



**Testimony of
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Chairman
and
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Board Member
Financial Accounting Standards Board
before the
Capital Markets, Insurance and Government Sponsored Enterprises
Subcommittee of the Committee on Financial Services
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Prepared Statement

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Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

Good afternoon. I am Robert Herz, chairman of the Financial Accounting Standards Board (“FASB” or “Board”). With me is one of my fellow Board members, George Batavick. George is heading up the FASB’s recently established Small Business Advisory Committee.

We are pleased to appear before you today on behalf of the FASB. We want to thank you for inviting us to participate in this very important and timely hearing, particularly since H.R. 3574, or any similar legislation, if enacted, would preempt and override our thorough, objective, and public due process to improve the accounting and financial reporting for equity-based compensation.

George and I have brief prepared remarks, and we would respectfully request that the full text of our 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 enterprises. 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.

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.

Following the comment period, the Board actively redeliberates the issues. Those redeliberations often result in significant changes and improvements to the proposals we issue. Throughout the life of a project, 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 interested parties. We do our best to 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, including relevance, reliability, comparability, operationality, and cost effectiveness.

In March 2003, at a public meeting, the Board decided by unanimous vote to add a project to our agenda to address issues relating to improving the accounting for equity-based compensation. The project was in response to the high level of public concern expressed by many individual and institutional investors, financial analysts, creditors, the major accounting firms, study groups such as the Conference Board Commission on Public Trust and Private Enterprise, and many other parties, including a number of Members of Congress, about the need to improve the accounting for equity-based compensation. More specifically, many expressed support for eliminating the exception from expense recognition that presently exists only for so-called fixed plan employee stock options.

Many believe that the existing reporting for equity-based compensation results in significant distortions in the reporting of earnings, operating results, and operating cash flows of an enterprise—distortions that cannot be remedied solely by improvements in disclosures. The ultimate goal of the project is to develop a standard that results in reporting that more faithfully reflects the underlying economic effects of equity-based compensation arrangements and that brings about greater comparability of reporting in this important area. The project also provides an opportunity to achieve greater international convergence of accounting standards, an objective we have been encouraged to pursue by the Sarbanes-Oxley Act, the US Securities and Exchange Commission, and many other parties.

On March 31st 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. That 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 over 300 comment letters and over 130 unsolicited 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.

Based on our extensive public due process to-date, the Board believes that the proposal would significantly improve the financial reporting for equity-based compensation arrangements. We believe that by creating greater transparency, completeness, and a more level playing field in the accounting for different forms of equity-based compensation, the proposal would enhance the comparability of reported results between enterprises that choose to compensate their employees in different ways. The proposal would achieve that through a number of provisions, including by eliminating the existing exception for fixed plan employee stock options, which, as indicated earlier, are the only form of equity-based compensation that is not currently required to be reported as an expense in the financial statements. The proposal also includes provisions that we believe would improve the transparency of the effects of equity-based compensation on reported cash flows.

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, profitability, and other key financial metrics. Thus, under the current 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 enterprises 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 between our standards and international accounting standards that will, beginning next year, be followed by enterprises, including

many small and nonpublic enterprises, 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 on this topic, and decided to mandate expensing of employee stock options beginning in January of this year. I understand that implementation of their new standard 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 can enhance 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 economy.

With regard to potential economic consequences of our proposal, many economic experts that have reviewed the issue of the accounting for employee stock options, including Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul A. Volcker, Nobel Prize winning economists Robert C. Merton and Joseph E. Stiglitz, and groups like the Financial Economist Roundtable, the Republican Staff of the Joint Economic Committee of the US Congress, the Conference Board Commission on Public Trust and Private Enterprise (co-chaired by Peter G. Petersen and Secretary John W. Snow), major investment banks, and the Congressional Budget Office, all have indicated support for the mandatory expensing of all employee stock options. Indeed many of those experts have also indicated that mandatory expensing could have positive economic consequences because of the improvements in capital allocation that would result from eliminating the exception from expense recognition for fixed plan employee stock options, and, thus, having more credible, comparable, and transparent financial information.

I also would note that some of those experts and many compensation experts have indicated that the expensing of all employee stock options would result in a more accurate and meaningful assessment by employers of the true costs and benefits of the many available forms of equity-based compensation, thereby leading to sounder and more creative compensation approaches.

I would now like to hand over to George who will discuss the several special provisions contained in our proposal relating to small businesses, as well as other matters relating to our continuing work and due process on this important topic.

