A REVIEW OF FASB ACTION POST-ENRON AND WORLDCOM

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

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TUESDAY, MARCH 4, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION
Washington, DC.

The subcommittee met, pursuant to notice, at 3 p.m., in room 2123, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Bass, Ferguson, Issa, Otter, Schakowsky, Solis, Markey, Green, McCarthy, and Strickland.

Staff present: Brian McCullough, majority counsel; David Cavicke, majority counsel; Ramsen Betfarhad, majority counsel; Shannon Vildostegui, majority counsel; Will Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. This is the Subcommittee on Commerce, Trade, and Consumer Protection. Good afternoon. I would like to take this opportunity to welcome the subcommittee, my colleagues. I know there is another hearing right now. I also want to welcome our new subcommittee ranking member, Ms. Jan Schakowsky of Illinois. I look forward to working closely with her and advancing our productive agenda, bipartisan, of our committee. So I appreciate her help and her background.

It is also the first time for Mr. Herz to testify before the committee since he took the helm of the Financial Accounting Standards Board. So I want to thank him for coming, and we appreciate his insight.

What a difference a year makes. Last year at this time we held hearings in this committee directly related to the collapse of Enron. Among the most significant questions that arose were how a Fortune 100 company's true financial condition could be disguised absent a fraud.

As details of the Enron case surfaced, it was clear that Enron did not consolidate many of its financial obligations, often losing the company millions that it had in partnerships and other entities.

While Enron's use of the special purpose entity was intended to remove debt from the books of the parent company, thus presenting a healthier financial picture, we learned that certain accounting standards permitted many of Enron's activities.

Foremost among those was the standard for consolidation of special purpose entities. The standard permitted that the parent keep the financial partnership off its books for as little as a 3 percent equity investment.

We subsequently learned that in one case, it was only because of a technical violation that Enron failed the 3 percent test and was forced to restate its financials. Still, we learned that the use of special purpose entities was widespread. And in most cases, they were being used for legitimate purposes. The fact that SPEs could be both legitimate and also abused at fantastic levels raised some very troubling questions about our entire financial accounting standard system and the standards that govern it.

As more corporate failures and scandals splashed across the headlines throughout the year 2002, the importance of transparent accounting standards became clear to everyone. FASB's mission is laudable but not enviable. It is a difficult task to develop financial accounting standards that keep pace with a rapidly changing business environment.

To its credit, the board has undertaken a number of activities in an unprecedented timeframe trying to bring greater transparency to financial reporting and ultimately restoring investor confidence in such reporting. The so-called special purpose entities standard that was abused by Enron has already been changed to reflect true economic risk. Additionally, FASB has addressed the issue of accounting for and disclosing of guarantees and issued new requirements for energy trading contracts.

Among the changes FASB has given itself; more specifically, its administration and processes, a tune-up, so to speak. They have instituted some key operational changes to improve the efficiency and timeliness of issuing standards. This is a welcome change that has already produced results.

Additionally, while FASB should be praised for historically having an open and inclusive process, it has taken an additional and indeed very significant step toward both improving its process and product, the formation of the user advisory council.

This council was formed to receive input from the user community; that is, those in the investment community, including pension funds, mutual funds, and independent analysts that use the financial reporting.

I understand they held their first meeting last month. And I, of course, am anxious with my colleagues to hear more about the council. Although specific standards were often the topic of discussion, they highlighted the fact that our accounting system is based on very detailed standards where exceptions to the standards can be more detailed than even the standards.

By comparison, the European system and specifically the British model rely more on general accounting principles than individual standards. This, in turn, requires auditors to make learned judgments that must be justified.

I think that there is some learning to be had for us from a principle-based system. In fact, I included a provision in legislation that I authored last year, H.R. 5058, and that this subcommittee approved requiring committees to issue financial statements based on three fundamental principles. I am, therefore, pleased to see that FASB has already issued a proposal for comment on the topic of principle-based accounting and conducted a roundtable discussion to begin the dialog on a very complex issue. This subcommittee was one of the leaders in pushing principle-based accounting in our legislation, H.R. 5058, and I am glad to see that FASB is at least starting a roundtable discussion.

While it may seem less important, the FASB has entered into a memorandum of understanding with the International Accounting Standards Board on the goal of convergence of financial accounting standards as the European Commission is pressing hard to have all 7,000 public companies in the EU member states adhere to the international accounting standards by 2005. The issue of convergence or harmonization of accounting standards will in my opinion be the most critical issue facing FASB in a year or 2.

In theory, I am hopeful that in harmonizing, the benefits of each accounting system will prevail. However, I cannot dismiss the notion that we may be sacrificing some of our autonomy in the process. I am also concerned as to how the convergence will affect our companies. We need to be careful so that financial accounting standards do not become yet another set of pawns being played for sake of gaining an advantage in international trade and competitiveness.

Although this is the first hearing on accounting standards this Congress, I can assure you it will not be our last. Unfortunately, as our recent financial history was somewhat defined by corporate collapses of historic proportions, we all now realize how vitally important it is to maintain high-quality and effective financial accounting standards.

Again, Mr. Herz, I want to thank you very much for your attendance today. And, with that, I welcome the opening statement of our ranking member.

Ms. SCHAKOWSKY. Thank you, Chairman Stearns. I appreciate your convening this hearing today. This is my first hearing since becoming the ranking member of this very important subcommittee. And I am honored to be here. I look forward to working with you and all of the members on both sides of the aisle to protect the rights of consumers.

I want to thank the Financial Accounting Standards Board, FASB, Chairman Herz for appearing before this committee today and for taking the time before this hearing to come and meet with me, as I know you have with many of the stakeholders that are involved in this issue. I appreciate that kind of diligent, good outreach.

Today's hearing will give us an opportunity to aid FASB's efforts, to improve our accounting standards and strengthen corporate accountability. Restoring credibility in accounting is extremely important to our economy. We need to restore investor confidence in our financial markets to create jobs and help our struggling economy.

Since January 2001, we have lost 2 million private sector jobs. Corporate greed and fraud have had a terrible impact on our economy. CEOs at firms under investigation by Federal regulators and law enforcement agencies have pocketed $1.4 billion in the last 3 years. During the first 7 months of 2002, the value of shares at these firms plunged by $530 billion. And we can't let history repeat itself.

After initial resistance by the Bush administration and the House leadership, Congress finally acted by passing the Sarbanes-Oxley Act. At the time I was a member of the Financial Services Committee. So I am very familiar with this legislation.

Sarbanes-Oxley represents a positive first step, but it will not make a real impact unless it is vigorously implemented and corporate criminals are aggressively prosecuted. To date, neither has happened. Here we are over 5 months later, and corporate criminals remain free while workers and investors are paying the price of Ken Lay's and other corporate executives' misdeeds. The SEC has yet to implement many reforms. And the public accounting office board is still not up and running. Today we will focus on FASB's role in reforming the accounting industry.

Mr. Chairman, I thank you for holding this hearing because we need to make the private sector and Federal regulators implement reforms. This is an urgent situation. FASB has an important role to play in this process.

I look forward to hearing from Chairman Herz. In his short term at FASB, the chairman has taken action to help close loopholes that have allowed corporations to deceive investors by creating special purpose entities, or SPEs.

Enron's insiders used SPEs to hide debt and to deceive workers and investors. FASB has changed the rules for accounting of SPEs. In order for a corporation to create an SPE, the parent company must own no more than 90 percent of the SPE. And they must pass a seven-factor test. In the past, it was a 97 percent threshold. I look forward to learning more about this new standard.

FASB is also wrestling with the question of whether or not to expense stock options. I want to go on record as strongly supporting expensing stock options. And I recently wrote to you with several of my colleagues to encourage FASB, to take action to expense stock options.

Mr. Chairman, I would like to submit that letter for the record.

Mr. STEARNS. By unanimous consent, so ordered.

[The letter offered by Hon. Jan Schakowsky appears at the end of the hearing.]

Ms. SCHAKOWSKY. Opponents of expensing stock options contend expensing would lead to the elimination of stock option plans for rank and file workers. However, according to the U.S. Bureau of Labor Statistics, in 2001 only 1.7 percent of non-executives received stock options.

Federal Reserve Chairman Alan Greenspan and corporations such as Coca-Cola, Gnarl Motors, Boeing, Home Depot are among the over 120 companies that expense stock options. We should make sure that all corporations play by the same set of rules. This will help investors get a more accurate picture of their investments and will help prevent future Enrons.

The Sarbanes-Oxley mandated FASB to collect user fees. I understand that the fee mechanism has not yet been implemented. This could lead to a funding crisis later this year. I am eager to hear Chairman Herz's assessment of when he expects this new system to be in place.

I know FASB is working to improve international accounting standards, the accounting treatment of loans, as well as many other very important initiatives. I look forward to learning more about FASB's progress on all of these issues.

Finally, in the past, Congress has too often weighed in at the behest of powerful special interests to block reforms. I hope members will learn from the past and will allow FASB to do its job. I look forward to hearing Chairman Herz's testimony.

Thank you very much, Mr. Chairman.

Mr. STEARNS. I thank my colleague.

And now the gentleman from Idaho, Mr. Otter.

Mr. OTTER. I have nothing.

Mr. STEARNS. Okay. Mr. Shimkus.

Mr. SHIMKUS. Mr. Chairman, is that 5 plus 3 minute rule in effect here?

Mr. STEARNS. We are very flexible.

Mr. SHIMKUS. I was a few minutes late.

Mr. STEARNS. You can have 3 to 5 on your opening statement. And we are going to go around.

Mr. SHIMKUS. I think I will defer, Mr. Chairman, and try to take a few minutes when I get a chance.

Mr. STEARNS. That would be fine. Okay.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

Thank you Chairman Stearns for holding this important hearing today.

It was this time last year that this Committee held oversight hearings on the Enron implosion and that this Subcommittee held legislative hearings on important public policy issues involving accounting standards. While our work exposing the fraud at Enron and WorldCom was big news, much of our hard work in the accounting standards area went unnoticed. These most certainly were not the sexy issues of corporate governance failures and securities fraud that dominated the headlines in 2002. Yet our discovery that some of the accounting standards, when applied improperly, were used to hide the financial condition of a company instead of reveal it was an important one. Our work here last year, and the FASB's diligent efforts since that time, will lay the foundation for reliable and transparent disclosure in the years to come.

The FASB has been busy over the last year. One of the most significant changes FASB made was not to the standards themselves but to its own rules of procedure. FASB instituted new rules for its voting process, changing the unwieldy supermajority voting mechanism to a simple majority vote. This is in no small part responsible for the quantity of issues FASB has begun to tackle in the past year. And, I might add, the quality of work at the FASB has still been first rate. Those projects include completed work on off balance sheet accounting for special purpose entities as well as various proposals for comments on principle-based accounting; the IASB's proposal for expensing of stock options; and a myriad of revenue recognition issues.

The FASB Act, sponsored by Mr. Stearns and passed out of this Subcommittee last Congress required FASB to resolve these issues. I applaud the FASB for quickly adding these issues to its agenda, and obviating the need for legislative direction.

The FASB has not yet, however, added the issue of accounting treatment for loan commitments to its agenda. Since companies generally invoke their commitments when they are on the brink of filing Chapter 11, these loan commitments leave lenders, and ultimately shareholders, exposed. Current accounting rules do not require loan commitments to be carried at fair value. As a result, shareholders have no means of determining the extent of the lender's exposure to rapidly deteriorating companies. For this reason, I urge FASB to add this important issue to its agenda.

Finally, I want to call on the Securities and Exchange Commission to recognize FASB standards as "generally accepted" for purposes of the securities laws and thereby provide FASB with the funds necessary for it to carry out its mandate. I encourage Chairman Donaldson to move expeditiously so that the FASB can continue to do its important work.

I thank Chairman Herz for being here today and look forward to his testimony. I yield back the balance of my time.

PREPARED STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Good afternoon. I would like to thank Chairman Stearns for having this hearing on the state of accounting regulations in the aftermath of the corporate collapses that devastated communities across the country over the last couple of years.

I am very interested in what Mr. Herz, the Chairman of the Financial Accounting Standards Board has to tell us about all his activities in his new post of critical importance to America's life savings.

My primary concern with the state of the accounting industry is the lack of auditor independence.

How can individuals and pension funds trust accountants who are auditing the books for minor fees, while at the same time pulling down millions and millions over many years in lucrative tax, management, and information technology (IT) consulting from the same companies?

FASB does not regulate this, but Congress does, and we urgently need FASB's professional opinion on this issue. It is now accepted that aggressive accounting has become a way for the Big Four accounting firms to compete with each other for access to the consulting businesses.

Unfortunately the questionable practice of accounting firms selling tax advice has been allowed to continue under Sarbanes-Oxley. Accounting companies in America, the defenders of the public's right to know how their money is being spent by these companies, are simultaneously competing with each other on who can have the most aggressive accounting and tax treatments.

The result is the fleecing of American investors and American taxpayers. They are getting us coming and going.

FASB is the ultimate expert in America on issues of accounting, and I would like to know whether they, as accounting regulatory professionals, believe it is possible for quality audits to be performed by the same people shopping tax avoidance schemes.

The most important issue that I believe is before the FASB for decision making right now is what is known in the industry as "special purpose entities" or SPEs, but what I refer to as pure deception.

These corporate fraud vehicles are intended to conceal debt and other liabilities from the publicly available, audited balance sheets of public corporations. Millions of individual American investors and the many pension funds that hold the life savings of millions more working Americans depend absolutely on the integrity of the public financial information.

I am a little concerned that the central part of the new rule appears to be raising the minimum outside investment in a SPE from 3% to 10%. On its face, it still seems unnatural for a company to create an entity in which it has a 90% stake that is not recorded on the balance sheet. I look forward to learning from the Chairman of FASB the other specifics of the SPE rule.

