress, the SEC, the FASB, and many other parties to restore public confidence and trust in the integrity of financial reporting. As Federal Reserve Chairman Alan Greenspan has stated, the enactment of this proposed legislation "would be a bad mistake for the Congress." I whole-heartedly agree. Speaking not just for the FASB, but for the millions of US investors and others that rely on the integrity of financial reporting and the capital market system, I respectfully urge you to oppose H.R. 3574.

In conclusion, let me assure you, Mr. Chairman, and the users, auditors, and preparers of financial reports that the Board will continue to carefully consider in an open, thorough, and objective manner all of the input received in response to our proposal. Our goal, consistent with our mission, is to develop a high-quality, cost-effective standard that will faithfully report the underlying economic effects of equity-based compensation transactions and, thus, improve the transparency and integrity of financial reporting.

Thank you again, Chairman Stearns. I would welcome the opportunity to respond to any questions.