Testimony of Robert H. Herz
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of the Committee on Energy and Commerce
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Prepared Remarks

Chairman Stearns, Ranking Member Schakowsky, and the Members of the Subcommittee, thank you for the invitation to appear today to review with you the actions and activities of the Financial Accounting Standards Board ("FASB" or "Board") since the bankruptcies of Enron Corp. ("Enron") and WorldCom, Inc. ("WorldCom"). 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. We are not part of the federal government. Our independence from reporting enterprises, auditors, and the federal government is fundamental to achieving our mission—to set accounting and reporting standards to benefit the users of financial information—most notably, investors and creditors. Those users rely heavily on credible, transparent, comparable, and unbiased financial reports for effective participation in the capital markets.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, ultimately with the Securities and Exchange Commission ("SEC").

Clearly, the events of the past year have shaken confidence in our reporting system and in our capital markets. While most of the problems seem to stem from outright violations of rules, fraud, and apparent audit and corporate governance failures, those problems also have prompted broader questions about virtually every aspect of our financial reporting system, including financial accounting and reporting standards and accounting standard setting.

I think those questions are appropriate and are healthy, and, quite frankly, I think they were overdue. As with crises in other areas of business or life, this crisis prompts reflection, introspection, a better understanding, and then rebuilding, change, and renewal. So it must be with our financial reporting system. And, I think a major lesson and an indelible reminder from this crisis is that sound financial reporting is indeed very key to the health and vitality of our capital markets, our economy, and our society as a whole. It matters!

So, what are we at the FASB doing to fulfill our mission and to play our important role in helping improve financial accounting and reporting and restore investor confidence? The answer is many things—in regard to specific technical areas, in terms of our own operations, and in terms of the whole structure and direction of accounting standard setting in this country.

On the technical front, we have significantly modified our agenda and priorities in direct response to issues that have come to light since the Enron and WorldCom bankruptcies. These issues include the accounting for special-purpose entities ("SPEs"), guarantees, energy trading contracts, stock-based compensation, and the broad area of revenue recognition. Let me touch briefly on each of those items.

With respect to SPEs, we issued new requirements in January 2003. Those requirements provide that enterprises with investments or other relationships with SPEs must carefully assess their involvement to determine whether they receive a majority of the risks or rewards of those SPEs. If so, the enterprises are required to report the assets, liabilities, and gains and losses of those SPEs within their own financial statements. We expect that under the new requirements many, but certainly not all, of the SPEs that currently are not reported by any enterprise will be reported in the future. The new requirements also significantly improve the disclosures related to an enterprise's use of, and involvement with, SPEs.

In a closely related project on accounting and disclosure of guarantees, we issued new requirements in November 2002. Those requirements provide that all enterprises recognize a liability at fair value for the obligations they undertake when issuing a guarantee and that those enterprises make additional disclosures about the guarantees. We believe the new requirements will result in a more representationally faithful depiction of an enterprise's liabilities. The requirements will also improve the transparency of enterprise's obligations and liquidity risks related to the guarantees it issues.

In October 2002, our Emerging Issues Task Force ("EITF") and the FASB staff addressed certain practice issues related to the accounting for energy trading contracts. The EITF decided to preclude mark-to-market accounting for certain difficult-to-value energy trading contracts. The EITF also decided to require that gains on certain energy trading contracts be shown net (rather than gross) in financial reports. At the same time, the FASB staff observed that no enterprise should recognize an upfront gain at the inception of entering into certain financial contracts, unless the fair value of those contracts are clearly evidenced by observable market transactions or market data.

We also have a current project on our agenda to improve the existing accounting requirements for measuring and disclosing the fair value of essentially all financial instruments, including those whose fair value cannot be reliably measured by observable market transactions or market data.

In December 2002, we issued new requirements relating to the accounting for stock-based compensation. Those requirements allow the more than 170 enterprises that are voluntarily changing to the preferable fair value approach of accounting for stock-based compensation to effect that change in several alternative manners.

The new requirements also provide for clearer and more prominent disclosures about the costs of stock-based compensation. Finally, the new requirements increase the frequency of key stock-based compensation disclosures from annually to quarterly.

We also issued a preliminary document for public comment about the accounting for stock-based compensation in November 2002. That document explains the similarities and differences between recent proposed requirements by our international counterpart, the International Accounting Standards Board ("IASB"), and the preferable fair value approach under existing US standards.

We have been reviewing the input received on that document and other input we have been receiving from investors, analysts, enterprises, and some Members of Congress about a variety of issues relating to the accounting for stock-based compensation. We will soon deliberate, at a public meeting, whether the Board should add a new project to its agenda to pursue further improvements in this area, including whether we should mandate the preferable fair value approach. Of course, any new project to pursue further changes to the accounting and reporting for stock-based compensation would be subject to the FASB's open and thorough due process procedures.

