



**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Commerce, Trade, and Consumer Protection Subcommittee
of the
Committee on Energy and Commerce
July 8, 2004**

Full Text of Testimony

Chairman Stearns, Ranking Member Schakowsky, 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 want to thank you for the opportunity to publicly express our concerns, and the concerns of investors, analysts, accountants, and many companies about H.R. 3574,¹ which, if enacted, will cut short and override the FASB’s current efforts to improve the financial accounting and reporting for equity-based compensation.

My testimony includes a brief overview of (1) the FASB, including the importance of the Board’s independence and the ability to conduct its work in a systematic, thorough, and objective manner, (2) the process the FASB follows in developing accounting standards, (3) the basis for the Board’s unanimous decision to issue a proposal to improve the accounting for equity-based compensation, (4) the input received in response to the proposal, (5) the current status of, and the FASB’s plans relating to, the proposal, and (6) some observations about H.R. 3574.

The FASB

The FASB is an independent private-sector organization.² We are not part of the federal government. Our independence from enterprises, auditors, and the federal government 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.³ Those standards are essential to the efficient functioning and operation of the capital markets and the United States (“US”) economy because investors, creditors, and other consumers of financial reports rely heavily on sound, honest, 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 (“Act”),⁴ 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 economic 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 the integrity of the standards in

¹ H.R. 3574, 108th Congress, 1st Session (November 21, 2004).

² See Attachment 1 for information about the Financial Accounting Standards Board.

³ See Attachment 2 for excerpts from recent materials about the importance of the FASB’s independence and concerns about proposed legislation.

⁴ Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

order to obtain the financial information necessary to properly assess and implement the public policies they favor.

Financial accounting and reporting is meant to tell it like it is, not to allow distortions or skew information to favor particular industries, particular types of transactions, or particular political, social, or economic goals other than sound, and honest reporting. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting standard is harmful to investors, creditors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.⁵

The Policy Statement, consistent with the language and intent of the Act, also reemphasizes the importance of the FASB's independence described earlier.⁶ It states:

By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.⁷

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"),⁸ maintains active oversight of the FASB's activities.

⁵ "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

⁶ Sarbanes-Oxley Act of 2002, Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

⁷ Policy Statement, page 5 of 8.

⁸ See Attachment 1 for information about the Financial Accounting Foundation.

What Process Does the FASB Follow in Developing Accounting Standards?

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including small businesses.

Our Rules of Procedure require an extensive and thorough public due process.⁹ That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, 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.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.¹⁰ Over the past two years, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures. Some of those actions were intended to increase the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses. Those particular actions include the following:

- Establishing a Small Business Advisory Committee (“SBAC”) in order to increase involvement by the small business community in developing accounting standards. The SBAC, whose members represent diverse perspectives and experiences, comprises lenders, investors and analysts,

⁹ See Attachment 1 for information about the FASB's due process.

¹⁰ The Securities and Exchange Commission (“SEC”) also recently reviewed the FASB's due process and concluded that “the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . .” Policy Statement, page 5 of 8.

preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community.

- Establishing a User Advisory Council (“UAC”) in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.
- Making our public Board meeting announcements available to interested parties more broadly through an email subscription service.
- Making our public Board meetings available to interested parties for monitoring via web cast on our website free of charge and via the telephone at a reduced cost.
- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website.

FASB’s Current Project to Improve the Accounting for Equity-Based Compensation

In March 2003, at a public meeting, the Board decided to add a project to its agenda to address issues relating to equity-based compensation. That decision was based largely on three reasons.

The first reason was the high level of public concern expressed by creditors, individual and institutional investors, pension funds, mutual funds, financial analysts, and other users of financial statements about the need to improve the financial accounting and reporting for equity-based compensation. The concern was not just about perceived abuses of executive compensation, but the broader issue of the appropriate financial accounting and reporting for equity-based compensation, in particular the need to eliminate the exception from expense recognition that presently exists *only* for fixed plan employee stock options. Those users of financial statements that have been urging the FASB to eliminate the exception for fixed plan employee stock options include:

- The Council of Institutional Investors (an association of more than 130 corporate, public, and union pension funds with more than \$3 trillion in pension assets)

