Interview with Former FASB Chairman Robert Herz

Outline
Naoto Kimura, a Japanese CPA and a partner of Avantia GP, had an opportunity to interview with the Former FASB Chairman Robert Herz in last December when Mr. Herz came to Japan in order to perform some seminars regarding his recent book, Japanese version of "Accounting Changes". This interview appeared in the Japanese accounting magazine "Keiei-Zaimu" which is the most major weekly accounting magazine for CPA and CFO in Japan.

* At the conference room in JICPA on 5th December.

1. Political Pressure in Setting Accounting Standards

Naoto Kimura ("Kimura"): As the Chairman of Financial Accounting Standards Board ("FASB"), you must have experienced political pressures, for example, when introducing accounting for stock option or responding to the financial crisis. Based
on your experience, please share your views on how accounting standards should be set and the political intervention in the standards setting.

Robert Herz (“Bob Herz”): It is difficult to imagine a situation where there is no political intervention at all. In a democratic society, it is natural for elected officials to try to exert influence. On the other hand, even if changes were made to enhance transparency of standards setting bodies, there will still be some who do not prefer such changes.

The two issues you mentioned, the introduction of stock option and the response to the financial crisis, would be the periods when FASB was subject to highest-level of powerful political pressure. First, the accounting for stock option before the change was advantageous for high-tech industry’s accounting practice, therefore, people who wanted to continue treating stock option without recognizing accounting costs spent millions of dollars for lobbying the United States legislature. I was invited to the Congress eight times within a span of one and a half years; needless to say, they did not invite us to praise what we were doing. However, my colleagues in FASB and I did not give into such pressure in order to improve accounting and to maintain trust in the standards setting body. Fortunately, investors, accounting professionals, some influential Senators, and, among the well-known, Alan Greenspan and Paul Volcker were our strong allies, enabling us to overcome the pressure in the end. We won the battle, although it was quite close and even ruthless. I believe it was an important change to ensure the integrity of financial reporting.

The second period was during the financial crisis, where the issue was on how to treat fair value in accounting. As you know, credit crisis preceded the financial crisis. Trillions of dollars of financial products such as mortgage-backed securities and asset-backed securities were being traded in the market. While the transactions were closed, they could be valued by the market price, however, once the inferior quality of the underlying mortgage or assets became known, transactions could not get closed; leaving the issue of how those products should be valued. The text-book theory says they should be treated at fair value, but the real question became, “what is fair value?” FASB received pressure to issue guidance on how to value complex securities in an environment where the trades were not executed. I believe this pressure was fair.

The United States did not have any rulebook on these issues until the financial crisis. I believe we were able to respond in an appropriate manner in an unprecedented circumstance.
2. The Significance of Accounting Estimates

**Kimura:** Thank you. Let me move onto the second question. The current accounting system calls for accounting estimates in various instances. I would like to focus on issues such as impairment accounting or tax effect accounting that even general businesses need to take into account, not the type of complex financial products referred earlier. In these fields, the value of an asset is determined based on a future business plan. Here, hindsight always becomes an issue. If things did not work out according to the plan, there is always the risk of someone pointing out, “Was the accounting treatment at that time appropriate?” Given such risk, can you share with us what you expect of businesses or auditors like us, given your experience as a standard-setter?

**Bob Herz:** First, let me make it clear that the reason why standards setting bodies require estimates is because the user of financial reporting requires these as relevant and important information. As a standards setting body of accounting rules, we expect that accounting estimates are based on the best available information at the time. In the case of impairment accounting or tax effect accounting which you mentioned, estimates will be made based on the documentation of future plans, etc. Auditors will review points such as whether they are reasonable, sufficiently documented, and consistent, etc.

In recent years, regulating authorities have criticized the auditors that their examinations of the managements’ estimates were insufficient; and, we have seen efforts to improve on the auditors’ side. However, enforcement and review of the auditors and businesses need to be consistent. I have some concerns that higher expectation is placed on the auditors than on the businesses.

