Testimony of
Robert H. Herz
Chairman
and
George J. Batavick
Board Member
Financial Accounting Standards Board
before the
Committee on Small Business and Entrepreneurship
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Prepared Statement

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Chair Snowe, Ranking Member Kerry, and Members of the Committee:

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 newly established Small Business Advisory Committee ("Committee"). The idea for the Committee originated with Senator Enzi at a hearing he chaired late last year.

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.

The Board recognizes the importance of small businesses to job creation, entrepreneurialism, and our nation's economy. Accordingly, the Board also recognizes the need to carefully evaluate whether our proposed improvements to financial reporting not only are conceptually sound and meet the needs of the users of those reports, but also whether the proposed improvements can be implemented by small businesses in a cost effective manner.

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.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002, is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report transparent and credible information about their activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises.

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. 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.

Our due process procedures include active participation by users, auditors, and preparers of the financial reports of small businesses. The recent formation of the FASB Small Business Advisory Committee is intended to further enhance that participation.

The Board makes final decisions only after carefully considering and analyzing the input of all interested parties. The Board must 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.

On March 31st of this year, the Board issued a proposal for public comment to improve the accounting for equity-based compensation. That proposal is the result of an extensive public due process that began in November 2002. That process included the issuance of a preliminary document for public comment, the review of over 300 comment letters and over 130 unsolicited letters, 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 all interested parties.

The Board believes the proposal will significantly improve the financial reporting for equity-based compensation transactions in many ways, including eliminating the existing exception for so-called fixed plan employee stock options, which are the only form of equity-based compensation that is not currently required to be reported as an expense in financial statements. 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 ignores the economic substance of those transactions.

The proposal also will provide greater comparability between enterprises that compensate their employees in different ways and, in the public company arena, between the nearly 500 enterprises that have voluntarily chosen to account for the cost of all of their employee stock options and the many others that have elected not to do so.

Finally, the proposal has the secondary, but important, benefit of achieving greater international comparability in the area of accounting for equity-based compensation. In that regard, our international counterpart, the International Accounting Standards Board ("IASB"), issued a final standard in February of this year requiring the expensing of all equity-based compensation. The IASB standard will be followed by enterprises in over 90 countries beginning next year.

The proposal includes several special provisions relating to small businesses. George will briefly discuss those provisions and other small business issues.

Chair Snowe, Ranking Member Kerry, and Members of the Committee:

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, since public enterprises are required to comply with our standards under the federal securities laws.

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 than the use of other existing comprehensive bases of accounting, such as tax basis, cash basis, or regulatory reporting.

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 defer effective dates, provide for differential disclosures, or provide other special provisions to alleviate the costs of implementing our standards.

With respect to our proposal to improve the accounting for equity-based compensation, 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 impacted 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 compensation cost for any reporting period would be measured based on the difference between any excess of the fair value of the enterprise's stock and the exercise price of the employee stock options granted with final measurement of compensation cost at the settlement date. The total amount of compensation expense required to be reported under that method 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, as compared to the proposed effective date of 2005 for public enterprises.

I also would like to note that the proposal includes a Notice for Recipients ("Notice") that highlights and describes these special provisions as well as other key aspects of the proposal. 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.

I also would note, however, that we are aware of some recent surveys and other input from investors indicating strong opposition to any exemptions from our proposed requirements for start-ups and newly public companies, respectively.

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 in May. We also plan to hold several 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 address key conceptual, measurement, disclosure, and cost-benefit issues and will include careful consideration of the ongoing input received from representatives of small businesses, 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 consistent with our mission and Rules of Procedure.

In conclusion, let me assure you, Chair Snowe, Ranking Member Kerry, and Members of this Committee, that you, and the users, auditors, and preparers of small business financial reports can have confidence that the Board will continue to actively solicit input from representatives of small businesses in response to our proposal. That input will be carefully considered in an open, thorough, and objective manner that will best serve the interests of all parties and that will lead to improving the transparency and credibility of financial reports and, thus, assisting in the strengthening of the US economy.

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