Thank you Mr. Chairman, and I look forward to improving corporate governance with all the Members of this panel.

Mr. STEARNS. Well, Mr. Herz, we want to welcome you, Chairman of the Financial Accounting Standards Board. And we look forward to your testimony and some of the things you have been doing. So the floor is all yours.

STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you, Chairman Stearns, Ranking Member Schakowsky, and members of the subcommittee. I thank you for the invitation to appear today to review with you the actions and activities of the Financial Accounting Standards Board since the bankruptcies of Enron and Worldcom.

I have some 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.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. HERZ. As you know, the FASB is an independent private sector organization. We are not part of the Federal Government. And 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.

Also, the FASB has no power to enforce its standards. Rather, 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.

Clearly the events of the past year have shaken confidence in our reporting system and in our capital markets. While I think 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 the accounting standard-setting process.

I think those questions are appropriate. I think they are healthy. 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, therefore, to our society as a whole. It matters.

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

First, on the technical front, we have significantly modified our agenda and priorities in direct response to issues that have come to light in the many scandals. These issues include the accounting for special purpose entities, accounting for guarantees, energy trading contracts, stock-based compensation, and the very broad area of revenue recognition. Let me briefly touch on each of those items and what we have been doing.

First, with respect to SPEs, as you mentioned, 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 would be 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 are currently not reported by any enterprise would so be 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 for 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 that the new requirements will result in a more representationally faithful depiction of an enterprise's obligations.

In October 2002, our Emerging Issues Task Force, known as 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 the financial reports.

At the same time, the FASB staff observed that no enterprise should recognize an up-front gain at the inception of entering into certain financial contracts unless the fair value of those contracts is 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.

In December 2002, we issued new requirements relating to the accounting for stock-based compensation in order to deal with the more than—it is now about 180 enterprises that have voluntarily said they would change to the preferable fair value approach for expensing of stock-based compensation. Those requirements address how the companies make that switch.

Moreover, the new requirements also provide for clearer and more prominent disclosures about the costs of stock-based compensation. They also 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 was issued to explain the similarities and differences between the recent proposed requirements by our international counterpart, the International Accounting Standards Board, and the preferable fair value approach under existing U.S. standards.

We have been carefully reviewing the input received on that document and other input we have been receiving from investors, analysts, enterprises, and 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 to stock options. 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.

As a longer-term solution to the many issues surrounding the accounting for revenue recognition, we also added a major project to the FASB's agenda addressing this whole area. The objective is to develop jointly with the international board 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.

Now let me turn to our own operations and some comments about the structure and direction of accounting standard setting in this country.

Last year when I joined, we launched a series of wide-ranging reviews covering a broad range of issues. Some of the key aspects of our reviews 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 principles-based accounting and international convergence and how all of these things impact the structure and direction of U.S. accounting standard setting.

With respect to improving our own 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 the previous 5 to 2 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 are also conducting a thorough process of mapping 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. The council 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 our agenda and on specific issues within ongoing projects.

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

In coming weeks, we expect to discuss at public board meetings the input received we have received on that. And we plan to continue to work closely with the SEC as it responds to the principles-based study requirements contained in the Sarbanes-Oxley Act.

We also have, as you mentioned, been devoting significant resources to the area of international convergence. We are working together on several major projects.

We also, as you noted, reached a historic agreement with the international board to use our best efforts to align our agendas and, very importantly, 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 U.S. and international standards. Because there are literally hundreds of differences between U.S. 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 so that we can make real progress.

Finally, with respect to structural improvements to U.S. standard setting, we have made recent changes that we believe are necessary to better control the proliferation and consistency of U.S. accounting standards. 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 U.S. would after a transition period of approximately 1 year be discontinued.

Second, we decided that with regard to our own EITF, we needed to take more involvement in the agenda deliberations and ultimate decisions of that group.

This has been a brief summary of some of our many actions and activities at the FASB. These actions and activities are designed to better meet the challenges and opportunities that face us and that I believe face the financial reporting system. I hope you will agree that it is not business as usual for us.

I believe 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 members of the subcommittee. I appreciate your continued interest in support of our mission and our activities. And I would be happy to respond to any questions you may have.

[The prepared statement of Robert H. Herz follows:]

PREPARED STATEMENT OF ROBERT H. HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

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.

Mr. STEARNS. I thank the chairman.

Just for the members' record, if you were here when the gavel came down and you did not have an opening statement, you're passing on your opening statement, you will get 8 minutes for questions. Otherwise, everyone gets five. And so we will proceed under that basis. And I will start.

Mr. Herz, I heard all the things you did. Could you say today that what you did with special purpose entities, if that had been in place, we would not have had an Enron perhaps?

Mr. HERZ. Well, we would have had rules that would not have allowed off balance sheet financing of some of the things that Enron did. Whether or not the company and the auditors would have acted as they did is another matter, I believe, but we would have had rules that would have caught the type of transactions, at least in theory, you know, the rules——

Mr. STEARNS. So the transaction that supposedly Jeff Skilling said he didn't know about but went forward could not have gone forward under this scenario that you just——

Mr. HERZ. It would have been counter to the new rules.

Mr. STEARNS. So, instead of getting a 3 percent equity, they would have to get a 10 percent equity.

Mr. HERZ. Well, probably even more. I mean, the way the standard is——

Mr. STEARNS. What you might do is just briefly tell us in reference to maybe an Enron what they would have to do under this scenario that you have outlined so a layman could understand it.

Mr. HERZ. Yes. I will try as best I can after 30 years in accounting.

The old rules, as you mentioned, allowed——

Mr. STEARNS. And I might point out FASB took 25 years to study the SPEs and came up with no clear conclusion. And you have been in office 3 or 4 months, and you have already made some major direction.

Mr. HERZ. Thank you. I attribute that not only to me but to all my board members and our staff.

Mr. STEARNS. Well, it shows you did. The urgency was there once we saw how easy it was to develop special purpose entities.

Mr. HERZ. Yes. The old rules, as you referred to, which, by the way, the FASB did not actually write, if you can believe it, they were contained in a question and answer by an SEC staff question and answer that was appended to an EITF issue on what were called build-to-suit leases, a very specific transaction, but somehow that answer using the 3 percent as an example kind of got canonized in practice. And people then used it to develop a whole industry, so to speak, of off balance sheet financing using special purpose entities.

That rule basically, as you outlined it correctly, was that as long as somebody put up at least 3 percent, an independent party, 3 percent of the total capitalization, meaning both debt and equity, of an entity, the assets and borrowings could be kept off the balance sheet and that entity would be treated as if it were an independent party. So you could deal back and forth with that entity as if you were doing it with General Motors.

Mr. STEARNS. You could hide lots of debt.

Mr. HERZ. Yes. That really was manifested from the normal consolidation rule that said that if somebody held the majority of the voting equity, that party would consolidate, even though that equity might be extremely thin and that vote may have really no effect because the entity was largely on autopilot. Its actions were predetermined.

Mr. STEARNS. So tell me now how under the new rules what the new rules would do to make——

Mr. HERZ. Well, if the new rules first make a cut as to whether one would use the old voting interest model for a normal operating subsidiary, if you owned the majority of the voting stock, you would consolidate, but what it looks at is whether or not that entity is properly capitalized and whether the people who have the vote have a meaningful vote if the entity is a real operating entity. That requires, among other things, kind of a presumption that there has to be at least 10 percent of capital to run that entity self-sustained.

Mr. STEARNS. Independent of the corporation?

Mr. HERZ. Independent of the corporation. And then if you fail that, you then go into this realm of SPEs. The notion there is that——

Mr. STEARNS. How could you do an SPE if you failed that?

Mr. HERZ. Well, you now say you are in a different model. You are in a model that looks at risks and rewards, rather than——

Mr. STEARNS. It's no longer an SPE?

Mr. HERZ. No, no. You are an SPE.

Mr. STEARNS. But it's a different model of an SPE?

Mr. HERZ. No, no. It's a different model for consolidation.

Mr. STEARNS. Oh, okay.

Mr. HERZ. The normal model for consolidation is still if you own an operating subsidiary and you own 51 percent of the stock and you control it or you have 100 percent of the stock and it's a properly capitalized entity, it's self-sustaining, you would continue to use the normal what we call voting interest or control model.

The problem with SPEs was that they didn't suit that model. They were thinly capitalized. The votes may have meant nothing. And so we first have to filter to determine whether or not you go into this alternative model, which is more of a risks and rewards kind of model.

When you go in there, basically the principle is you look for whoever has the majority of risks and rewards, no matter how it is derived. It could be derived from the thin equity, but it might be more often derived from various other forms of interests and arrangements in that entity.

So, for example, in the Enron-type arrangements, where basically they would have 100 percent of the up side and 97-plus percent of the down side, even though somebody else might have put up a thin amount of the actual equity, you would say, "Well, I know who has the majority of the risks and the rewards. It's not the person who owns that nominal amount of equity. It's somebody else." And you would look for that party looking for all of the arrangements. In the Enron situations, it would have been clear.

Mr. STEARNS. I can't say after listening to your explanation that I am 100 percent confident that we could stop Enrons. I mean, that is just my first observation, especially when you say you don't have the power to enforce your standards. So someone else has to enforce your standards once you come up with this new—and I assume that would be the SEC.

Mr. HERZ. At the first line of enforcement are the company accountants, then the auditors, and ultimately the SEC.

Mr. STEARNS. The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman.

Welcome. God bless you. God bless America. And we are going to need a little help in this area and all of the people who work with you.

How confident are you that the loopholes exploited by some of the accounting professionals working at Enron and WorldCom have been closed?

Mr. HERZ. Again, I think I would like to kind of give you total assurance in that regard, but that is beyond our role. We write accounting and reporting standards. And we have written standards to close——

Mr. MARKEY. Do you feel that you have closed the loopholes?

Mr. HERZ. We believe we have closed——

Mr. MARKEY. And now it's an enforcement issue? Do you think all of the loopholes are closed?

Mr. HERZ. Then it becomes an application and enforcement issue.

Mr. MARKEY. So you don't think there are any more loopholes?

Mr. HERZ. You know, in an area where there is endless structuring, there are people who still spend most of their time trying to find ways around whatever we do. I will never say, "Never."

Mr. MARKEY. How can you in the future prevent the same type of bootstrap argument by the issuers and the accounting profession that you just described to the chairman of the committee where a 3 percent equity interest test developed in some real estate leases was transformed into the Enron SPE, special purpose entity, loophole?

Mr. HERZ. Well, I think we need to do our best in order to identify all of those areas where you would look at it and say the current accounting rules don't reflect the kind of economics or common sense.

Mr. MARKEY. I guess what I am asking is, is it something that you've looked at in the past that allowed for that transformation, that in all subsequent regulations, you are going to ensure that you protect against occurring?

Mr. HERZ. I would say that we are trying to identify through looking at reports, through discussion with the SEC, through discussion with many groups, through discussion with our new User Advisory Council all of those areas where accounting doesn't seem to suit the underlying economics. Those are the kind of areas where I think the exploitation occurs.

People say like the 3 percent rule, maybe other areas, like leasing, that still exist. They say, "Gee, this is an opportunity to achieve an accounting result," favorable accounting result, that doesn't match what is really going on.

Mr. MARKEY. So what are accounting issues, then, other than the ones that you have noted in your testimony?

Mr. HERZ. Well, these are only my personal opinion. I am one of seven board members. So it's, again, my personal opinion. I have a few——

Mr. MARKEY. Well, you are like the chairman of the committee. My personal opinion doesn't count as much as the chairman's personal opinion counts.

Mr. HERZ. Right.

Mr. MARKEY. And the same thing is true, I assume, at FASB.

Mr. HERZ. No, no. One member, one vote. And I have administrative responsibilities, but all seven members vote on our agenda and all seven members have one vote on all technical issues.

That is important because we have a very deliberative process.

Mr. MARKEY. Well, you know what would be important, Mr. Chairman, I think at some point in the future, have all seven of them sit here. Then we can ask each one of them if they agree with the chairman so that we can see the difficulty that he has in actually implementing the philosophy which he is enunciating today.

Mr. STEARNS. Yes. I think my colleague has got a good point. We intend to have more hearings on this because it is obviously a little complicated and we would like to see the ongoing work that they are doing.

Mr. MARKEY. I think what he is telling us is that he is constrained. Shakespeare used to say that the will is infinite, but the execution is confined. What he is saying here is that he has the will to do it, but his execution is confined in getting the——

Mr. STEARNS. When he was smiling a lot, I think that is what he was conveying.

Mr. MARKEY. Yes, I know that.

Mr. HERZ. I would have a very efficient process if I could sit in the room and just write the rules myself, but they may not be as good, high-quality as what comes out of our seven-person process.

Mr. MARKEY. I think it is important for us to see of the seven which of them has a blind eye and see how many of them are coming into this, you know, that way. On the one hand, in the land of the blind, the one eye is king, but in an era where all investors can see quite clearly, what happened to them? And what projections have to be put on the books? They don't want any more blind-eyed regulators out there.

So it is very important, Mr. Chairman, for that to be made clear because I think you can't answer with the specificity that we need. And you are under tremendous pressure not to do the right thing, tremendous pressure. I appreciate that because the history of the agency is such that in 27 years on this committee, I know how much pressure FASB has been under. I've seen it, and I've heard it from your predecessor chairman.

I just want to make sure that we see more clearly what the pressure is on you each day. Who are the other people? What are their philosophies? Who are they responding to? Because that ultimately will determine the compromises which you have to accept that is less than what you would like to put on the books as a full guarantee. I think that is absolutely critical because we can't repeat the mistake again.

My district is a high tech district. And it's essentially seen a shambles of hundreds of companies' stocks. And it's just not something that investors or workers want to see happen again. Honesty is ultimately the long-term best strategy. And the puffing that went on is just something that can't be allowed to recur again.