- Institutional Shareholder Services (serving more than 950 institutional investors and corporate clients worldwide)
- The Office of the State Comptroller of New York (an investor, shareholder, and sole trustee of the nation's second largest pension fund at approximately \$100 billion in assets)
- Moody's Investor Services
- The Central Pension Fund of the International Union of Operating Engineers and Participating Employers (on behalf of more than 150,000 participants of the CPF)
- The Teachers Insurance and Annuity Association College Retirement Equities Fund (a financial services company with approximately \$262 billion in assets under management, serving nearly 3 million education and research employees at 15,000 institutions)
- The Investment Company Institute (a national association including 8,938 mutual funds, 535 closed-end investment companies, and 6 sponsors of unit investment trusts; its mutual fund members have assets of about \$6.539 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders)
- The Association for Investment Management and Research (now known as the CFA Institute, a nonprofit professional organization of 61,600 financial analysts, portfolio managers, and other investment professionals)¹¹
- The American Federation of Labor and Congress of Industrial Organizations (representing 13 million of America's workers in 65 member unions)
- The Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Peterson, chairman of the Blackstone Group, former Secretary of Commerce and chairman of the Federal Reserve Bank of New York, and John W. Snow, (former) chairman, CSX Corporation and former chairman, Business Roundtable).

¹¹ A 2001 survey conducted by the Association for Investment Management and Research found that more than 80 percent of financial analysts and portfolio managers responding to the survey believed that stock options granted to employees are compensation and should be recognized as an expense in the income statements of the enterprises that grant them. AIMR, "Analysts, Portfolio Managers Want Employee Stock Options Expensed on Income Statements, Global AIMR Survey Shows" (November 19, 2001).

In 2002, President Bush announced a ten-point plan to improve corporate responsibility.¹² That plan including the following statement: “The authors of accounting standards must be responsive to the needs of investors.”¹³ There is no other issue on the Board’s agenda on which investors have been clearer about the need for an improvement in the existing accounting standards.

The second reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was because of the complexity and noncomparability and, thus, potential lack of transparency created by the alternative accounting treatments presently available for reporting equity-based compensation. That lack of transparency has been magnified by the recent trend of enterprises adopting the voluntary fair value provisions of FASB Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995).¹⁴ The trend has increased the divergence between the financial reports of enterprises that do not make wide use of employee stock options as compensation and the financial reports of those that do, and between those enterprises that voluntarily expense employee stock options and those that do not.

As indicated above, fixed plan employee stock options are the *only* form of employee stock options that *is not* required to be reported as an expense in the income statements of the enterprises that grant them. All other forms of employee compensation, including cash salaries, bonuses, fringe benefits, restricted stock, stock warrants, performance-based stock options, indexed-based stock options, employee stock ownership plans, are (and have long been) required to be reported as an expense. Moreover, when equity-based grants of any form are issued to nonemployees for goods or services, they also are (and have long been) required to be reported as an expense.

The exception for fixed plan employee stock options is clearly an anomaly in today’s financial accounting and reporting. That anomaly results in an absolute and relative distortion of profitability and other key financial metrics. The greater the use of those instruments, the greater the distortion. As indicated above, the distortion creates an unlevelled playing field that inappropriately favors those enterprises that are the greatest users of fixed plan employee stock options over other enterprises that either have chosen to compensate their employees in different ways (including different forms of equity-based compensation) or use fixed plan employee stock options but have voluntarily elected to expense them.

¹² Ten-Point Plan to Improve Corporate Responsibility sand Protect America’s Shareholders (March 7, 2002).

¹³ *Id.*

¹⁴ See Attachment 3 for a list of 576 companies that have voluntarily adopted option expensing under the fair value method.

The distortion misleads investors, particularly, but not limited to, less sophisticated investors. The overall effect is a diversion of investment and capital resources away from their most efficient employment. As Federal Reserve System Chairman Alan Greenspan stated, “[if] you don’t expense stock options, then you’re getting a distorted view as to what the profitability of a particular operation is, and you will get a distortion in the allocation of capital.”¹⁵ Many other economic experts that have reviewed this issue agree, including former Federal Reserve Chairman (and current chairman of the Trustees of the International Accounting Standards Committee Foundation) Paul A. Volcker,¹⁶ Nobel Prize winning economists Robert C. Merton¹⁷ and Joseph E. Stiglitz,¹⁸ the Financial Economist Roundtable,¹⁹ the Republican Staff of the Joint Economic Committee of the US Congress,²⁰ the Conference Board Commission on Public Trust and Private Enterprise,²¹ and the Congressional Budget Office.²²