Thank you, Bob—and good afternoon everyone.

Before I outline the special small business provisions contained in our proposal to improve the accounting for equity-based compensation, I would first like to provide some brief background on small businesses and financial accounting and reporting standards.

First, there is no federal law requiring nonpublic enterprises to use FASB standards. Thus, for most small businesses, the use of our standards is primarily a private choice. For some small businesses, that choice may be influenced by whether they have plans to become a public enterprise.

For other small businesses, the decision to follow FASB standards may be influenced or controlled by their current or potential lenders, suppliers, other contracting parties, or State regulators. To the extent that one of those parties requires that the financial reports of a small business comply with our standards, that requirement presumably reflects that party's opinion that our standards result in better, more transparent, information for their respective purposes.

Second, it is also important to note that the FASB has long recognized as part of our public due process procedures that the costs of complying with our standards can fall disproportionately on small businesses. In recognition of that fact, the Board actively solicits and carefully considers requests from users, auditors, and preparers of the financial reports of small businesses to provide for special provisions to alleviate the costs of implementing our standards. Those requests come from our continuous and ongoing due process and deliberations throughout the life of a project.

In following our project on equity-based compensation, all interested parties, including large and small businesses, can take advantage of our free weekly Action Alert e-mail subscription, which discusses current agenda items and past Board decisions. Interested parties also can attend our open Board meetings, call in, or listen to our free web cast of our meetings on the day of the meeting, with replays of our meetings available for one week thereafter. Our meetings get extensive news coverage by the top news agencies, and our free website includes an up-to-date summary of all equity-based compensation issues discussed and our tentative decisions.

We actively seek input from various State CPA societies whose membership, in turn, briefs their clients, in many cases small businesses, on the status of this and other Board activities. In addition, liaison meetings with various groups having small business representation, and Board member and staff speaking engagements

provide additional means of receiving valuable input from the small business community.

With respect to this proposal, it is our understanding that although the use of employee stock options is prevalent at some small businesses, particularly start-ups and venture capital backed enterprises that plan to become public enterprises, the vast majority of small businesses in the US do not grant employee stock options. As indicated earlier, however, for those small businesses that are affected by our proposal, the proposal includes several special provisions intended to alleviate the costs of implementing the proposed requirements.

First, the proposal includes a special provision that would permit most small businesses (including all that are nonpublic enterprises) to measure compensation cost using a simpler, less costly “intrinsic value method,” rather than the fair-value-based method that would be required for most public enterprises. Under the intrinsic value method, the amount of compensation expense required to be reported would generally be equivalent to the amount of the income tax deduction for stock options.

Second, the proposal includes a special provision that provides that most small businesses that are nonpublic enterprises would have a simpler, less costly “prospective” transition to the proposed new requirements.

Finally, the proposal includes a special provision that provides that the effective date of the proposed standard for nonpublic enterprises would be delayed for one year until 2006.

I also would like to note that the proposal includes a Notice for Recipients (“Notice”) that highlights and describes these special provisions. The Notice requests that respondents to the proposal indicate what other special provisions for small businesses might be appropriate and whether any or all such special provisions should also be extended to public enterprises that are small business issuers under the federal securities laws. The Notice also highlights and describes 19 other key aspects of the proposal, including the proposed mandatory recognition of compensation cost, valuation methods and guidance, measurement attribute and measurement date, employee stock purchase plans, attribution of compensation cost, modifications and settlements, disclosures, transition, cash flows, and the overall understandability of the proposal.

The Board currently plans to discuss the proposal’s special provisions and other issues about the proposal with representatives of small businesses at the inaugural public meeting of our Small Business Advisory Committee on May 11. Our request for agenda items for this meeting showed interest in the proposal. We also plan to hold public roundtable meetings with valuation and compensation experts,

and users, auditors, and preparers of financial reports in June to discuss a broad range of issues about the proposal.

Following the end of the proposal's comment period in June, the Board plans to redeliberate, at public meetings, issues raised in response to the proposal. Those redeliberations will include careful consideration of the ongoing input received from all parties, including ongoing input from the members of the Small Business Advisory Committee.

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.

On behalf of myself and Bob, I would again like to express our appreciation for inviting us to participate in this hearing. All of the information we obtain in connection with this hearing will be carefully considered.

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 continue to actively reach out and solicit input in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner. Our ultimate goal is to develop 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.

Thank you again, Chairman Baker. Bob and I would welcome the opportunity to respond to any questions.