Mr. HERZ. I appreciate your observations. I would note, however, that just to make sure everybody in the audience understands, all of our board members are full-time board members. They severed their prior connections. So the seven-person board is there to add quality. It comes from people with different backgrounds, different pieces of insight. Again, I wouldn't judge it as more kind of internal pressures and compromise. It's a process to build in views and qualities.

Mr. MARKEY. If I may finish up, Mr. Chairman, you see, Mark Twain used to say that history doesn't repeat itself, but it does tend to rhyme. So you kind of wind up with a similar kind of debate, a little bit different, but pretty much the same debate, different characters, and whatever. So that's where you are right now, not identical, but the same pressures are out there.

And, again, it's the same eerie situation that we have with the war in Iraq, where the price of oil is up at $40 a barrel. It could be up there for 6 months. Somebody named Bush is conducting a war. It's not identical, but it rhymes, you know, looks close.

And that is really, I have found here after 27 years, the way these issues tend to evolve. The pressures that you are under I think are probably no different than the pressures that any of your predecessors were under.

Anyway, I thank you, Mr. Chairman.

Mr. STEARNS. I thank the colleague.

Mr. Otter from Idaho, you are recognized for 8 minutes.

Mr. OTTER. Well, thank you, Mr. Chairman.

Following up on my colleague just prior to me, one of my favorite quotes is what I am afraid we are practicing here today. It comes from Matthew 15:14. That is, if the blind leadeth the blind, they will both falleth in the ditch.

I am concerned about some of your responses to previous questions. I guess I have to start out by asking, "Have you talked to the SEC about these new rules and regulations?"

Mr. HERZ. We talk to the SEC every day.

Mr. OTTER. Has the SEC agreed that these will stop the loopholes?

Mr. HERZ. They have reviewed, participated in what we do, and I think they believe that the standard we have come out with is a good, solid standard.

Mr. OTTER. And they are prepared to say that?

Mr. HERZ. Oh, yes. They have.

Mr. OTTER. They have said it?

Mr. HERZ. Yes.

Mr. OTTER. So, then, let me ask you this question, why is it ever necessary for an accounting product from a public corporation ever to reflect anything but the value? Why would an accounting product ever reflect off balance sheet loans or off balance sheet obligations?

Mr. HERZ. Well, the model you are espousing actually would have allowed Enron to continue to show things, maybe 97 percent on balance sheet, 100 percent, somewhere in that range, but the accounting rules, I said, the longstanding accounting rule before these things were engineered, was that you consolidate something based upon being able to control that. If you don't control something, at least then what you do is you show your investment in it.

Now, we have changed that with this rule to reflect what we regard as what you are saying, better economics, the risk and reward kind of model for these situations.

Mr. OTTER. And you think that that will now close all of the loopholes?

Mr. HERZ. I think it will close all the ones that we know about. I will repeat. And this may not comfort you, but there are people that spend all of their time structuring. And no matter what we do, they sit in our audience. And we believe they try and figure out ways around things that we do.

Now, we think because our rule is broad, because there are anti-abuse clauses in the way we have crafted it—and that is a little new for U.S. accounting standard-setting, that we think it will catch everything that we know about and even things that we couldn't think about.

Mr. OTTER. Let me phrase this in a different way. Walk me through the scenario, this lease scenario, that would provide a corporation to offer for public consumption a balance sheet which doesn't reflect total liabilities and total assets. Walk me through that scenario.

Mr. HERZ. That wouldn't reflect total liabilities and total assets? What is the involvement of that entity in the other entity? You would have to give me all of those facts.

Mr. OTTER. Well, you are the one who stated that the way this happened was under a lease purchase agreement. Under a lease purchase agreement, they have control of the asset——

Mr. HERZ. Yes.

Mr. OTTER. [continuing] through a lease agreement, which is once-a-year payments. So all they have to reflect, then, is "We owe you for 1 year." Is that what you are saying?

Mr. HERZ. I understand what you are saying now. That was the original derivation of the 3 percent rule, what were called these synthetic leases or build-to-suit lease transactions. In those transactions, people were allowed to basically retain 100 percent of the up side and bear 97 percent of the down side. And they didn't reflect that.

Mr. OTTER. I want to stop right there for a minute. You got me through part of the scenario. How could, then, the owner of the asset that was leasing to the other entity have any kind of a collateral balance sheet which would reflect anything more than a 1-year lease? The rest of it would be total liability not matched by the asset. Right?

Mr. HERZ. The owner, the legal owner, of the asset was not the enterprise leasing the asset or using it.

Mr. OTTER. I understand that.

Mr. HERZ. This could have been your corporate headquarters or company's corporate headquarters owned by a special purpose entity, a charity, something like that, that was owning the asset. The financing was derived by the support of the lease arrangements and by a guarantee from the corporate lessee, whose asset it really was.

You asked me, "was it a bad rule?" It was a terrible rule. We have changed it.

Mr. OTTER. Well, I guess maybe we don't have enough people watching enough people. I don't know how else you stop that.

I am going to end here, Mr. Chairman, and thank you for the time. But I would have to agree with Mr. Markey, and that is that we get all seven faces here before us, all at once, so that we can ask one a question and have the other six respond to it as well.

Mr. STEARNS. Thank the gentleman. The ranking member?

Ms. SCHAKOWSKY. Thank you, Mr. Chairman, both Messrs. Chairman.

Stock options in the past have masked or perhaps were even used to deceive investors and workers as to the true financial conditions of the company. I think Warren Buffett put it best. This is his quote, "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculations of earnings, where in the world should they go?" I wondered what your thoughts were on Mr. Buffett's rhetorical questions.

And you also mentioned that a deliberation is going to begin. I would like to know what your view is and a little bit about that deliberation, particularly its timing.

Mr. HERZ. Yes. Well, I agree with Mr. Buffett. Until I joined the FASB, I was actually a member of the International Accounting Standards Board. That board undertook starting in August 2001, put on its agenda the whole topic of what they call share-based payments or what we call stock compensation, which includes stock options and after a year of what I thought were thorough deliberations came to very similar conclusions, as the FASB had done 10 years prior to that, namely that granting a stock option is compensatory, that it should be measured at the grant date. The best way possible that people come up with are using option pricing models but making certain adjustments. So a couple of things. But, of course, as you know, the FASB was essentially thwarted by lobbying efforts and by political interference at that point in time from making that carry.

We are, as I said, committed to the idea of international convergence, but even if we weren't, it is clear from the first day I got to the FASB from the many e-mails, letters I have gotten from individual investors, from analysts, from others, that this is a topic that needs to be revisited.

So the first thing we did was to try and address the issue for the many companies that have switched as to how they make the switch to the preferable method.

The second thing we did was say, "Here is what the international fellows came up with, our colleagues. It is very similar to what the FASB concluded, but there are some important differences. What do you think about those?" We have gotten the comments in. We are summarizing them, analyzing. And probably at our board meeting next week, we will decide whether or not we put on our agenda now a formal project to say, "Let's go back and decide whether or not we should mandate expensing of options."

Assuming we put that project on our agenda,—and, again, there are seven people who vote; I certainly will vote for that—the question is, what will be the methodologies? Will it be what the FASB came up with 10 years ago and have been incorporated in footnotes for many years now? Will it be the IASB method or will it be some other method?

We have gotten a lot of suggestions in between, you know, if a way is to potentially enhance the consistency of the evaluation. We have also gotten a lot of recommendations from many people as to other forms of disclosure that might be useful. So what I anticipate is we are going to have another look at all of those and see if we can come up with what we believe is the best accounting and the best disclosure.

Ms. SCHAKOWSKY. How long will that process take assuming that it is on your agenda?

Mr. HERZ. Well, that will depend. I would like to do it as quickly as possible, but that, again, will depend. If we were just to say, "What is in the footnotes now gets moved into the financial statements," what we call the 123 method for FASB statement 123, which is what the FASB came up with a decade ago, that could be relatively quick.

On the other hand, if we say, "No. There are some real areas that we think could be improved, there are ways to maybe improve the consistency of the measurement," then that may take a little longer.

Ms. SCHAKOWSKY. I don't have much time left, but I do want to know more about what it means to harmonize the FASB and the IASB, particularly from a consumer standpoint. So while there is not much time remaining now, maybe you could help educate me about that.

Mr. HERZ. I would be happy to.

Ms. SCHAKOWSKY. Let me just ask you this, then, briefly, "How would you characterize IASB in terms of its stringency and its impact on transparency disclosure," all the things that we care about?

Mr. HERZ. Well, the IASB was set up a little bit like the FASB model. It has a group of trustees, of which Paul Volcker is the chairman, just like we have a group of trustees. The board itself is 14 members because of the need for geographic representation from various parts of the world.

Their processes are very similar to ours. I would say while they have headed more toward less detailed standards, I think their standards have become more detailed and ours a little less detailed. So I think there is also harmonization in kind of level of detailed implementation guidance in the standards. That is also important to that effort to have the rules actually look and feel the same.

Mr. STEARNS. I thank the gentlelady. The gentleman from New Hampshire, Mr. Bass.

Mr. BASS. Just a quick question, sir. Do you have jurisdiction over the issue of accountants performing consulting services?

Mr. HERZ. No.

Mr. BASS. Okay. I didn't think so.

I will yield back, Mr. Chairman.

Mr. STEARNS. Ms. Solis?

Ms. SOLIS. Yes. Thank you, Mr. Chairman.

I apologize for coming in late. I didn't hear all of the testimony presented, Mr. Herz, but I did have just two basic questions. My first is the issue regarding funding for the FASB by the SEC. And I am trying to understand that the SEC under the leadership of Chairman Harvey Pitt failed to take steps to fund the FASB. To me funding is crucial obviously to your organization to do its job and to fulfill its mandates and missions.

When do you expect SEC under the new chairmanship, Mr. Donaldson, to begin assessing a fee on the public companies?

Mr. HERZ. Let me, if I can, clarify that a little bit. I think you are essentially correct, but let me clarify it. Sarbanes-Oxley, what it says is that the SEC essentially should recognize us, and thereafter a fee would be levied on all public companies. That fee would be levied in the same way as the fee for the Public Company Accounting Oversight Board, the PCAOB, which, as you know, is still in the formation stages in that.

My expectation from recent conversations with Chairman Donaldson, with the other commissioners is that they are now working on the recognition quite diligently. There are documents going around in there, in-house there. So we expect that to be concluded in the not-too-distant future.

The issue then becomes the mechanics of the billing mechanism because, remember, this is going to be levied on all 15-17 thousand issuers based upon a computation. The data is being gathered by our people, by the SEC, by the PCAOB people together. It may require some SEC rulemaking.

We are eager to get that all in place because, as you said, we are well into our new fiscal year and our voluntary contributions. People know that we are now going to be getting this new mandatory funding mechanism and have said, “We wish you well.”

So getting all of that coordinated because I think the SEC is right, it has the view that if you’re sitting out there and you’re IBM, you ought to get one bill that covers both. But, of course, we are ready for them. We have been ready to go. We submitted our budget. But the PCAOB because of the gestation period of formation is still a little behind that. Getting that all together there are still some implementation issues to go.

Now, I think the good thing is that our trustees had some foresight in the past and put away a reserve fund that we are now using. I think we have enough cash to keep on going for a while, but we also have deferred some hiring. So there are certain things we would like to do that until we see the cash coming in the door, we are not going to do certain things.

Ms. SOLIS. My second question, if I might, is with the issue regarding revenue recognition. Of course, one of the issues of the accounting standards that I am most concerned about is the impediments that prevent positive changes from being made in the standards. I believe that a single standard for revenue recognition that is out there applicable to all companies would help to prevent any abuses there. So what is the status, if you can elaborate on that, on your project?

Mr. HERZ. Yes. As I mentioned in my opening statement, we have put a major project on our agenda and have started it to try and do exactly what you say because the existing rules on revenue recognition which are voluminous but are contained by our count in over 140 different standards, rules, regulations, pronouncements by various groups over a 40-year period, they do have inconsistent rules, they have contradictory rules, there are things that are hard to understand. And so we think we need to build a better conceptually, consistent, coherent model or models on this topic.

Because of the breadth of this subject, it affects almost every company. A couple or 3 or 4 years ago, maybe it wasn’t every company that had revenues, but nowadays I guess it’s just about everyone, various industries, all sorts of different transactions. The task is daunting for us to come up with something that would meet the needs of investors and other users because it could represent a big change that would be operational, could be implemented by companies, all of that. So we need to carefully not only develop the method but check it out very carefully.

Ms. SOLIS. Do you expect any major opposition?