Many enterprises, including some in the high technology industry, that have voluntarily expensed their employee stock options have requested that the Board mandate the expensing of all employee stock options. It is also interesting to note some of those enterprises, including Wal-Mart Stores, Inc., Netflix Inc., and Home Depot, Inc., have historically offered broad-based stock option plans to many nonexecutive employees and have indicated that adopting fair value expensing for all employee stock options will not result in a curtailment of those programs.²³

The third reason the Board decided to add a project to its agenda to address issues relating to equity-based compensation was the opportunity to achieve convergence to a common, high-quality international accounting standard in this area. The International Accounting Standards Board (“IASB”) issued a proposal in November 2002 that would require that all stock options be expensed at their fair value at grant date.²⁴ To maximize the opportunity for international convergence,

¹⁵ Hearing of the Joint Economic Committee, US Congress, on “Economic Outlook” (April 21, 2004).

¹⁶ Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Testimony of Paul A. Volcker (June 3, 2002), pages 3 and 4.

¹⁷ Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004), page 2 of 3.

¹⁸ Joseph E. Stiglitz, “The Roaring Nineties” (October 2003), pages 115-139.

¹⁹ Statement of Financial Economist Roundtable on the Controversy over Executive Compensation (November 24, 2003).

²⁰ Joint Economic Committee, Republican Senate Staff, Economic Policy Research, “Understanding the Stock Option Debate,” Report 107-04 (July 9, 2002), page 18.

²¹ The Conference Board, “The Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation” (September 17, 2002), page 6.

²² The Congressional Budget Office, “Accounting for Employee Stock Options,” Section 3 (April 2003), pages 4 and 5.

²³ News from Carl Levin, US Senator, Michigan, “Stock Option Roundtable Dismissed as One-Sided” (May 8, 2003), page 2; Reed Hastings, “Expense It!” *The Wall Street Journal* (April 5, 2004).

²⁴ IASB Proposed IFRS, *Share-Based Payment* (November 2002).

the FASB concluded that it needed to consider the US accounting requirements for equity-based compensation concurrently with IASB's consideration of its proposal.

The FASB has long been committed to actively working with the IASB and other national accounting standard setters to promote international convergence of accounting standards concurrent with improving the quality of financial reporting.²⁵ Both the Act²⁶ and the Policy Statement²⁷ indicate the support of the US Congress and the SEC, respectively, for the FASB's convergence efforts.

Since March 2003, the Board has held 38 public meetings to discuss the project. Preparations for those meetings included thousands of hours of research on issues relating to the project, including the review of the results of many research studies on the topic.

In addition, the Board and staff have participated in public and private discussions about the project with hundreds of individuals, including members of the Financial Accounting Standards Advisory Council, the UAC, the Option Valuation Group,²⁸ and other groups and organizations representing preparers, auditors, and users of financial reports. The Board also has conducted field visits with a variety of enterprises of various sizes, including small businesses, covering a range of industries to discuss issues relating to the project.

In February 2004, at a public meeting, the Board unanimously agreed to the issuance of a proposal for public comment. That proposal was issued on March 31, 2004, for a 90-day comment period.²⁹

The proposal contains a detailed Notice for Recipients encouraging comments on over 20 specific issues. Attachment 4 includes the Notice for Recipients and a Summary of the key provisions of the proposal.

What Has Been the Input Received in Response to the Proposal?

Following the issuance of the proposal for public comment the Board has been actively meeting with and soliciting input from valuation experts, and users, auditors, and preparers of financial reports on issues raised by the proposal. For example, on May 11, 2004, at a public meeting the Board discussed the proposal

²⁵ FASB, *Rules of Procedure* (December 1, 2002, as amended), page 2.

²⁶ Act, Section 108(a)(2).

²⁷ Policy Statement, page 4 of 8.

²⁸ The Board established the Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of stock options. Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraph C37.

²⁹ *Id.*

with over twenty representatives of small and medium-sized businesses at the inaugural meeting of the SBAC.