Finally, with respect to our technical activities, our EITF issued new requirements in November 2002 addressing certain revenue recognition issues arising from revenue arrangements with multiple deliverables. Those requirements should improve the comparability and transparency of the reporting of revenue from the delivery or performance of multiple products, services, or rights to use assets. Examples of those types of arrangements include the sale of a cellular telephone with related telephone service, or the sale of medical equipment with related installation service.

As a longer-term solution to the many issues surrounding the accounting for revenue recognition, we added a major project to the FASB's agenda addressing this whole area broadly. The objective is to develop, jointly with the IASB, a coherent, conceptually consistent model for revenue recognition that would replace much of the existing literature and that would serve as a principles-based source for developing future accounting guidance as new types of transactions emerge in the marketplace.

In terms of our own operations and the whole structure and direction of accounting standard setting in this country, last year we launched a series of wide-ranging reviews covering a broad range of issues in this area. Some of the key aspects of our review and findings relate to improving our speed and timeliness, increasing the involvement of investors and other users of financial reports in our activities, the topic of a principles-based accounting system, international convergence, and how all of these things impact the structure and direction of US accounting standard setting.

With respect to improving speed and timeliness, our independent oversight body—the Financial Accounting Foundation—amended our Rules of Procedure last year to require only a four to three vote of the Board, rather than a five to two vote, to issue both proposals and final standards.

Also last year we implemented a reorganization of our senior staff to enhance the focus and accountability of our staff activities. We also are conducting a thorough process mapping of all our procedures in order to identify and to hopefully eliminate those procedures that are redundant or do not add value, while at the same time not compromising our thorough and open due process.

To increase the involvement of investors and other users of financial reports in our activities, we recently established the User Advisory Council ("UAC"). The UAC includes representatives from mutual fund groups, major investment and commercial banks, rating agencies, and other groups that represent investors and other key users. We held our first public meeting of the UAC on February 13, 2003. We intend to use the UAC as a source of input on FASB agenda decisions and on specific issues within ongoing FASB projects.

We issued a proposal for public comment on the whole subject of principles-based accounting standards in October 2002. In December 2002, we held a public roundtable meeting with respondents to discuss various aspects of that proposal.

In the coming weeks, we expect to discuss at public Board meetings the input received in response to the proposal and decide what additional actions, if any, the FASB should pursue in this area. We also plan to continue to work closely with the SEC as it responds to the principles-based study and reporting requirements contained in the Sarbanes-Oxley Act of 2002.

We also have been devoting significant resources to the area of international convergence. Our recent work in this area includes developing procedures and protocols used not only by the FASB but also by the IASB and other major national standards setters in working together. In addition, we are working with the IASB on several major joint projects, including, as mentioned earlier, revenue recognition, business combinations, and reporting on financial performance. We are also closely monitoring the progress of the IASB on other key projects.

In October 2002, we reached a historic agreement with the IASB to use our best-efforts to align our agendas and, very importantly, to undertake a specific project (with the help and support of the SEC staff) aimed at accelerating the convergence process by trying to eliminate or narrow some of the areas of difference between current US and international standards. Because there are literally hundreds of differences between US and international standards, realistically, this effort will still be ongoing, well beyond 2005 when Europe adopts international standards en masse. But we need to set this process in motion now, so that we can achieve greater progress in this important area going forward. The overall objective of international convergence is not convergence just for the sake of convergence, but rather to arrive at high-quality accounting solutions that improve the transparency of financial reporting in the US and abroad.

Finally, with respect to structural improvements to US accounting standard setting, the FASB made several recent changes that we believe are necessary to better control the proliferation and consistency of US accounting requirements. First, we decided that the role of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants as a second senior-level accounting standard setter in the

US would, after a transition period of approximately one year, be discontinued. We also decided that, in the future, the maintenance and development of any industry-based standards would reside with the Board.

Second, we decided that with regard to our EITF, two FASB Board members would become members of the EITF agenda committee and the FASB Board members would more actively participate at all EITF meetings. Moreover, all future EITF decisions would be subject to the FASB Board's review and ratification. Finally, we broadened the composition of the EITF to include a user representative to ensure that the user perspective is properly considered in the EITF's deliberations.

This has been a brief summary of some of our many actions and activities at the FASB, post-Enron and WorldCom. These actions and activities are designed to better meet the challenges and opportunities that face us and that face the financial reporting system. I hope you will agree that it is not business as usual at the FASB and that we are on the right track.

I believe that the overriding goal must be improvement of the overall financial accounting and reporting system in this country. That's what it is all about—sound, transparent, unbiased information that the system needs to work effectively. I know that many Members of Congress and the investing public are demanding that we and others continue to take bold and decisive actions to restore investors' confidence, the capital markets expect it, and I believe that our country deserves nothing less.

Thank you again, Mr. Chairman, Ranking Member Schakowsky, and all of the Members of the Subcommittee. I very much appreciate your continuing interest in, and support of, the mission and activities of the FASB.

I would be happy to respond to any questions.