Mr. HERZ. People don't like change.
Ms. SOLIS. Then how do we——
Mr. HERZ. I have already learned that. But we are in the change business. We are going to do what we think is right. We need the input, and we need to test. It is very important to us that something we develop is actually useful. It is also important to us that it can be actually put into practice in a faithful way and can be done in a cost-effective way.
So we need to check all of those things out, but I personally—you know, the fact that people oppose things, if they oppose them on good, sound grounds, good, sound arguments related to the accounting, to the usefulness, things like that, listen but not if they oppose it because they don't want change or because it might have detrimental economic effects to their particular interests.
Ms. SOLIS. Thank you very much. Thank you, Mr. Chairman.
Mr. STEARNS. Thank the gentlelady. Mr. Issa?
Mr. ISSA. Thank you, Mr. Chairman.
Mr. Herz, let me start off with a broad question. Would it be fair to say that your goal and that of your six colleagues should be to have the information that the CEO gets, the information that the board of directors gets, the information stockholders have available to them, and the information the IRS acts upon for purposes of taxation? In a perfect world, this should be the same information.
Mr. HERZ. You got there until you went to taxing. Okay?
Mr. ISSA. At the present time—and I asked it deliberately for a reason. The first three if you like.
Mr. HERZ. The first three I like provided that it is also that information is really—let me say I don't want to sound pejorative at all, but one of the things that I have found—and maybe it is a sign of the times—is that the needs and views of investors and analysts and people who run the money is often very different as to what is useful from the views of the people running the companies.
Ideally it should be the same. I agree with you. But it isn't.
Mr. ISSA. Let me rephrase the question. I will break it down a little bit. When it comes to whether or not an asset is an asset, a liability is a liability, and profit is profit or losses are losses, would you say that as to the state to the balance sheet and the state of the real profit, that the information should be transparent, that that information should always be the same dollars and cents?
Mr. HERZ. I believe so, yes.
Mr. ISSA. And then you took exception to the word "tax."
Mr. HERZ. Right.
Mr. ISSA. Are you of the opinion that it is reasonable and fair to state profits or lack thereof for purposes of generally accepted and FASB accounting differently than you do for taxes, that two sets of books are reasonable to maintain in that case?
Mr. HERZ. Well, this is not my area of expertise. Fiscal policy, including taxes, are for you to decide, but I know that the taxes are used to raise revenues, are used to produce certain stimulus, things like that now——
Mr. ISSA. I am thrilled to have you in front of me so I can ask the question to make exactly that point.
Mr. HERZ. I don't know enough to judge whether I can have a substantive view on that.

Mr. ISSA. Well, since you have had 30 years of accounting, would it be correct to say that today for purposes of profit, we tend to have greater profits for tax purposes? I will assume that it is because Congress wants the money but that, in fact, we take different amounts for tax purposes than we show on compliant information given to stockholders.

Mr. HERZ. I don't know whether it is greater or less. I have seen some reports recently that say the amount of taxable profit is generally less.

Mr. ISSA. I guess it all depends on your business. Certainly you are trying to make your taxable profit less while the government perhaps, as you alluded to, is trying to make it more.

Do you have an opinion, forgetting about what is our job, that it would be better if there were one system?

Mr. HERZ. Well, I believe that we try in what we do to mirror what we believe are economics, what we believe is proper accounting. So if you want to say that things are going to get taxed on that basis, understanding that that is the way we develop our rules, I wouldn't personally object to that. I don't know whether it would satisfy all the other objectives of taxation.

Mr. ISSA. I am going to go out on a limb and say this in the form of a question but probably a little bit of a statement at the same time. Since it appears as though the Federal Government and our insistence as legislators allows a system that says tell your stockholders you're making a profit when, in fact, you tell the IRS you're not or tell your stockholders you're not making a profit while you are paying taxes on a profit that you've told your stockholders you didn't make, wouldn't you say that that is, in fact, the first step to telling corporate America that two sets of books are okay as long as you're compliant with a set of rules, even if the fact that that occurs means one of those books is cooked? And we'll use the word "cooked" in a broad and only slightly pejorative way.

Mr. HERZ. I don't think I can respond to that, as I say, in this without knowing enough about—I am not an expert in either the tax code or the motivations behind specific provisions in the tax code to judge as to whether it is cooked or not. Regulators also have different systems, and they are done for safety and soundness. So if your purpose is a little bit different, the way you do things can be a little different.

Now, we happen to think that our objective is to design good information for investors, creditors, and other users of that financial information. It is not designed for regulatory purposes. It is not designed for tax purposes because that is not what we think about when we design the rules.

Mr. ISSA. So, if I can, Mr. Chairman, in the spirit of Mr. Markey's closing statement, it would be fair to say that, to a certain extent, each of your agencies, the IRS, FASB, et cetera, enjoys the same set of criteria as the guy who wants to hire an accountant and one says, "One and one is two," and the next one says, "No. One and one is two," and the third one says, "One and one is two," and the last guy says, "What would you like it to be?" and he gets the job.

I would propose that today our problem is that we are not looking for the consistency that true and proper statement and accounting and tax should be all the same. And I would say until we get to that point, until we get to one set of books as at we are not heading toward the type of accounting that is going to help the business world be consistent and honest and ethical, as we certainly want them to be.

I yield back the balance of my time.

Mr. STEARNS. I thank the gentleman. The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. I am going to be brief because we are going to have a vote in our Health Subcommittee downstairs.

I can understand the concern about the tax avoidance and tax schemes coming from Texas, but Enron hasn't paid Federal taxes in I don't know how many years because of some of those. So obviously they were successful.

I know in your response to Mr. Bass concerning that FASB doesn't have jurisdiction over the issue of accounting work versus consulting, in your opinion as an accountant, it just seems like, again, with examples of not just Enron but a host of other companies, that we have a conflict that maybe this Congress or the SEC ought to look at that issue and say, "You can't serve two masters," just in your professional opinion.

Mr. HERZ. Yes. And I was an accountant, an auditor, for a long time. My belief is that the master is the public, is the public interest. And that is the overriding interest. That means the ability to do excellent audits that meet the public expectation.

Now, I think in order to do those audits, you do need some tax capabilities. You do need some systems capabilities and all of that. But that is not rendered necessarily to provide the additional service. It is rendered to provide the excellent audit.

Mr. GREEN. Okay. Again, tell me—and I will use Enron because it is my hometown—the accounting firm, 27 million is consulting and 25 is auditing. Do you see that that is almost a prima facie case? In hindsight, we can say it is, that there is a conflict between having consulting and auditing with the same firm at the same company. Again, in your opinion, should we try to address it?

Mr. HERZ. First of all, I think the Sarbanes-Oxley and the SEC is addressing it. Whether you need to do more I don't know. I mean, I believe that the issue of the 25 million was probably significant also. And the question is, what was in the heads of the people who were making the bad decisions? Was it the consulting fees? Was it keeping the audit client? How were they compensated?

Learning about that is really the key to driving behavior. That could vary firm to firm. It could vary circumstance to circumstance.

Mr. GREEN. I understand that problems with Enron, like a lot of companies, it just was not the conflict between the consulting and the auditing function. There were boards of directors. There's lots of problems. But that is something I think that the SEC—and I know it is not within your purview, but hopefully the SEC will address it as strong as they could.

Do the fact that accountants also sell tax advice, which in many documented cases turned out to be illegal, if not questionable, tax shelters, in a subtle way alter the way that they would interpret subjective accounting questions?

Mr. HERZ. Again, I think on the audit you do need good tax accountancy just to do—you know, taxes are still a major part of getting to the bottom line.

The question of whether the firm or even other people ought to be in the business of peddling aggressive tax arrangements, that to me is the broad issue. Whether it's an auditor, a lawyer, or anybody else, some of these arrangements in my own view—and I am not a tax expert, but I did come across some of them in practice. They defy belief.

Mr. GREEN. I appreciate that. In your professional opinion, is the FASB offering accountants guidance on how to treat these tax questions?

Mr. HERZ. We have an existing standard, standard number 109, which has been in place for 12-13 years that deals comprehensively with accounting for income taxes, but, like a lot of other things and like what people would like to go to, principles-based, it requires good, honest, professional judgment in a lot of cases.

Mr. GREEN. Since it has been in place for 10 to 12 years and most of what we have seen is the last 5 to 6 years, obviously we might need to revisit that.

Mr. HERZ. I have been reading the Senate joint committee report quite eagerly and carefully that looked over all the Enron arrangements to understand whether there might be some implications on the accounting side. Most of that is not targeted at the accounting side. It is targeted at the actual use of tax arrangements there. But I read that stuff.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I am going to go vote. I also appreciate the effort by the chair and the committee to talk about the special purpose entities. I think that's——

Mr. STEARNS. And I thank the gentleman. And just to the gentleman's question to you, the Sarbanes-Oxley Act identified non-prescribed types of consulting. You can't do information technology, investment banking, but there are others that you can. And so the whole thing is not prohibited, but at the same time, there are in place legislative fits to do this. The question is, are people going to comply with it?

Mr. HERZ. I don't know. I think that that's one thing that what you'll have to need—they will probably also thank me for this—is somebody needs to bring in the new auditing board, the PCAOB, once they get up and running. I am sure that will be a key part of their examination process.

Mr. STEARNS. Mr. Ferguson?

Mr. FERGUSON. Thank you, Mr. Chairman.

I thank Mr. Herz for being here today. I am new on the committee. I just came from a term on the Financial Services Committee, which is not only interesting but exciting given everything that happened last year, the last couple of years. Obviously we did a lot of work on Financial Services last year, as they did here on Energy and Commerce, relating to Enron, WorldCom, transparency issues.

And I just wanted to touch on that for a minute in terms of loan commitments with banks, investment banks and commercial banks. Can you just walk with me through that for a moment? My understanding is it's a——

Mr. HERZ. Yes.

Mr. FERGUSON. [continuing] different treatment in how these institutions treat loan commitments and why there is a difference.

Mr. HERZ. Yes. Loan commitments, of course, are a form of financial instrument and one of many. Traditionally, those who have traded loan commitments have shown them on a mark-to-market basis as a trading activity. And that has traditionally been some of the investment banks.

Loan commitments, however, are not only traded. They are extended more generally by commercial banks as a line of credit, which may or may not be drawn down, may end in the origination of a loan.

I think that we have been doing some work in that. We are just about to issue a new standard that says that commitments to purchase or sell loans are really what we call derivatives and, therefore, ought to be carried on a mark-to-market or fair value basis, whether you are an investment banker or bank, whoever you are. So that activity would be now more common, common accounting across the same different types of enterprise, whether it be an investment bank or a commercial bank.

I know that some of the investment banks, or at least one that I am familiar with, believe that loan commitments to originate loans ought to also be carried on a mark-to-market basis. That has traditionally been viewed as a more normal traditional banking activity accounting for banks. The bank regulatory accounting does not require fair value for that in the financial statements. We require supplementary footnote disclosure relating to the fair value of all financial instruments, including loan commitments, or actually working on improving that whole supplementary data.

But right now for a bank that extends loan commitment that are intended to result in the issuance of a loan, it is not done on a mark-to-market basis. Now, some of the investment banks I think believe that it ought to be, and they believe that that is not only the better accounting because they certainly believe in fair value. That is how they live their world. But they believe that in certain cases, large ticket commercial loans to big companies are being used in the loss leader kind of mode to garner investment banking business and are being underpriced, essentially, are being given a favorable interest rate.

That is of concern to us. And we have discussed it directly with bank regulators, with major banks who seem to view it otherwise, either don't believe it is happening or don't believe the mark-to-market accounting is the right way to go on that.

I think it was Congressman Dingell who asked the GAO to look at that. I am very eager to understand the results of that review to see whether or not there is something that is being disguised here.

Mr. FERGUSON. What has lead you to—you are talking about perhaps pending issuance of a new regulation. Am I paraphrasing it properly?

Mr. HERZ. Only in regard to loan commitments to purchase or sell loans, not commitments to originate a loan.

Mr. FERGUSON. Is that also under discussion or not?

Mr. HERZ. It is not formally under discussion, but we are certainly aware of all of the activity around it.

Mr. FERGUSON. Why is there differential treatment now?

Mr. HERZ. Well, I think because if you're originating a loan, it's like selling your own product. It's not dealing in other people's product, which is a commitment to buy or sell other people's loans. That, the origination of loans, is viewed as a normal banking activity that is covered by a non-mark-to-market model.

Mr. FERGUSON. the regulation that you were talking about, the new regulation that you are talking about, why is that being pursued? Is that an effort toward transparency as well?

Mr. HERZ. Well, we believe in looking at that issue, that those are really like derivatives. We already have a rule that says that derivative contracts should be mark-to-market.

Mr. FERGUSON. Is there a mechanism now, though, under current accounting rules that allows for investors to know if loans or loan commitments have been made by banks under market rates, below market rates?

Mr. HERZ. Only annually through the disclosures which we mandate on fair values.

Mr. FERGUSON. Would that make sense in terms of kind of this climate that we are in today in terms of——

Mr. HERZ. It might make sense.

Mr. FERGUSON. [continuing] protection of investors and transparency?

Mr. HERZ. Again, we talked to banks and bank regulators. And they say their evidence indicates that that is not happening, that origination are done at the fair rate.

Mr. STEARNS. The gentleman's time has expired.

Mr. FERGUSON. Thank you, Mr. Chairman.

Mr. STEARNS. The gentlelady from Missouri, Ms. McCarthy.

Ms. MCCARTHY. Thank you, Mr. Chairman.

I appreciate very much the opportunity, Mr. Herz, you have given us to discuss some of our, as you would so politely put in your paper, shaken confidence in the reporting system and capital markets. And I very much appreciate all that you and your organization are trying to do.

I wanted to pose a situation to you and wonder if you are looking into this or, if not, who in this fast world of corporate governance and audit is looking into it. In my area, the two top executives of the company had considerable gains on stock options. The corporate auditors, the auditors that were advising the company, the board, et cetera, advised these two executives who were no longer with the company to create a tax shelter, to put those stock options in tax shelters so they could avoid the tax on them. The IRS is looking into it, and it looks like they will both be very poor people when this is over.

Mr. HERZ. Yes.

Ms. MCCARTHY. I guess my question is hopefully you or someone is looking into this very issue of there is a governance failure, yes, a corporate governance failure, but there is an audit failure here, too. These auditors are paid by the corporation to advise the board and the corporation. And then they were paid by the corporation to advise these two executives how to avoid taxes.

I thought there was a bright line from the legislation that we thought we had passed that was going to avoid things like this.

Mr. HERZ. Well, it's not our area. We deal with accounting and financial reporting rules that would be——

Ms. MCCARTHY. This is accounting, financial reporting rules. How can the auditors be paid by the company to advise two executives how to avoid taxes?

Mr. HERZ. That is my understanding. I may be wrong. I am just saying what I remember was something that was addressed by the SEC as part of their recent looking at implementation of parts of Sarbanes-Oxley. I remember reading some articles back and forth about that issue as to how far the tax advocacy work ought to be restricted or not.

