



THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

*Copy Board,  
JTB, DM  
TBL,  
VC  
Daryl Cantor  
DMS 1/14*

January 10, 1994

The Honorable David L. Boren  
United States Senate  
453 Russell Office Building  
Washington, D.C. 20510

Dear Senator Boren:

Thank you for your letter of November 30, 1993 regarding the Financial Accounting Standards Board's ("FASB") project on the accounting for stock-based compensation.<sup>1</sup> Your letter notes the significant Congressional interest in this project and expresses concerns for the independence and neutrality of the FASB and for the credibility of the financial reporting process. You ask for my views on the need for the FASB to set neutral accounting standards and on the implications of legislating accounting standards.

I appreciate the interest of Congress regarding an issue that may have significant consequences, particularly for small, high-technology companies that rely on employee stock options to recruit and retain talented individuals. Some members of Congress and others have indicated that if the FASB proposal is adopted the earnings of these companies would be lowered and the cost of capital for these companies would be raised. These are important concerns for an industry that must keep pace with rapidly advancing technology and global competition.

I also appreciate, however, the fundamental concerns expressed in your letter regarding the potentially harmful effects that Congressional action in this area may have on the integrity of financial accounting and reporting and on the credibility of the financial information that provides the basis for investing, lending, and public policy decisions.

The Commission has not adopted a formal position on either the continuation of the FASB project or, should it continue, the direction to be taken in any final standard. However, considering

---

<sup>1</sup> FASB, Exposure Draft: Proposed Statement of Financial Accounting Standards, "Accounting for Stock-based Compensation" (June 30, 1993) (the "exposure draft").

The Honorable David L. Boren

Page 2

the Commission's oversight of the FASB's process and the historical emphasis on the need for neutral accounting standards, I believe that, in general, it is inappropriate for Congress to prescribe accounting standards through legislation, especially when such legislation is designed to serve social or political goals favored by a specific industry or group.

#### Commission Oversight of the FASB Process

The Federal securities laws are designed to protect investors through the disclosure of reliable, complete, material information. Financial statements prepared by management and audited by independent public accountants are a central feature in this disclosure system. Since 1938, the Commission has looked to the accounting profession for leadership in establishing and improving accounting standards. The FASB, formed in 1973, is the current private sector body designated by the accounting profession to set accounting standards.

In setting standards, the FASB follows a long, thorough deliberative process. That process requires open meetings where additions to the FASB's agenda and proposed standards are discussed. Prior to acting on any significant proposed standard, the FASB issues for public comment a discussion memorandum or similar document exploring all the issues, public hearings are held, a draft proposal is published for public comment, and the proposal may be "field tested." The FASB then studies the information received during this process and redeliberates all issues regarding the proposal before issuing a final standard.

The SEC staff closely monitors all FASB standards-setting projects. The SEC staff reads the comment letters, observes FASB open meetings, task force meetings, and public hearings, and expresses any concerns and interests it may have to the FASB and its staff. Once a standard is adopted, the SEC staff continues to consult with the FASB staff on implementation issues and whether interpretations or changes in the standard may be necessary to achieve the objectives of the standard. This oversight will be conducted for the stock-based compensation project, as it is for all others.

As noted in your letter, the FASB project on accounting for employee stock options is far from complete. The comment deadline for the exposure draft was December 31, 1993. The field test of the proposed standard is yet to be completed. Public hearings on the proposal will be held in Connecticut and California in March 1994. A final standard is not anticipated until the fourth quarter of 1994. Furthermore, the exposure draft suggests a three-year

The Honorable David L. Boren

Page 3

period of footnote disclosures before any expense would be recognized in registrants' financial statements.<sup>2</sup>

The FASB members assured the Commission during an open meeting among the Commission and the FASB members on November 17, 1993 that each issue discussed in the exposure draft remains an open question before them, and that all issues will be redeliberated following the public comment process, the scheduled public hearings on the project, and an analysis of the field test results.

#### Historical Emphasis on the Need for Neutral Accounting Standards

Shortly after the formation of the FASB, the issue of the neutrality of accounting standards was discussed in a variety of contexts. Some expressed concern about the potential effect of Commission rules and FASB accounting standards on, among other things, corporate spending for such national priorities as oil and gas exploration and research and development activities.<sup>3</sup>

In 1978, the Commission faced such concerns when it adopted financial reporting requirements related to oil and gas producing activities. Commentators on the Commission's proposing release indicated that if the Commission's rules were adopted then managers would seek to mitigate the effects of the rules on reported earnings by reducing their exploration expenditures. The Commission recognized the possibility that the decisionmaking process at individual companies to some degree could be affected "in a dysfunctional manner" based on the new rules, but stated,

While the potential economic impact of financial accounting standards should be assessed in the process of establishing

---

<sup>2</sup> If a final standard regarding the accounting for stock-based compensation is adopted, and if that final standard contains the proposed three-year disclosure period, the SEC staff would review these disclosures as part of its routine review of registrants' filings.