**Kimura:** On that point, currently, when the regulators scrutiny a certain audit engagement, it is possible for them to use the outcomes two or three years subsequent to the opinion to form their opinion; effectively, such opinion will be biased by the benefit of hindsight. Could you share your view on this?

**Bob Herz:** Such practice is not appropriate and regrettable. The future is always uncertain and most estimates do not realize accurately. Therefore, any difference between the estimate and actual outcome in itself does not prove that the estimate
was inaccurate. The focus of the review should be on how the estimate was formed: whether it was based on the best available information at the time and if it was made without bias.

That being said, whether the preconditions used and the judgment by the management were reasonable must be scrutinized, by comparing them with external evidence and industry projection, etc. Auditors should remember to always take skeptical viewpoint in reviewing whether the management’s view is biased or not.

3. Understandability of Accounting Standards

Kimura: I see. Now the next question is on the understandability of the accounting standards. The accounting standards have evolved significantly in the past 10 years or so, including the accounting estimates you described. On the other hand, some criticize that they have become too complex for the general public and businesses other than large, sophisticated companies. Although there are many areas where users and businesses have to enhance their efforts, it is hard to argue that the current accounting standards include points that are too complex. Please explain your thoughts on the issue.

Bob Herz: I have some comments. First, we need to consider who we mean by the term “user”; whether it is the user of the financial reports of listed companies or unlisted companies, etc. At least in the United States, the users in the latter case are mostly banks, whereas the investors are the main users of the former case. It may be necessary to differentiate according to what the priorities are for the actual users, based on the different circumstances. For most of the accounting rules, it is more desirable to have the same set of rules; however, there are some cases where cost and benefit should come into the picture.

The second point is that there are two types of complexities in accounting standards: the unavoidable and the avoidable. In the case of complex transactions, accounting procedures will reflect the complexity of the transactions. However, there are some standards that are complex even though such complexity could have been avoided. As a standard setting body, I believe it is important to minimize such avoidable complexity. Standards often become complex by setting exceptions or numerical criteria; these are points that should be noted.

4. Principles-based Accounting and Rules-based Standards
**Kimura**: Related to what you mentioned, I would like to ask your opinion on principles-based accounting and rules-based standards. Traditionally, the accounting standards in the United States have been viewed as very complex, with a significant number of standards. However, you have made efforts to simplify the standards through efforts such as codification of standards as the chairman of FASB. Also, you have expressed preference for principles-based accounting. On the other hand, the general public sometimes views principle-based accounting as abstract, because one standard covers all businesses and transactions. Please elaborate on this issue.

**Bob Herz**: I have no problem with discussing the pros and cons of principles-based accounting and rules-based standards; but I feel that comparing International Financial Reporting Standard (“IFRS”) and US-GAAP is over-exaggerated. FASB standards are also based on principles. One has to admit that there are significant numbers of guidance, but as long as they are consistent with the principles, I do not think they are problematic. Having said so, it goes without saying that having too many and too detailed guidance that people focus on the guidance without understanding the principle is considered problematic. As you pointed out, my personal view on accounting standards is that it should be based on principles; even the standards issued by joint projects should have clear goals and be based on principles. It is enough to provide thorough explanation and show only some examples for practical application. However, it is a fact not only in the United States but elsewhere that there is possibility of being subject to regulatory scrutiny, or, depending on the circumstance, being sued; for this reason, it is reasonable for some to prefer having guidance as giving layer of safety.

**Kimura**: Although you consider principles-based accounting more preferable, your book, “Accounting Changes: Chronicles of Convergence, Crisis, and Complexity in Financial Reporting” points out factors in the United States that work against principles-based accounting. Can you discuss what is necessary to resolve such situation?

**Bob Herz**: In reality, it will be difficult to carry out a drastic reform, and, it is not necessarily appropriate. I am saying this because such action may cause people to
think that the accounting standards setting body can do as it pleases, and may reduce the trust towards the system. Therefore, I believe it is necessary to establish a conceptual framework which is superior to the current framework: next, state clear goals and principles, and, finally, provide guidance for practical application to help the users’ understanding.