I can't remember exactly where it came out. I am sure Ms. Washington does because she knows everything about that.

Ms. MCCARTHY. I just learned they took it out. That's too bad.

Mr. HERZ. Again, that's not what we do. Again, I think that is something that the new PCAOB presumably in the course of what they are going to be monitoring the auditors, auditing standards, all of that, will be part of, I would expect, their charge and their role.

Ms. MCCARTHY. It would seem to me whoever advises the accounting industry ought to probably step up to the plate on this one. I mean, it's one thing if those executives had paid the auditors themselves. The company was paying for that advice to them to avoid the taxes. It doesn't help the confidence of any of us taxpayers when those kinds of things go on within an industry. So that's why I wanted to pose it to you, to get your thoughts on it.

We may have to readdress some of the legislation. It is hard to make a perfect bill, but I believe on this one, we should have been a little bit more strident.

Mr. HERZ. Yes. I personally think—and, again, this is only putting on the hat of my experience in my prior incarnations, so to speak—I think there is not only that issue but the issue of how was it that the auditors, whoever was selling these schemes concluded that those schemes were viable under the tax code. I think that is the root of the problem.

Ms. MCCARTHY. Well, Mr. Chairman, thank you for this hearing.

Mr. STEARNS. Sure. Let me just ask my members. I think we are going to do another short round. So if you want to stay and ask questions? Are you finished?

Ms. MCCARTHY. Yes. I yield back.

Mr. STEARNS. Okay. I want to follow up a little on what Mr. Ferguson's question was. You have an investment corporation. You have a banking corporation. And you look at their books. Forget Enron and WorldCom. You look at these banks, investment companies. You have no clue that these folks from their balance sheet have a huge amount of commitments, loan commitments, to these people and that they're moving exponentially.

So just tell me briefly, how do commercial bank accounts for loan commitments differ from investment bank accounts for loan commitments? We'll take that difference there. And what could FASB do so that—you know, I am not investing in Enron or WorldCom. I am investing in an investment company, Salomon Brothers or I am investing in Bank of America. How could I determine that these folks are on the hook with an Enron for billions and billions of dollars? It keeps getting larger and larger.

Mr. HERZ. Well, I think first there are overall disclosures relating to all commitments.

Mr. STEARNS. But you couldn't tell it in Enron's case.

Mr. HERZ. You couldn't tell——

Mr. STEARNS. You couldn't know until they declared bankruptcy, right?

Mr. HERZ. You're right.

Mr. STEARNS. And even after they declared bankruptcy, the whole thing didn't come out. And now, as we stand today, it is not millions. It's billions. And it is hard even to understand——

Mr. HERZ. The investment banking model, the mark-to-market model, would say, "I look at that commitment. I look at the company's credit. And I evaluate how much in the marketplace I could not redo that commitment for today's current facts." So it kind of says, "What are today's facts? And what is that commitment worth or how much is it likely to cost me on a value basis?"

The traditional banking model is to look at all credit exposures by whomever the counter party is, the borrower, whether it is a loan outstanding, whether it is a commitment to that, and say, "Okay. What do I think I need to put up as a loan loss reserve." There are two ways of getting to the exposure model.

Mr. STEARNS. An investment corporation doesn't have to do that to put up——

Mr. HERZ. No. They assess value, rather than saying, "What do I think my gross losses are going to be?"

Mr. STEARNS. Because the taxpayers are supporting the FDIC in banks, really, the taxpayers have a lot here at stake because if the banks go under, then taxpayers are going to support them. So I think it's crucial, the distinction between the two of them, and that the fiduciary responsibility is higher for you in dealing with bank transparency because taxpayers are on the hook. Is that true?

Mr. HERZ. That is partially true. I mean, there are two sides to every argument. I will give you the side that the bank regulators would give. They would say that using a hard-to-measure fair value model for these kinds of things in place of a loan loss reserve is going to unnecessarily create false volatility in the earnings. That will produce false results as well. I am not of that opinion.

Mr. STEARNS. So if I get a look at one of these investment companies and find this information, it is going to create a problem for Enron or WorldCom?

Mr. HERZ. The view is that fair valuing these things is not only hard to do but is not the proper accounting. That is a traditional banking view of the world.

Mr. STEARNS. Say that statement again. It sounds like the corporation and the investment company are sort of keeping all of the information and that it is not transparent. Say that statement again.

Mr. HERZ. Well, the banking model assesses all of your exposures to a particular credit or borrower, whether it be outstanding loans, loan commitments, other arrangements, and then provide your best estimate of what you think your losses are going to be based upon the current facts.

Mr. STEARNS. So CitiBank should have done that with Enron?

Mr. HERZ. As the facts emerged, yes.

Mr. STEARNS. As the facts emerged.

Mr. HERZ. Yes. Now, of course, with Enron, most of the—I don't know. You may know better, but, of course, what happened publicly all happened in one quarter.

Mr. STEARNS. Well, it didn't happen all in one quarter.

Mr. HERZ. I agree with you, but the information that came out——

Mr. STEARNS. Mr. Skilling left in the summer, months before, because, in my humble opinion, he knew what was happening.

Mr. HERZ. The real acid test would be, what would a mark-to-market model have said in August 2001 versus a banking model?

Mr. STEARNS. Right.

Mr. HERZ. That is the way to look at it. Both would look at the current information, by the way.

Mr. STEARNS. Would you consider adding a project of loan commitments to FASB's agenda? Do you think it is important?

Mr. HERZ. We have discussed that a number of times. We said loan commitments are one of many financial instruments. It would be hard to do just one in isolation. We are committed toward moving toward more fair value in general, but we would like to do that in a way that also achieves international convergence. I would say that—and this, again, is my own view.

Mr. STEARNS. Not the other six members?

Mr. HERZ. Not necessarily the other six. I'm not saying it isn't. I'm saying not necessarily.

Mr. STEARNS. Is this a yes? Am I hearing you say yes?

Mr. HERZ. Mr. Markey can ask each one of them.

Mr. STEARNS. From your standpoint, if you had to vote today, you would put loan commitment on FASB's agenda?

Mr. HERZ. No, I would not.

Mr. STEARNS. You would not?

Mr. HERZ. Not with our existing resource base, I would not. It is not the highest of our priorities in my view.

Mr. STEARNS. Well, if you had the resource base, you would?

Mr. HERZ. I would, yes.

Mr. STEARNS. you think it is important, but you realize——

Mr. HERZ. Yes. I also would like to understand. For me, it is kind of a baffling debate and pieces of evidence. We have been presented from the investment banks or one largest investment bank evidence as to this being a systematic problem not using fair value.

Mr. STEARNS. "Systematic" meaning not 1 or 2 years but 25 years?

Mr. HERZ. Well, no. Across many large commercial loans.

Mr. STEARNS. I see. Okay.

Mr. HERZ. We have discussed this with bank regulators, banks, and all of that. And they say, "No. These people are not correct." Now——

Mr. STEARNS. "These people" being?

Mr. HERZ. The investment banks.

Mr. STEARNS. Okay.

Mr. HERZ. Their evidence is not correct. This is not going on. Again, we don't have investigatory powers.

Mr. STEARNS. But you think it is going on?

Mr. HERZ. I think Congressman Dingell asked——

Mr. STEARNS. You personally think it is going on?

Mr. HERZ. I don't know whether it is going on now, but I do think that if it is going on and if there are—to me, fair value accounting is an earlier detection device for those kinds of things than the normal ongoing accounting.

Mr. STEARNS. Because they have a lot to lose.

Mr. HERZ. It is just the way it worked. When something is properly valued, it tells you what the situation is, rather than trying to make, kind of, guesses. Again, I am interested in what the GAO came up with because they have been asked I understand by Congressman Dingell to look at this issue.

Mr. STEARNS. At least you agree that banks should not have hidden liabilities, like loan commitments, that are disclosed to investors only when the entity goes bankrupt. I mean, there should be some precursor out there to say, "Something is happening here at Enron/WorldCom" well in advance, instead of when they file bankruptcy. That is when CitiBank says, "Oh. Here. By the way, we are not talking about $300 million. We are talking about $1.3 billion."

Mr. HERZ. Yes. But, to be fair, the existing rules on accounting for loan loss allowances required an assessment of current facts in order to make the estimate of what the loss allowance ought to be. So it's also supposed to take into account current facts.

Mr. STEARNS. Yes. Okay. My time has expired. Ranking member, questions?

Ms. SCHAKOWSKY. No. Maybe you answered this already when Congresswoman Solis was talking to you about the fees that you need to operate FASB. When do you expect to have this process completed? I understand it has to do with developing the formula, et cetera.

My concern is exacerbated by what you just said about resource base. I am assuming that you are limited in what you can do because of the money. So what about your fees?

Mr. HERZ. Well, again, we are one party of three parties in getting this accomplished. So our desire would be tomorrow. Again, noting that it ought to be done properly, it probably makes sense to have one billing that includes both our fees and the fees to the PCAOB.

I have heard—I don't know that this is definitely the case—that it may require some SEC rulemaking in order to get that done. I would estimate based upon all that the earliest that everything can get done is probably April or May.

Now, if the bills go out in April or May, people start to pay, then I think we start hiring.

Ms. SCHAKOWSKY. I want to get back just briefly to this business of harmonizing FASB and IASB. Just as we are now really focusing on the issues of corporate governance and accountability, I want to be sure that this notion doesn't delude those efforts. Since I don't know anything about it, maybe it's strengthening those efforts. I don't know. If you could talk a little bit more about that?

Mr. HERZ. Well, I do want to make a very important point that we are not doing convergence just for the sake of convergence. I mean, the most overriding goal to us is improvement of U.S. financial reporting. But we do think that having common reporting across the global capital markets, the major capital markets, is something that certainly we have been told is desired by investors, by analysts, by the companies that operate——

Ms. SCHAKOWSKY. It's useful unless we are going to the lowest common denominator.

Mr. HERZ. Exactly. And I believe, having been a member of the IASB, I believe that they have quality processes and quality people. So, in fact, I think it actually makes the process richer than it probably would have been just——

Ms. SCHAKOWSKY. Can you give me an example of some way that going by the IASB standard might improve our situation?

Mr. HERZ. Well, again, these are my own personal biases, but I think, for example, they have a better model for impairment of assets than we do. Our model is based on what are called undiscounted cash-flows. It doesn't take into account the time value of money at all.

Their standard does in looking at whether or not an impairment has arisen. We kind of say, "As long as you're going to recover it over the remaining life of the asset, even though the value might be miles below the carrying value, as long as you're going to recover it, you don't have to impair it." They would look at it more on a value basis. So that's, for example, one area where I think they have better rules.

One area that we are looking at, we may converge sooner, hopefully in the not-too-distant future, but we will see, is on business acquisitions. We have a rule that you have to value the in-process research and development, the value of the projects, research projects, under development at the company you buy. You have to do a precise valuation. Then you write it off immediately, which doesn't to me make a lot of sense because it says that these have some value. That is often what you paid for. Their rule would say, "No. This is an asset, and we ought to carry it as an asset."

That is why we are going through this very systematic process of we have identified all of the differences, at least all the ones we think we know about, which are in the hundreds. And we are systematically trying to say, "Your standard better than ours, ours better than yours. Let's see if we can come to a common answer." In some cases, we find that neither of our standards are particularly good.

Ms. SCHAKOWSKY. Is the IASB flexible in terms of changing? Are we the only ones that——

Mr. HERZ. No. The boards are both very open to change, and the idea is to find the best solution. The issue then is with the constituents and the politics.

Ms. SCHAKOWSKY. Thank you. I wish you the best.

Mr. STEARNS. I thank the gentlelady. The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman.

Media reports indicate that Royal Abhold's recent financial shenanigans were not the first time the company engaged in accounting subterfuge. CFO magazine reported this week that when Abhold first filed its results for 2001, differences in accounting treatment led to a 90 percent disparity between earnings under Dutch and U.S. GAAP rules. Abhold buried the explanation for this disparity in a footnote in one of its SEC filings, which currently is not a violation of any rules. Is FASB concerned that disclosing a 90 percent disparity in a footnote is inconsistent with the principles of transparency?

Mr. HERZ. I think that is exactly why we are trying to move to common global standards so you don't even have that issue arising.

Mr. MARKEY. What steps would you recommend that FASB take today?

Mr. HERZ. First of all, that disclosure is a reconciliation that is mandated by the Securities and Exchange Commission.

Mr. MARKEY. What recommendation would you make to make sure this is nonrecurring?

Mr. HERZ. My recommendation would be that the MDNA requirement specifically address those kinds of situations.

Mr. MARKEY. What is the deadline that you would like to see established so that this 90 percent disparity not again inflict investors?

Mr. HERZ. I'm not at the SEC, but the sooner the better.

Mr. MARKEY. It should be done immediately? Is this a serious problem before you?

Mr. HERZ. I believe. And the question is whether or not—and you would have to ask the SEC whether they believe that that should have been done under their existing MDNA requirements.

Mr. MARKEY. I appreciate that, but it appears to have been legal. Would you change that standard so there is more information?

Mr. HERZ. I don't know whether it is legal or not, but certainly I agree with your premise that something like that needs to be clearly explained in a prominent way.

Mr. MARKEY. All right. Then we will send your recommendation on to the SEC out of this committee, I would hope.

Now, you noted in your testimony that FASB recently decided that AICPA's accounting standards executive committee would no longer act as a senior-level accounting standards setter in the United States. You explained that maintenance and development of any industry-based standards should reside with FASB. As you know, the accounting oversight board established by Sarbanes-Oxley has authorized to establish or adopt auditing independence and other standards relating to the preparation of audit reports for public companies.

Given FASB's decision to retain responsibility for the maintenance and development of any industry-based standards, should the new public company accounting oversight board outsource its standard settings responsibility to private, professional, accounting organizations, or should it do this work in-house?