In addition, the Board held public roundtables on June 24, 2004, in Palo Alto, California, and June 29, 2004, in Norwalk, Connecticut. Over seventy individuals from a broad range of enterprises, 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 at the four half-day public meetings.

To date the Board has received thousands of comment letters in response to the proposal. Consistent with the FASB's Rules of Procedures Board members are required to read all of the comment letters received.

The vast majority of the comment letters received in response to the proposal are form-like letters. Some of those letters are from employees of several high-technology industry companies. While heartfelt in their urging the Board not to do anything that might result in their employers' reducing the amount of employee stock option grants, they generally do not address the financial accounting and reporting issues raised by the proposal. Thousands of other form letters were received from union employees and investors expressing unqualified support for the proposal.

Excluding the form-like letters, we have many other letters from a broad range of enterprises, accounting firms, valuation experts, compensation consultants, trade and professional associations, and academics. Those letters provide detailed input on one or more of the many financial accounting and reporting issues raised by the proposal.

What Is the Current Status of, and the FASB's Plans Relating to, the Proposal?

Later this month, the Board plans to begin its public redeliberations of the proposal. The redeliberations, consistent with the FASB's Rules of Procedure, will address the key conceptual, measurement, disclosure, and cost-benefit issues raised by the proposal. Those issues will include (1) what is the relevant measurement attribute and relevant measurement date for equity-based compensation; (2) what is the appropriate basis for attribution of compensation cost; (3) what disclosures should be required; (4) what is the appropriate transition and effective date for the new requirements; and (5) what modifications, if any, to the new requirements should be made for small businesses. For each of these issues the public redeliberations will include careful consideration of the comment letters and other input received from all parties.

The redeliberations also will benefit from the FASB staff and Board's ongoing discussion of the key issues with interested parties from a broad range of perspectives, including representatives of small businesses and valuation and compensation experts that the FASB will continue to consult with throughout the entire process. As with virtually all FASB projects, the redeliberations will likely result in a number of changes to improve the proposal.

Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board.

The Board's current plans are to issue a final standard in the fourth quarter of this year. The Board, however, has no fixed deadline for issuing a final standard and will continue its public redeliberations as long as is necessary to develop a high-quality and cost-effective accounting standard that will best serve the needs of investors, creditors, and other consumers of financial reports. As with all of the FASB's activities, the SEC staff will closely monitor and oversee the Board's due process on this important project.

Some Observations about H.R. 3574

As many experts have indicated, the provisions of H.R. 3574 are seriously flawed, violate fundamental concepts of financial accounting and reporting, and, if enacted, would be harmful to the overall capital market system.³⁰ The Board strongly opposes such an effort to block improvements to the financial accounting and reporting for equity-based compensation. That opposition is based on many conceptual and technical reasons, including the following.

First, H.R. 3574 would override the Board's independent, objective, open, and ongoing due process to make unbiased decisions on the substance and timing of improvements to the accounting for equity-based compensation.³¹ As indicated above, such intervention would be in direct conflict with the expressed needs and demands of many investors and other users of financial reports. Such intervention also would appear to be inconsistent with the language and intent of the Act and

³⁰ Letter from Edward Nusbaum, CEO, Grant Thornton LLP, to the Honorable Richard H. Baker, US House of Representatives (March 17, 2004), page 4; Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton; see Attachments 2 and 5 for additional comments from experts on H.R. 3574.

³¹ Of note, after appearing to mandate the substance and timing of the accounting for the expensing of certain stock options in Section 2, and constraining the substance and timing of any existing or future accounting for expensing stock options in Section 3, Section 5 inexplicably states that “[n]othing in this Act shall be construed to limit the authority over the setting of accounting principles by any accounting standard setting body. . . .”

the related Policy Statement, both of which were intended to enhance the independence of the FASB.

Second, H.R. 3574 would have an adverse impact on the FASB's efforts to achieve timely convergence of high-quality international accounting standards in this important area. As indicated above, such Congressional intervention would appear to be inconsistent with the language and intent of the Act and the related Policy Statement, both of which indicate support for the FASB's convergence efforts.