5. SEC Movements: Announcement of SEC’s Roadmap for the Adoption of IFRS, and the Possibility of Voluntary Adoption

**Kimura**: Since the last question which dealt with the situation in the United States, I would like to ask another question related to the United States. Since the announcement of a roadmap for adoption of IFRS by the Security and Exchange Commission (“SEC”) in 2008, one may say that the situation has changed dramatically. Could you tell us your views on the SEC’s moves in the past two to three years?

In Japan, voluntary adoption of IFRS is allowed currently, with some companies already adopting IFRS in their financial reporting. Do you think it is possible for SEC to approve voluntary adoption in the United States? Please share your views.

**Bob Herz**: I still firmly believe that the companies listing in global capital markets should adopt one set of high-quality international standards. The SEC’s roadmap you referred to was only a proposal: the responses to SEC’s public comments request included few positive comments, and it sort of disappeared from the radar. I remember that the roadmap was announced in August 2008, and everyone remembers what happened in the following month. The world changed. Priorities for SEC staff had to change. With the enactment of Dodd-Frank Wall Street Reform and Consumer Protection Act, SEC had to make hundreds of new rules, dropping down IFRS on the list of priorities. Meanwhile, cooperation between FASB and International Accounting Standards Board (“IASB”) continued; although we made our best efforts, it was difficult to reach common opinion on the main projects. Thus, the goal of establishing uniform, high-quality international standard through convergence started to be seen as difficult.

So, the reply to your question would be, even under such circumstance, SEC continues to support the goal of one set of high-quality international standards itself. Voluntary adoption is considered as an alternative method for achieving the goal. Chair Mary Jo White and Chief Accountant James Schnurr of SEC have said that SEC will announce some action in the near future. Whether it is voluntary
adoption or not is yet unknown, but in that case, I presume it will be allowed for certain large companies.

6. The United States' Role in the Future

**Kimura**: Against such backdrop of the current developments in the United States, your book includes passages such as “I would like to ask all the people who trust a single set of high-quality international standard to be patient with United States,” and, “Without the United States, any accounting system will not be truly international.” Please tell us what you think about the role the United States should play in a world with global accounting standards.

**Bob Herz**: The United States has the largest economy and capital markets in the world, so any system without its participation cannot be regarded as truly global. Currently, approximately 500 large companies use IFRS in the American market as foreign companies and, international investments by American investors are on the rise. Thus, it is in the interest of the United States to have the standards used by foreign companies to be of high-quality. Therefore, separate from the question of whether voluntary adoption of IFRS should be allowed to United States public companies, it is essential for SEC and FASB to continue their global roles pro-actively.

7. Deferral of Revenue Recognition Standard?

**Kimura**: I see. Now, let me move on to a more recent topic. In The Current Financial Reporting Issues Conference of Financial Executives International (“FEI”) held in November 2014, the assistant director of FASB commented that FASB was considering deferral of the scheduled 2017 implementation date of revenue recognition standard. Although you have already left your position in FASB, could you comment on this move?

**Bob Herz**: I was also present at the FEI conference you mentioned. I believe FASB is following appropriate process in working on the issue, and I have complete trust on the way they work. I expect FASB to reach decision in early 2015, after having collected sufficient inputs on whether more time is necessary for the standard to be applied to practice in the right manner. Vice Chairman James L. Kroeker, who used to serve as Chief Accountant of SEC, commented that, even if it is decided to defer the implementation date for one year, it does not mean that businesses can just
cease their preparation and wait one year until the implementation date, the preparation should continue even in the event of deferral; meaning that withholding the preparation for one year is unacceptable. I also believe that SEC will carefully monitor so as to avoid such lag in the preparation.

8. Goodwill Amortization

Kimura: So, even if the implementation is deferred, businesses should continue preparing for the new standard. Now, allow me to move on to a very different topic, which is specific to Japan: goodwill amortization. As you know, whereas JGAAP allows rule-based amortization, US-GAAP and IFRS conduct impairment test without amortizing goodwill. In the United States, the rule not to amortize goodwill was implemented shortly before you became FASB chairman; but in Japan, our standard setting body is still working on continuing the rule-based amortization to this day. Please share us your personal view.