Mr. HERZ. Yes. Again, this is only my opinion. This is, to make it clear to anybody following this, not part of our charge or mandate, but I think the premise of what you read is a reasonable analogy and reasonable thought process to go through. My view, personal view,—and I can't say I have studied all of this—would be that the PCAOB needs to probably figure out some kind of, for want of a better word, its own conceptual framework for auditing standards, develop some principles and expectations, and then decide what structure it needs and the kinds of people it needs.

Mr. MARKEY. In-house? You are saying do it in-house?

Mr. HERZ. No. I think that they need to bring in some outsiders as well because——

Mr. MARKEY. But bring the insiders in to do it in-house? Outsiders to help do it in-house?

Mr. HERZ. I believe what they need to do is to develop a set of concepts, principles, and expectations. You desperately, though—and we do it through developing our own standards. You need to make sure you have the right kinds of people in the process and input.

Mr. MARKEY. I appreciate that. As you may know, the Sarbanes Act provides the oversight board with the authority to conduct investigations and disciplinary proceedings. There has been some discussion that the oversight board should contract out this responsibility in a manner similar to the peer review process used by the now defunct public oversight board. In your opinion, should the accounting oversight board established by the Sarbanes Act conduct audit inspections or should the inspections be performed by private contractors?

Mr. HERZ. I think that if they can get the qualified people, they ought to do it.

Mr. MARKEY. Is that in-house?

Mr. HERZ. Yes, but it is going to take a massive number of people.

Mr. MARKEY. I appreciate that.

Mr. HERZ. In the U.K., for example, they have had for a number of years a group called a joint monitoring unit, which does inspections of the auditors. It is a separate unit. This is just for the U.K., which is a much smaller country, a much smaller market. I believe they just have over 100 inspectors. So you can kind of figure out what it would need in this country probably, 300, if not more.

Mr. MARKEY. Well, they have 100 million people. We have 270 million. Can we——

Mr. HERZ. Their capital market is not proportional to ours.

Mr. MARKEY. You would still do it, but you would do it in-house?

Mr. HERZ. I think if they get the qualified people, I think they should conduct the inspections.

Mr. MARKEY. You need as many policemen as you need. You are saying the crime rate is higher potentially in the United States. So we need more policemen here than in England.

Mr. HERZ. I would say the playing field for the crime rate is larger.

Mr. MARKEY. Yes, I've got you. They can do it with billy bats, although we need bigger weapons.

The FASB, the advisory council, let me go to this. You have noted now here today that FASB recently established a user advisory group to increase the investing community's participation in accounting standards activity. According to the materials that FASB provided for today's hearing, it appears that virtually all of the members of the council are affiliated with the Nation's largest banks, brokerages, and financial management firms with the exception of a representative from the AFL-CIO. Was there any effort to include representatives from shareholder advocacy groups, such as the Council of Institutional Investors?

Mr. HERZ. Yes. In fact, I am going to be talking with them in a couple of weeks, them and the National Association of Investors, and all of that. We welcome any and all people from the small investor groups. I think that would——

Mr. MARKEY. You are going to put them on the council?

Mr. HERZ. I would love to.

Mr. MARKEY. So the invitation is in the mail out there to you at the Council of Institutional Investors. You are in.

Mr. HERZ. I would like to get, actually, some of the people from the investment clubs as well.

Mr. MARKEY. How about the Investment Company Institute?

Mr. HERZ. Actually, we got a lot of the nominations from the Investment Company Institute.

Mr. MARKEY. Okay. That's good. Thank you.

I appreciate your indulgence, Mr. Chairman.

The Joint Committee on Taxation report just out recently talked a lot about abusive tax shelters created by investment banks like Merrill Lynch, Bankers Trust for the express purpose of tax avoidance. Now, these deals had no real underlying economic purpose. I understand that many of the reports' findings and recommendations get at issues dealing with the tax code. But, as you said earlier here today, there could be implications for financial disclosure.

Mr. HERZ. Yes.

Mr. MARKEY. Exactly what are you doing to make sure that transactions or entities created for tax avoidance purposes are clearly flagged for ordinary investors in the company's accounting statements? Can you give us a succinct statement?

Mr. HERZ. I will tell you first I have read not all 3,000 pages of the report but a good part of it. I have had my staff studying it. Our next step is I have asked our staff to arrange a meeting with the joint Senate staff, committee staff, and others who were involved in preparing that to discuss what we might do, what the IRS might do, all of that.

Mr. MARKEY. Could you report back to Chairman Stearns and to the committee on any changes you decide to make as a result of your review of the joint report? Can you do that for the committee?

Mr. HERZ. Yes.

Mr. MARKEY. Thank you. I think it is important for us to get the report back as well.

Can I ask one final question, Mr. Chairman?

Mr. STEARNS. Sure. Go ahead.

Mr. MARKEY. Mr. Chairman, some companies that oppose expensing of stock options claim that the expenses associated with options already are incorporated in diluted earnings per share figures and, therefore, there is no need to expense options. What is your response to that argument?

Mr. HERZ. I don't agree. Would you like to know why?

Mr. MARKEY. I would love to hear it.

Mr. HERZ. Options are equity instruments. That argument to me is like saying any time you buy anything with an equity instrument, including your stock, you shouldn't account for it other than in earnings per share.

So if I buy legal services or I buy a car, I pretend I got the car for free. I wouldn't depreciate it. All I would say is I have got another share outstanding. And so that to me is not the way I understand the transaction. There is a transaction which you paid for with a valuable instrument. That is how you acquired it. It happens that that instrument is also an equity instrument, which, therefore, deludes the existing shareholders as well.

Mr. MARKEY. I thank you so much. I think you for that answer. And I thank you for your service to our country. You have a valuable a job, as important a job in restoring investor confidence and, therefore, our economy. Thank you.

Mr. STEARNS. I thank my colleague.

Mr. Herz, as I understand it, there might be one other FASB board member in the audience.

Mr. HERZ. Yes.

Mr. STEARNS. I thought you might want to just tell us, introduce the person.

Mr. MARKEY. It's like the Ed Sullivan Show here. Yes. And in our audience, my colleague, Dr. Katherine Schipper.

Mr. STEARNS. Welcome, Dr. Schipper. We just are not going to ask you. We just obviously want to say hello.

Mr. HERZ. Not until the next time.

Mr. STEARNS. Until the next time.

I want to also leave the record open for 5 working days so that if members want to ask any additional questions. And I would hope that, Mr. Herz, you can answer some of the questions our staff might submit to you.

Let me just say that I think you provide a fresh breeze here, and we appreciate your honesty. I hope in the future that you will continue this and fight the status quo, which you pointed out is hard to change. We are here to try and help do that.

With that, the subcommittee is adjourned.

[Whereupon, at 4:53 p.m., the foregoing matter was adjourned.]

[Additional material submitted for the record follows:]

FINANCIAL ACCOUNTING STANDARDS BOARD
March 28, 2003

Via Hand Delivery

The Honorable CLIFF STEARNS
United States House of Representatives
Washington, DC 20515

DEAR MR. CHAIRMAN: Attached is my written response to the questions submitted by the Members of the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce and attached to your letter of March 13, 2003.

I look forward to seeing you again on April 1, 2003. Please contact me or our Washington, DC representative, Jeff Mahoney (703-243-9085), if any additional information is required.

Sincerely,

ROBERT H. HERZ

Attachment

FOLLOW-UP QUESTIONS TO MARCH 4, 2003 HEARING

ACCOUNTING FOR LOAN COMMITMENTS

Question 1) How do commercial banks and investment banks account for loan commitments? Why is there a difference in the accounting treatment for the same loan commitment?

Response: Historically, commercial banks and investment banks have had very different business models. The business of commercial banks has traditionally included accepting deposits from entities with idle funds and originating loans to entities with investment or spending needs.[1] In contrast, the business of investment banks has traditionally included buying, holding as inventory, and selling financial instruments for their own accounts from and to customers and other dealers and traders.[2] The distinct activities of commercial banks and investment banks have resulted in different financial accounting and reporting practices.

In general, commitments to originate loans in the ordinary course of business when no fee is charged have no immediate accounting effect, though enterprises, including commercial banks, are required to consider such commitments when evaluating the liability for other credit exposures.[3] If, however, any fee is received for a commitment to originate or purchase a loan or group of loans, that fee is initially reported as a liability.[4] If the commitment is exercised, the fee is recognized and reported in income over the life of the loan as an adjustment of the loan yield, or if the commitment expires unexercised, the fee is recognized in income upon expiration of the commitment.

In addition, information about loan commitments,[5] including their fair value (and the fair value of loans and other financial assets and liabilities) and the methods and assumptions used to estimate the fair value,[6] is required to be disclosed in the notes to enterprises' financial statements. The fair value disclosures must also be in a form that makes clear whether the fair value and related carrying amount represent assets or liabilities.[7]

As active dealers and traders of financial assets and liabilities, investment banks have historically employed specialized industry practices for both internal and external reporting of financial instruments, including loan commitments.[8] That practice provides that inventory and other positions in financial instruments, including loan commitments, be reported at fair value.[9] In addition, changes in the fair value of those instruments are reported in income in the period in which the changes occur. The specialized industry practices are intended to reflect the economic substance of the unique activities of those enterprises.[10]

The Financial Accounting Standards Board ("FASB" or "Board") has two active projects that will improve the existing accounting and reporting for loan commitments. First, the FASB plans to issue a new standard in April 2003 that will amend the existing requirements for the accounting and reporting for derivative instruments and hedging activities. That standard will clarify that enterprises that issue commitments to originate mortgage loans that will be held for resale, and most commitments to purchase or sell loans, should be accounted for as derivative instruments. Thus, as derivative instruments, those loan commitments will be required to be accounted for and reported at fair value.[11]

Second, the Board has a current project to improve the existing fair value disclosures of financial assets and liabilities, including loan commitments. The objectives of that project are (1) to provide guidance relating to the often-difficult issue of measuring the fair value of financial instruments and (2) to improve the form and content of the information about those fair values. We are currently deliberating

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[1] AICPA Audit and Accounting Guide, *Banks and Savings Institutions* (2001), ¶1.01.

[2] AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities* (2002), ¶¶1.04, 1.07.

[3] *Banks and Savings Institutions,* ¶6.71.

[4] FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (1986), ¶8. The accounting for loan and commitment fees received or paid by mortgage banking enterprises is subject to the requirements of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (1982), ¶¶20-27.

[5] FASB Statement No. 5, *Accounting for Contingencies* (1975), ¶¶18 and 19.

[6] FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (1992), ¶10.

[7] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (1998), ¶532(b).

[8] *Brokers and Dealers in Securities,* ¶7.01.

[9] *Brokers and Dealers in Securities,* ¶7.02; see FASB Statement No. 91, ¶34.

[10] *Brokers and Dealers in Securities,* ¶7.01.

[11] FASB Statement No. 133, ¶17.

those issues at public meetings and plan to issue a proposal for public comment before the end of this year.

Finally, the Board recognizes that business models change and in the case of commercial banks and investment banks they appear to be converging. Having different accounting for similar transactions or financial instruments based on business models is a concern to the Board. As new accounting guidance is issued, consideration is given to eliminating business model differences where appropriate. Also with respect to financial instruments, the Board has indicated its desire to require all enterprises to report all financial instruments at their current fair value when the conceptual and practical issues relating to fair value measurement are resolved. The Board is working on those issues. The second project discussed above is part of that process.

Question 2) How can we make sure that accounting policy does not encourage imprudent lending activity?

Response: The mission of the FASB is to establish and improve standards of financial accounting and reporting for both public and private enterprises. The focus of the FASB's mission is on consumers—users of financial information, such as investors, creditors, and others. We attempt to ensure that financial accounting and reporting standards result in financial reports that provide consumers with an informative picture of an enterprise's financial condition and activities and do not color the image to influence behavior in any particular direction.

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

Representatives of the FASB have had recent informal discussions with representatives from a major investment bank that included discussions about the existing accounting for loan commitments. Those representatives indicated that they believe the existing accounting for loan commitments encourages imprudent lending activity by commercial banks.

Representatives of the FASB also have had recent informal discussions with representatives from commercial banks and financial institution regulators. The discussions included discussions about the existing accounting for loan commitments. Those representatives indicated that they do not believe that the existing accounting for loan commitments encourages imprudent lending activity.

It is our understanding that the US General Accounting Office, in response to a request by Energy and Commerce Committee Ranking Member the Honorable John D. Dingell, is in the process of updating its May 1997 report, "Bank Oversight: Few Cases of Tying Have Been Detected." It is our understanding that that update may include consideration of whether the current accounting for loan commitments encourages imprudent lending activity by commercial banks. The FASB will carefully review the results of that report to the extent that it contains any findings or recommendations relevant to the Board's mission.

Question 3) Is there a mechanism to ensure that banks are adequately pricing their credit in order to compensate them for any attendant risks at the time the loans and loan commitments are made?

Response: Existing financial accounting and reporting standards require enterprises, including banks, to evaluate at each reporting date the incurred credit losses related to loans and off-balance-sheet financial instruments, including loan commitments.[12] Provisions for incurred loan and loan commitment credit losses are required to be reported as a charge to enterprises' operating income with the corresponding entry to an allowance for loan losses account or a liability for credit losses account, respectively, in enterprises' financial statements.

Actual credit losses for loans and off-balance-sheet financial instruments, including loan commitments, are required to be deducted from enterprises' reported account balances for the allowance for loan losses or the liability for credit losses, respectively.

In addition to the disclosures discussed in response to question 1, existing financial accounting and reporting standards also require enterprises, including banks, to disclose (1) information about impaired loans, including information about the recorded investment in impaired loans, enterprises' income recognition policy, restructured loans, and the activity in the allowance for loan losses reported balance;[13] (2) information about estimates used in determining the carrying amounts of assets and

[12] FASB Statement No. 5, ¶8; FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (1993), ¶8.