Enterprises in 90 countries around the world will begin to report all equity-based compensation as an expense, in a manner generally consistent with the proposal, beginning on January 1, 2005.³² Those enterprises will join enterprises in Canada, which were required to begin expensing all equity-based compensation, consistent with the proposal, beginning in January of this year.³³ Of note, over 350 Canadian enterprises, and hundreds of other foreign enterprises that comply with international accounting standards, are SEC registrants and are required to file their financial reports in the US.

Addressing the impact of H.R. 3574 on the independence of the FASB and the convergence of accounting standards, The Honorable Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation, stated in recent testimony before Congress:

I suggest that, before acting, Senators and Congressmen ask themselves two simple questions:

“Do I really want to substitute my judgment on an important but highly technical accounting principle for the collective judgment of a body carefully constructed to assure professional integrity, relevant experience, and independence from parochial and political pressures?”

“Have I taken into account the adverse impact of overruling FASB on the carefully constructed effort to meet the need, in a world of globalized finance, for a common set of international accounting standards?”³⁴

³² International Financial Reporting Standard 2, *Share-Based Payment* (February 2004).

³³ *Stock-Based Compensation and Other Stock-Based Payments*, Section 3870 (September 2003).

³⁴ Hearing on Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board, Before the Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs, United States Senate, Testimony of The Honorable Paul A. Volcker (April 20, 2004), page 2 of 2.

Third, although titled the “Stock Option Accounting Reform Act,”³⁵ the provisions of H.R. 3574 have exactly the opposite effect by essentially preserving, protecting, and perpetuating the existing accounting for stock options that have resulted in an unlevel playing field favoring certain enterprises that are the greatest users of fixed plan employee stock options over other enterprises that have either chosen to compensate their employees in different ways.

For example, the provisions of H.R. 3574 would appear to require that only stock options granted after December 31, 2004, to the chief executive officer and the four other most highly compensated employees of certain SEC registrants be reported as compensation expense in those enterprises’ income statements.³⁶ Thus, if an SEC registrant grants stock options to employees other than the top five executives, that compensation cost would not be reported in the enterprises’ earnings.

Moreover, the provisions of H.R. 3574 would appear to require that for purposes of determining the “fair value” of the stock options granted to the top five executives the “assumed volatility of the underlying stock shall be zero.”³⁷ It is universally accepted that a large part of a stock option’s fair value is the result of volatility of the underlying stock price.³⁸ Thus, the amount of compensation cost for the top five executives reported in the enterprises earnings would be substantially less than its fair value.

A recent *Washington Post* editorial commented on the “top five executives” provisions of H.R. 3574, stating:

The second problem with the bill is its illogical content. In the past, opponents of expensing options have claimed that the value of options is unknowable. But the House bill abandons that claim by requiring that companies include in their profit-and-loss statements the value of options for their top five executives. Having conceded that, however, the bill goes on to say that the cost of options granted to employees outside the top circle should be left out, implying that they cost nothing. But they do not cost nothing. In high-tech companies, which grant options generously to middle-ranking employees, the top five

³⁵ H.R. 3574, Section 1.

³⁶ H.R. 3574, Section 2(m)(1)-(2).

³⁷ H.R. 3574, Section 2(m)(3)(A)-(B).

³⁸ Hearing on H.R. 3574: Stock Option Accounting Reform Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Summary of Testimony of Robert C. Merton (March 3, 2004), page 2 of 2.

executives get only a small fraction of the total – less than 5 percent in the case of Intel Corp. or Cisco Systems Inc.

Moreover, the House bill stipulates that companies should use an unorthodox method for valuing options that minimizes their worth. If the bill became law, the options granted by Intel last year would force it to deduct a modest \$3.5 million from its reported profit – compared with the hefty \$991 million it would have to deduct under the proposed FASB reform. Cisco, for its part, could report \$1.1 billion more in profit if the House bill passed. Small wonder that Intel and Cisco have led the lobbying charge in favor of the legislation.³⁹

The provisions of H.R. 3574 also would appear to exempt certain SEC registrants that are “small business issuers” from having to report any compensation expense for stock options granted.⁴⁰ Similarly, the provisions would also appear to exempt certain SEC registrants from having to report any compensation expense for stock options granted to employees for three years after an “initial public offering.”⁴¹ In both cases, to the extent that a qualifying SEC registrant grants stock options to its employees, the amount of compensation cost would be understated in those enterprises’ reported earnings.⁴²

The provisions of H.R. 3574 also would raise a host of practical and implementation issues that would likely be very disruptive to enterprises, auditors, and the entire financial reporting system. As one example, the provisions would appear to prohibit the SEC from recognizing any accounting standard relating to the expensing of stock options unless and until two conditions are met: (1) an economic impact study by the Secretary of Commerce and the Secretary of Labor has been completed, and (2) the standard prescribes exercise or other settlement date measurement for the options granted.⁴³

³⁹ “High-Tech Holdup,” *The Washington Post* (June 10, 2004), page A18.