Bob Herz: Before explaining my personal view, allow me to update you on the current situation in the United States. FASB is considering an alternative option for unlisted companies to allow goodwill amortization. In addition, it is starting to review allowing amortization to listed companies in certain cases. Statement of Financial Accounting Standards (“SFAS”) 142 was issued before I started working for FASB. Traditionally, financial statements users of listed companies held the view that goodwill should not be amortized, and added back amortization expense even if it had been amortized. It was based on the thinking that the treatment did not reflect the economic reality; I personally support this view.

I am aware of the complexity of the current impairment testing method: a debate on whether the test could be simplified has been active for the past few years. However, the bottom line is, accounting should reflect the economic reality. I believe that at least allowing amortization an across-the-board does not reflect the economic reality of individual companies.

Kimura: Am I correct to understand that you think the Japanese accounting standard on goodwill amortization rule should be subject to convergence in the future?

Bob Herz: My basic belief is that a single set of high-quality international standard
is best for the users. That makes my answer to your question “Yes”, but on the other hand, I do not regard the current practice on goodwill as not necessarily the best. Anyhow, I am against goodwill amortization.

9. Requirements for Global Talent

**Kimura:** Please excuse me for asking a hardball question. The next question is on human resources development. Based on your experience and your career which has spanned the globe: please advise the younger generation, who look up to you in becoming a global accounting professional.

**Bob Herz:** If your goal is to become a global talent, I believe the best way is to live abroad and work in a different culture. However, not everyone has such a chance, so I suppose my advice would be to immerse yourself in different culture and work-style through reading or having dialogue with people from various countries/regions to give insight to the differences that exist. That being said, I think nothing beats the actual experience of living abroad and gaining work experience abroad.

10. Future Accounting Education

**Kimura:** In addition to being global, what other thoughts do you have on the future accounting education?

**Bob Herz:** It is essential to first study economics and finance as well as the actual business processes before studying individual accounting rules. I believe you cannot be a good accounting professional by starting from gaining knowledge on individual accounting rules without possessing understanding on the business or economics which the rule is targeting. Also, skills such as teamwork and problem solving skills are becoming essential for accounting professionals.

11. Entering the “Accounting Hall of Fame”

**Kimura:** Before moving on to my final question, I would like to ask your comment on being inducted to the Accounting Hall of Fame based on your achievements.

**Bob Herz:** As only approximately 90 accountants have been inducted in 150 years of history, I am really proud to join them. Also, I appreciate the fact that my colleagues
in accounting recognized the value of my work at FASB soon after I left FASB. Past inductees include historic names such as Brandt C. Louie, William Welch Deloitte, Arthur Edward Andersen, which makes me extremely proud to be one of them. Also, the induction of my good friend David Philip Tweedie in the year after my induction has been a source of joy. While some accountants are inducted after they passed away, I feel happy to be around at the time of my induction. Accounting Hall of Fame is known to accountants, but, when I told my daughter who is in the teaching profession, her comment was, “Is that a joke? Is there a Hall of Fame in the field of accounting? (laugh)”

12. Message for the Readers of Shukan Keiei Zaimu

**Kimura**: I express my heartfelt congratulations. It was a privilege to interview you, a famous accountant hall of famer. Finally, could you give a message to our readers?

**Bob Herz**: With pleasure. First, I am extremely proud of being an accounting professional with Certified Public Accountant and Chartered Accountant. Our profession is extremely important for the capital markets as well as the clients seeking our advice. Various skills need to be combined for the work we do, and, objectivity is required. Therefore, I would like to stress to the readers that you are contributing to such work. And, I would like to ask the readers to perform work at a high level with due objectivity and integrity.

**Kimura**: Thank you very much for sharing your valuable experience and views, which reminded me of the importance of working with pride as an accounting professional at all times.