[13] FASB Statement No. 114 (amended 1994), ¶20.

liabilities, including estimates about loan losses;[14] and (3) information about all significant concentrations of credit risk arising from all financial instruments, including loans and loan commitments.[15]

The FASB also has under its review and consideration two current projects of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AcSEC") that are expected to improve the existing financial accounting and reporting requirements relating to the credit risks of loans.

The first project will improve the accounting and reporting for loans and certain debt securities acquired in a transfer. The project is intended to update the existing guidance related to the amortization of discounts on certain acquired loans. AcSEC plans to issue the updated guidance in the near future.

The second project will improve the accounting and reporting for the allowance for credit losses. The project is intended to provide additional guidance to enterprises, including banks, on the recognition, measurement, and disclosure of the allowance for credit losses related to loans. AcSEC expects to issue a draft of the proposed guidance for public comment in the near future.

Question 4) Would requiring banks to recognize up front losses from mispriced loans discourage this practice, or, at least, provide meaningful transparency to regulators and investors?

Response: As indicated in response to question 3, enterprises, including banks, are required to report incurred and actual credit losses related to loans on the face of their financial statements. As indicated in response to question 1, enterprises, including banks, also are required to disclose the fair value of those loans in the notes to their financial statements.

There are a number of difficult conceptual and practical issues that the Board would need to resolve before it could consider requiring all financial assets and liabilities, including all loans, to be reported on the face of all enterprises' financial statements at fair value. As indicated in response to question 1, the Board is actively addressing some of those issues in its current project to improve the existing fair value disclosures of financial assets and liabilities.

Finally, as indicated in response to question 2, in recent informal discussions, representatives of commercial banks and financial institution regulators indicated that they did not believe that there exists a prevalent practice by banks to misprice loans.

Question 5) Do current accounting rules require banks to disclose on a real time basis that they have not priced their loans correctly?

Response: As indicated in response to question 3, enterprises, including banks, are required under existing accounting and reporting requirements to report incurred and actual credit losses related to loans on the face of their financial statements. As indicated in response to question 1, enterprises, including banks, also are required to disclose the fair value of those loans in the notes to their financial statements.

The FASB has in recent years conducted and sponsored research related to issues surrounding "real time" financial reporting. As one example, on January 31, 2000, the FASB issued a report that identified practices for the electronic distribution of business information and considered the implications of technology for business reporting in the future.[16] Any movement to real-time financial reporting would require that the SEC pursue significant changes to the existing rules and regulations governing the reporting requirements for public enterprises, including banks.

Question 6) If a bank makes a loan commitment at below market rates, should it immediately recognize a loss?

Response: As indicated in response to questions 1 and 3, under existing accounting and reporting requirements a loan commitment, including a loan commitment issued at below market rates, generally has no immediate accounting effect, though an enterprise, including a bank, would be required to consider such commitments when evaluating its allowance for credit losses.

In addition, the fair value of a loan commitment, including the fair value of a loan commitment with a below market rate, would be required to be disclosed in the notes to enterprises' financial statements as part of the overall disclosure of the fair values of financial instruments.

[14] AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* ¶¶ 12 and 13.

[15] FASB Statement No. 133, ¶ 531(d).

[16] Business Reporting Research Project, Steering Committee Report, *Electronic Distribution of Business Reporting Information* (2000).

Finally, as indicated in response to question 1, the FASB has two active projects that will improve the existing accounting and reporting for loan commitments, including loan commitments issued at below market rates.

Question 7) Is there a mechanism under current accounting rules that lets an investor know if loans and loan commitments have been made at below market rates? Isn't FAS 107 supposed to require footnote disclosure of the losses incurred as a result of making below market interest rate loans?

Response: See response to question 6.

Question 8) Can we improve upon the existing standard so that investors get better information about the financial impact of these mispriced loans on a real time basis?

Response: As indicated in response to question 2, there are differing views between the investment banks and the commercial banks and financial institution regulators as to the prevalence of mispriced loans. Also, as indicated in response to questions 1 and 3, several active projects are under way to improve the existing financial accounting and reporting standards related to loans.

Question 9) Has FASB examined the explosions in bank balance sheets that resulted when bankrupt firms like Enron and WorldCom drew their loan commitments?

Response: As indicated in response to question 2, the mission of the FASB is to establish and improve standards of financial accounting and reporting for both public and private enterprises. The FASB has no power to enforce its standards.

It is our understanding that the banks that transacted with Enron and WorldCom included some of the largest banks in the US with assets exceeding hundreds of billions of dollars.[17] Some, therefore, might question the characterization of "explosions in bank balance sheets" when "Enron and WorldCom drew their loan commitments."

Question 10) Is it desirable for bank financial statements to have hidden liabilities like loan commitments that are not disclosed to investors until the lines are drawn by near bankrupt entities?

Response: As indicated in response to question 1, under existing financial accounting and reporting standards, information about loan commitments, including the fair value of loan commitments and whether a loan commitment represents an asset or a liability, is currently required to be disclosed in the notes to enterprises' financial statements. The Board also has a current project to improve those disclosures.

Also as indicated in response to question 1, the FASB plans to issue a new standard that will clarify that enterprises' that issue commitments to originate mortgage loans that will be held for resale, and most commitments to purchase or sell loans, should be accounted for as derivative instruments. Thus, enterprises that issue those types of loan commitments will be required to report those instruments as assets or liabilities on the face of their financial statements at fair value.

Question 11) Will you consider adding a project on loan commitments to FASB's agenda?

Response: As indicated in response to question 1, the FASB has two active projects that will improve the existing accounting and reporting standards for loan commitments.

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of a diverse constituency, including the SEC. Agenda requests from constituents are periodically reviewed and evaluated by the Board at public meetings. The FASB's limited resources require that the Board be selective in determining which requests should be further considered for inclusion on the FASB's technical agenda. Moreover, the FASB's independence requires that the Board must, after soliciting input from constituents, make its own decisions about its agenda.

To aid the Board in its agenda decision-making process, the Board has developed a list of factors to which it refers in its periodic review and evaluation of proposed topics. Any constituent request to add a project to the Board's technical agenda, including a request to add an additional project on loan commitments, would include consideration of the following factors:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors, or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);

[17] For example, Citigroup Inc. reported $1,097,190,000,000 and $1,051,450,000,000 in total assets as of December 31, 2002, and December 31, 2001, respectively. Citigroup, Inc., 2002 Annual Report (2003), p. 31.

- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed;
- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;
- *Practical consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;
- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the US and other countries with a resulting improvement in the quality of US standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;
- Cooperative opportunities—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and
- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the International Accounting Standards Board ("IASB"), or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

PRINCIPLES-BASED ACCOUNTING

Question 12) Are accountants required under GAAP to apply rules in a way that illuminate financial results rather than obscure them? What rules under GAAP require accountants to do this?

Response: Under existing generally accepted *auditing* standards, an independent auditor of an enterprise's financial statements is required to state in the auditor's report his or her opinion about whether the enterprise's financial statements "present fairly" the enterprise's financial position, results of operations, and cash flows.[18] Auditing standards provide that the auditor's opinion

> . . . should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation . . .; (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, it is neither too detailed nor too condensed . . .; and (e) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements. [Footnote reference omitted.][19]

Those standards also recognize that there may be an occasion where the literal application of generally accepted accounting principles ("GAAP") by enterprises might have the effect of rendering the enterprise's financial statements misleading. In those cases, the auditing standards provide that the "proper accounting treatment is that which will render the financial statements not misleading."[20] Moreover, in those cases the auditor's opinion is required to describe "the departure [from GAAP], its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement."[21]

In addition to the existing auditing standards, in January 2003, as directed by the Sarbanes-Oxley Act of 2002 ("2002 Act"),[22] the SEC adopted rules that require that an issuer's principal executive and financial officers each certify the financial statements and other information contained in the issuer's quarterly and annual re-

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[18] AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report* (1992).

[19] SAS No. 69, ¶4.

[20] AICPA Professional Standards, "General Standards, Accounting Principles," ET § 203[.02] (1988).

[21] ET § 203[.01].

[22] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a), 116 Stat. 745, 777 (2002).

ports.[23] Those rules require officers to certify, among other things, that based on such officer's knowledge "the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report . . ." [24]

The 2002 Act also required that the SEC "conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system." [25] The FASB has been working closely with the SEC staff in this area, and in October 2002, we issued for public comment a proposal on this whole subject ("Proposal").[26] The Proposal included the following statement:

> The Board . . . expects to consider the need for an overall reporting framework similar to that in IAS 1 (Revised), *Presentation of Financial Statements.* The main objective of that reporting framework would be to provide guidance on issues such as materiality assessments, going-concern assessments, professional judgments, accounting policies, consistency, and presentation of comparative information. It also could include a true and fair override to deal with the extremely rare circumstances in which management concludes that compliance with a requirement in an accounting standard would be so misleading that it would conflict with the objectives of financial accounting and reporting. Some believe that such an override is needed to more clearly convey the economic substance of transactions and events in such circumstances, while others believe that such an override would undermine the principles in the standards, regardless of limitations on its use. [Footnote reference omitted.] [27]

As part of the Proposal process, respondents were asked to comment on whether the Board should develop a similar reporting framework and include a true and fair override in US GAAP. The Board received more than 130 comments in response to the Proposal. The Board also held a public roundtable discussion in which 30 individuals participated.

With respect to the reporting framework: Some of the respondents that addressed that question said that the Board should develop a similar reporting framework—separately or as part of a conceptual framework improvements project. Some of those respondents said that while similar guidance is contained in US GAAP, it is disbursed among many different sources and that having that information in one place (in a single framework) would make it easier to understand the accounting model.

Others disagreed with the need for such an accounting standard, some stating that such a standard is only necessary when accounting practice is widely divergent and that that environment does not exist in the US.

With respect to a true and fair override: Some of the respondents that addressed that question said that they supported a true and fair override for US GAAP but only in rare situations and if properly disclosed to ensure that users understand that an override has occurred in the preparation of financial statements.

Other respondents disagreed with the need for a true and fair override, some stating that such an override already exists in US auditing standards.

In the coming weeks, the Board plans on continuing to discuss issues raised by constituents 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 2002 Act's requirement to study and report on the potential adoption by the US of a principles-based system.

Question 13) English accounting rules provide that accountants must certify that financial accounts are "True and Fair"—presenting results that are both correct and understandable. Please explain how this concept works and how it differs from U.S. Accounting Standards.

Response: The United Kingdom's ("UK") Companies Act 1985 (as amended) ("1985 Act") provides that:

> Directors of companies incorporated under the Companies Acts . . . prepare accounts that give a true and fair view of the state of affairs of the company, and where applicable the group, at the end of the financial year and of the profit or loss of the company or the group for the financial year." [28]

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[23] Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 33-8124 (August 29, 2002).
[24] Certification of Disclosure in Annual and Quarterly Reports, 17 CFR § 240.13a-14(3) (2002).
[25] Pub. L. No. 107-204, § 108(d).
[26] FASB Proposal, *Principles-Based Approach to U.S. Standard Setting* (October 2002).
[27] FASB Proposal, p. 7.
[28] UK Accounting Standards Board, *Foreword to Accounting Standards* (1993), ¶ 8.

UK accounting standards incorporate the true and fair view in a "Foreword to Accounting Standards" ("Foreword"). The Foreword, in addition to describing the 1985 Act, states:

> Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view . . .
>
> The requirement to give a true and fair view may in special circumstances require a departure from accounting standards. However, because accounting standards are formulated with the objective of ensuring that the information resulting from their application faithfully represents the underlying commercial activity, the Board envisages that only in exceptional circumstances will departure from the requirements of an accounting standard be necessary in order for financial statements to give a true and fair view.
>
> If in exceptional circumstances compliance with the requirements of an accounting standard is inconsistent with the requirement to give a true and fair view, the requirements of the accounting standard should be departed from to the extent necessary to give a true and fair view. In such cases informed and unbiased judgement should be used to devise an appropriate alternative treatment, which should be consistent with the economic and commercial characteristics of the circumstances concerned. Particulars of any material departure from an accounting standard, the reasons for it and its financial effects should be disclosed in the financial statements. The disclosure made should be equivalent to that given in respect of departures from specific accounting provisions of companies legislation.
>
> The Financial Reporting Review Panel . . . and the Department of Trade and Industry have procedures for receiving and investigating complaints regarding the annual accounts of companies in respect of apparent departures from the accounting requirements of the Act, including the requirement to give a true and fair view. The Review Panel will be concerned with material departures from accounting standards, where as a result the accounts in question do not give a true and fair view, but it will also cover other departures from the accounting provisions of the Act. [29]

As indicated in response to question 12, a concept somewhat analogous to the UK true and fair view currently exists in the US. In the coming weeks, the Board plans on continuing to discuss issues raised by constituents 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 2002 Act's requirement to study and report on the potential adoption by the US of a principles-based system.

Question 14) Chairman Stearns proposed in legislation that accountants be required to reconcile FASB's fundamental principles of transparency and understandability for every application of accounting rules. Please explain how this proposal would work.

Response: The FASB is uncertain how Chairman Stearns proposal would work in light of the existing auditing standards requirements and the recently enacted officer certification requirements of the 2002 Act. As indicated in response to question 12, in the coming weeks, the Board plans on continuing to discuss issues raised by constituents 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 2002 Act's requirement to study and report on the potential adoption by the US of a principles-based system.

STOCK OPTIONS

Question 15) Please explain the difference between the tax treatment of options and the GAAP treatment.