⁴⁰ H.R. 3574, Section 2(m)(4)(A).

⁴¹ H.R. 3574, Section 2(m)(4)(B).

⁴² In commenting on Sections 2(m)(4)(A) and (B), Associated Press, Business Writer, Bruce Meyerson stated: “Bizarrely, though the purpose of these two exemptions is to ensure a continued source of cheap fuel for smaller businesses to grow, the bill would also grant a free three-year pass to Google, an established Internet juggernaut which plans to sell billions worth of stock in an initial public offering,” Bruce Meyerson, “Congress threatening to derail stock options reform – again,” *San Jose Mercury News* (June 8, 2004), page 2 of 2.

⁴³ H.R. 3574, Section 3(a).

Existing accounting standards prescribe as the preferable method of accounting for employee stock options a grant date fair value measurement approach.⁴⁴ The more than 575 enterprises that have begun voluntarily expensing all employee stock options are required to follow the preferable method.⁴⁵ That method, however, does not encompass an exercise or other settlement date measurement approach as would appear to be required by the provisions of H.R. 3574. Thus, the existing voluntary expensing of all employee stock options by more than 575 enterprises would no longer be permitted.

In addition, H.R. 3574 has a section entitled “Improved employee stock option transparency and reporting disclosures.”⁴⁶ The disclosures required under those provisions, however, are not “more detailed” or as comprehensive as those disclosures required under existing generally accepted accounting principles.⁴⁷

Moreover, the H.R. 3574 disclosures fail to include the proposed improvements to disclosures contained in the proposal responsive to the requests of many users of financial reports, including new and improved disclosures about the related income statement and cash flow effects of equity-based payment arrangements.⁴⁸

Finally, and perhaps most importantly, H.R. 3574 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 fair financial reporting. That signal would likely prompt others to seek political intervention in future technical activities of the FASB. In recently commenting on this issue, the CFA Institute, whose members include more than 70,000 investment professionals and educators, stated:

Politicizing the process can only work to destabilize it and will ultimately be detrimental to those investors who have the least ability to gather political influence.⁴⁹

⁴⁴ Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (October 1995), paragraph 11.

⁴⁵ *Id.*; see Attachment 3 for list of 576 companies that have voluntarily adopted option expensing under the fair value method.

⁴⁶ H.R. 3574, Section 4.

⁴⁷ Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (December 2002), paragraphs 2(e) and 3.

⁴⁸ FASB Exposure Draft, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004), paragraphs C144-C156.

⁴⁹ Letter from Patricia Doran Walters, PhD, CFA, Senior Vice President, Professional Standards & Advocacy, CFA Institute, to the Honorable Richard H. Baker and the Honorable Paul E. Kanjorski, United States House of Representatives (May 10, 2004), page 3 of 4.

For all of the above reasons, H.R. 3574 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 recently indicated, the enactment of this proposed legislation “would be a bad mistake for the Congress.”⁵⁰ I wholeheartedly agree. Speaking not just for the FASB, but for the millions of US investors, creditors, and other consumers of financial reports that rely on credible, transparent, and unbiased financial information, I respectfully urge you to oppose H.R. 3574.

Conclusion

In conclusion, let me assure you that you, and the users, auditors, and preparers of financial reports, including small business financial reports, can have confidence that the Board will carefully consider the input received in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner. Our ultimate goal is to develop, with oversight by the SEC staff, an accounting standard that will faithfully report the underlying economic effects of equity-based compensation transactions and, thus, significantly improve the transparency and integrity of financial reporting in the US. As indicated above, the enactment of H.R. 3574 would undoubtedly have the exact opposite effect.

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

⁵⁰ Hearing of the Joint Economic Committee, United States Congress, on “Economic Outlook” (April 21, 2004).