Response: Under existing US GAAP most grants of stock options to employees are reported in the financial statements at zero expense because enterprises have the choice, if the options meet certain criteria, to measure expense using the intrinsic value of the options at the date of grant.[30] The intrinsic value is the difference between the exercise (or strike) price of the option and the market price of the underlying stock.

The other choice, which is the preferable method of accounting under US GAAP, is to measure the option grants at fair value at the date of grant. Until recently

[29] *Foreword to Accounting Standards,* ¶¶ 16 and 18-20; footnote reference omitted.
[30] FASB Statement No. 123, *Accounting for Stock-Based Compensation* (1995), ¶ 11.

only a few companies chose the preferable method. In recent months, however, more than 200 companies decided to expense or intend to expense stock compensation using the preferable method.[31]

In contrast, it is our understanding that the tax treatment for enterprises issuing stock compensation is dependent upon the tax classification of the options issued. The two primary types of options recognized in the tax code are incentive stock options and nonqualified stock options.

Incentive stock options are options that meet special conditions under the tax code. Incentive stock options have no tax consequences at grant or exercise date to the employer. The employer, however, may obtain a tax deduction if the employee sells the shares received from exercising the option if those shares are sold within one year of exercise or within two years of grant. If that occurs, the employer receives a deduction equal to the intrinsic value of the option at exercise.

Nonqualified stock options are deductible by the employer as compensation expense upon exercise. The measurement of the expense typically is based on the intrinsic value at exercise date.

Question 16) What would be the implication of harmonizing the treatment?

Response: The purpose of financial accounting and reporting standards is to provide investors with unbiased, transparent, and comparable information about enterprises' underlying economic activities. It is our understanding that the purpose of tax accounting is to raise revenues for the US Government and to promote various public policies. It, therefore, is not surprising that the financial accounting and tax accounting treatment for many transactions, including stock compensation, differ.

The tax accounting treatment of stock compensation may not be consistent with the purpose of financial accounting and reporting. For example, the tax treatment (1) ignores recognition of an expense for stock compensation until long after the exchange transaction has occurred and (2) permits noncomparable expense recognition treatment for economically similar types of stock compensation arrangements. The latter reason is also viewed by many investors and other users of financial statements as a flaw in the existing financial accounting and reporting standards for stock compensation and has, in part, resulted in the Board recently adding a project to its agenda to improve the reporting for stock compensation.[32]

Moreover, the FASB is committed to promoting the international convergence of accounting standards concurrent with improving the quality of financial reporting. It is not likely, for the reasons stated above, that the IASB and our other international counterparts would conclude that adopting the US tax treatment as the financial accounting and reporting standard for stock compensation would improve the quality of international financial reporting.[33]

USER ADVISORY COUNCIL

Question 17) Who sits on the Advisory Council—i.e., what groups are represented? Who formed the group and who will determine its composition?

Response: Attachment 6 to FASB Chairman Robert H. Herz's March 4, 2003, testimony before the Subcommittee on Commerce, Trade and Consumer Protection contains a listing of the initial members of the FASB's User Advisory Council ("UAC") and their affiliations. The UAC was formed by the FASB, and the FASB will determine its composition.

Question 18) What role will the Council play in the FASB's process of developing an agenda and accounting standards?

Response: The FASB expects that the UAC will assist the FASB in raising awareness of how investors and investment professionals, equity and credit analysts, and rating agencies use financial information. The UAC will serve as another resource to the FASB both in formulating its technical agenda and on specific projects that the Board undertakes.

Question 19) The legislation passed out of the Subcommittee last Congress included principles that financial reporting should be transparent and equally usable for both the average investor and industry professionals. Will the Advisory Council's input balance the goal of providing useful information that meets the needs of both groups (Professionals and consumers)?

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[31] Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Stock Options Using the Fair Value Method," Bear Stearns (March 24, 2003).

[32] FASB News Release, "FASB Adds Projects to Its Agenda on Employee Stock Options and Pensions" (March 12, 2003).

[33] See IASB Proposed IFRS, *Share-Based Payment* (November 2002) (proposing a fair value grant date approach to the accounting for stock compensation similar to the preferable fair value method contained in FASB Statement No. 123).

Response: The objectives of US financial reporting are to

> . . . provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable *diligence*.[34]

Thus, US financial reports are not intended (nor is it a realistic to expect financial reports) to be useful to all investors. Rather, financial reports are intended to provide useful information only to those investors and other users of financial statements that have a reasonable understanding of business and economic activities and exercise reasonable diligence. The FASB expects that the UAC's input will assist the FASB in raising awareness of how those investors (both professionals and consumers) use financial information.

PRIMACY OF FASB

Question 20) FASB has discontinued the role of the AICPA as a senior level standard setter. FASB has also decided that development of industry-based standards should reside with FASB. Do you expect that this determination will be challenged? Should this determination be codified?

The AICPA issued a press release announcing that it supported the FASB's decision that, after a transition period, the AcSEC should cease issuing Statements of Position that create new US GAAP.[35] In addition, as indicated in the memorandum from the Office of Chief Accountant attached to the March 7, 2003, letter from SEC Chairman William H. Donaldson and FASB Chairman Robert H. Herz to Chairman Cliff Stearns and Representative Janice D. Schakowsky, the SEC anticipates finalizing a policy statement in the near future that will recognize the FASB under the 2002 Act as the independent private-sector accounting standard-setting body in the US.

[34] FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises* (1978), ¶34 (emphasis added).

[35] AICPA Press Release, "American Institute of Certified Public Accounts Shifts Focus to Industry-Specific Accounting Guidance" (November 5, 2002).

Congress of the United States

Washington, DC 20510

February 3, 2003

Financial Accounting Standards Board
File Reference 1102-001
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Sent by email to director@fasb.org

Re: Employee Stock Option Accounting

To Whom It May Concern:

In response to the Financial Accounting Standards Board's (FASB) Invitation to Comment on the proper accounting for employee stock options, we wish to strongly voice our support for an honest accounting standard that would require all employee stock option compensation to be shown as an expense on corporate financial statements.

The current U.S. accounting standard allows companies to choose whether or not to report stock option compensation as an expense in their financial statements filed with the Securities and Exchange Commission. This accounting treatment has led to a variety of stock option abuses linked to excessive executive compensation, inflated company earnings, dishonest accounting, and corporate misconduct.

Since the 1980s, stock option compensation has funneled millions of dollars to U.S. corporate executives and now accounts for a large share of compensation paid to chief executive officers (CEOs) at U.S. corporations. Business Week has estimated that, in the aggregate, employee stock options now account for "a staggering 15 percent of all shares outstanding" at U.S. publicly traded corporations. The amounts paid to CEOs are striking, including the $123 million paid to Enron's CEO in 2000, and the $700 million paid to the CEO of a high technology company in 2001. Typically, such payments never appear on a company's financial statement, despite the size of the payment and even though the common practice is that the company claims the compensation as an expense on its federal corporate tax return. The omission of any stock option expense in the financial statement, combined with the inclusion of this expense in the company's tax return, means that huge stock option grants lead to overstated earnings. Federal Reserve Chairman Alan Greenspan has estimated that stock options have been used to overstate reported company earnings by an average of 6 to 9 percent.

But this is not the only problem associated with stock options. A September 2002 report issued by a blue-ribbon panel established by The Conference Board found that the current accounting treatment of stock options helped "foster[] what appears to be a vicious cycle of increasing short-term pressures to manipulate earnings in order to bolster stock price in order to cash in on options." Such earnings manipulation is associated not only with the Enron scandal, but many of the other accounting scandals in 2002. These stock option abuses and the dishonest accounting associated with them have damaged investor confidence in the accuracy and reliability of U.S. corporate financial statements.

In response to this loss of confidence, over 120 U.S. companies, including such American giants as Coca-Cola, General Motors, General Electric, Dow Chemical, Amazon.com, Home Depot, and Wal-Mart, have announced that they will begin expensing options in 2003, joining longtime expensers like Boeing and Winn-Dixie. Other companies, however, especially in the high technology sector, have announced that they will not expense stock options until required to do so. This division of approach means that, until FASB acts, there will be a discrepancy between those companies that are voluntarily expensing options and those that are not, when there ought to be a level playing field in which everyone operates under the same accounting rules. This discrepancy looms large in light of the huge dollars involved in many stock option awards. Failing to impose a uniform expensing requirement would not only allow companies that do not expense options to inflate their earnings, but would also disadvantage the companies that do report stock option expenses as well as hinder financial analysts and investors attempting to understand company financial statements and compare corporate performance.

Some opponents of stock option expensing argue that, due to the difficulty of precisely estimating stock option values, expensing will confuse rather than educate financial analysts and investors about a company's financial condition. But many accounting standards require estimated valuations and, as Warren Buffett has pointed out, the only value that everyone agrees is incorrect for a stock option is zero. The better approach to curtail stock option abuses and restore investor confidence in financial statements is to require all companies to use the same stock option valuation methodology to ensure stock options are expensed and the comparability of financial statements is strengthened.

Some critics also contend that expensing stock options would eliminate broad based stock option plans and hurt average workers, but this contention is contradicted by the factual record. First, successful U.S. companies that offer broad-based stock option plans to their workforce have already determined that they can expense employee stock options without having to end this form of compensation. Two recent examples are Home Depot and Wal-mart, which offer broad-based plans to many average employees and have announced they will begin expensing options this year. Secondly, only a small percentage of U.S. companies now issue stock options broadly to average workers, even when those workers are eligible to receive them. A recent nationwide survey conducted by the U.S. Bureau of Labor Statistics found that in 2000 – a banner year for stock options – only 1.7 percent of non-executive workers actually received any stock options.

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This survey, the most extensive review of actual worker receipt of stock options in corporate America, demonstrates that most workers do not now receive stock options and would be wholly unaffected by any changes in stock option plans, even assuming any change were actually to take place. In short, neither broad based stock option plans nor average workers would be hurt by honest accounting.

Now is the time to end the dishonest accounting of stock options and recognize the expense associated with this compensation. FASB was prevented by political pressures from expensing options in 1994, but has consistently contended over the years that expensing is the correct approach. According to the Association for Investment Management and Research, over 80 percent of U.S. financial analysts and portfolio managers agree. The International Accounting Standards Board is already advocating this approach in its proposed accounting standard for stock-based compensation. Many others also support stock option expensing, from leading figures like Federal Reserve Chairman Alan Greenspan, former Federal Reserve Chairman Paul Volcker, investor Warren Buffett, and Nobel Prize winner Joseph Stiglitz, to such groups as the Council of Institutional Investors, the Investment Company Institute, The Conference Board's Commission on Public Trust and Private Enterprise, and the Consumer Federation of America. The more than 120 companies that are now expensing options also deserve a fair accounting standard that will not place them at a disadvantage with competitors who refuse to show this expense.

Requiring companies to expense employee stock options would strengthen the accuracy of financial statements and help restore public trust in our financial reporting system, our companies, and our markets. We urge FASB to issue a proposed stock option accounting standard as soon as possible and to promulgate a final standard by the end of 2003.

Sincerely,

John McCain
John McCain

Pete Stark
Pete Stark

Carl Levin
Carl Levin

Stephanie Tubbs Jones

Earl Pomeroy

Mike Castle

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Ed Case

Barbara Lee

Dennis J. Kucinich

George Miller

Jerrold Nadler

Mark Pryor

Bill Nelson

Herb Kohl

William O. Lipinski

ONE HUNDRED EIGHTH CONGRESS

U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515–6115

W.J. "BILLY" TAUZIN, LOUISIANA,
CHAIRMAN

February 27, 2003

The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856

Dear Chairmen Donaldson and Herz:

Pursuant to Rules X and XI of the U.S. House of Representatives and this Committee's jurisdiction over the Financial Accounting Standards Board (FASB), we are writing to inquire into the status of your implementation of Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 (Public Law 107-204, July 30, 2002). Section 108 authorizes the Securities and Exchange Commission (SEC) to promulgate such rules and regulations as it deems necessary or appropriate to carry out its authority pursuant to Section 19 (b) of the Securities Act of 1933, as amended by Section 108, to recognize as "generally accepted" for purposes of the securities laws accounting principles established by a standard-setting body that meets the criteria set forth in paragraph (1) (A) of new Section 19 (b). Section 109 provides that the budget and expenses of the standard setting body so designated by the SEC shall be funded by an annual support fee collected from issuers by an allocation formula, subject to review by the SEC. Recent press reports, "Accounting Board To Get Millions In Private Money," Washington Post, Wednesday, January 22, 2003; and "Pitt's Last Licks," Business Week, February 24, 2003, indicate that FASB may be facing a cash crunch in the near future due to failure to carry out these mandates. This is unacceptable.

The Honorable William H. Donaldson
Mr. Robert H. Herz
Page 2

Please provide us with a report by the close of business on Friday, March 7, 2003, on your progress to date and a time table for steps to be taken to carry out these important statutory requirements. We understand that the SEC is carrying an enormous workload and faces its own considerable funding and staffing issues. We continue to support increased funding for the SEC and decry the fact that the promised funding has not materialized. Our responsibility, however, is FASB. In the wake of the accounting scandals that brought down Enron and other companies, FASB has been asked by the SEC and the Congress to address concerns about the timeliness, transparency, and complexity of its rules promptly and to proceed expeditiously to resolve the financial accounting and reporting issues highlighted by the spate of accounting debacles and financial restatements. The successful completion of these tasks is dependent on the successful implementation of Sections 108 and 109.

This Committee's Subcommittee on Commerce, Trade, and Consumer Protection will be looking into these issues at an oversight hearing on March 4, 2003. We look forward to receiving your responses, and thank you for your cooperation and attention to this important investor protection issue.

Sincerely,

Cliff Stearns
Chairman
Subcommittee on Commerce, Trade, and Consumer Protection

Janice D. Schakowsky
Ranking Member
Subcommittee on Commerce, Trade, and Consumer Protection