<sup>3</sup> Similar concerns have been expressed on several occasions over the years by those who would be affected by a proposed FASB standard. For example, many concerns regarding the protection of broad national interests were raised in connection with the recent change in the accounting for retiree health benefits. This change has resulted in huge losses being reported by some companies, particularly by industrial companies that are struggling to remain competitive in a global economy. Most sources agree, however, that the new financial information provided by this change in accounting standards has helped to stimulate a necessary and timely policy debate over health care costs and coverage in this country.

The Honorable David L. Boren

Page 4

new standards, the objective of providing useful information to investors should be overriding.<sup>4</sup>

The Commission further noted,

... that attempts to foster particular national economic policies, such as an increase in domestic petroleum production, are not appropriate considerations in formulating financial reporting standards. Financial reporting should seek to provide investors with useful information that is relevant, reliable, comparable, and unbiased. Otherwise, the capital allocation process would be distorted and ultimately the credibility of the information provided by financial reporting would be lost.<sup>5</sup>

During this time frame, Oscar Gellein, then a member of the FASB, delivered an address regarding "neutrality" in standard setting. He said, "Neutrality implies representational faithfulness to what the information purports to represent - as contrasted with representational bias for a selected mode of behavior."<sup>6</sup> Mr. Gellein indicated that neutrality means an "evenhandedness" of reporting events. He noted that accounting standards setters should guard against designing financial reporting to influence behavior toward a specified end because: (1) they are not competent to make the value judgments required or to design the means to assure that end, (2) they cannot predict the "rippling effects" of their actions, (3) financial reporting would need to be designed and redesigned repeatedly to keep up with changing social or political goals, and (4) most significantly, there is "the likelihood that financial reporting would lose its

---

<sup>4</sup> Accounting Series Release No. 253, 43 Federal Register 40688, 40700 (Sept. 12, 1978), which also states,

The Commission's belief that financial accounting should seek to portray financial position and operating results in a meaningful manner is based on its view that financial reporting on this basis would provide useful information to investors and other users of financial information. The Commission agrees strongly with the FASB's tentative conclusion that the objectives of financial reporting should be couched in terms of the needs of those for whom the information is intended. (Footnote omitted.)

<sup>5</sup> Id. at n. 32.

<sup>6</sup> Address by Oscar S. Gellein, "Neutrality Has Consequences," before the 1978 Annual Convention of the American Accounting Association, reprinted in FASB Viewpoints (Sept. 29, 1978).

The Honorable David L. Boren

Page 5

standing as a vital force in maintaining a healthy capital market."<sup>7</sup>

Mr. Gellein's views are representative of those expressed by others regarding the benefits of neutral accounting standards.<sup>8</sup> Donald Kirk, past Chairman of the FASB, stated,

In my judgment, actuaries, accountants and other measurement practitioners should be extremely wary about crossing the line that divides neutral measurement and political objectives. Measurements should be unbiased. The decision-maker may choose, for political reasons, to ignore those measurements. But if the measurement is designed, in the first place, purposefully to point in a particular direction, the burden of an unsound decision is shifted from the decision-maker to the measurer, and the credibility of the measurer and his standards are diminished.<sup>9</sup>

More recently, my predecessor, Richard Breeden, in discussing the recent savings and loan crisis, stated,

The purpose of accounting standards is to assure that financial reporting is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose.<sup>10</sup>

---

<sup>7</sup> Id.

<sup>8</sup> See, e.g., Robert T. Sprouse, "Commentary on Financial Reporting," Accounting Horizons 110, 114 (June 1988), which states, in part:

Perhaps, in time, all the interested parties will understand that an accounting standard is neither an efficient nor an appropriate means of facilitating a particular industry's access to the capital markets or pursuing particular national economic goals. The U.S. Congress has far more powerful and appropriate tools at its disposal.

<sup>9</sup> Donald J. Kirk, "Self-Regulation in a Deregulatory Environment," FASBVIEWPOINTS (Feb. 25, 1982).

<sup>10</sup> Testimony of Richard C. Breeden, *Concerning Issues Involving Financial Institution Accounting Principles Before the Senate Committee on Banking, Housing and Urban Affairs, 101st Cong., 2d Sess., 38* (September 10, 1990).

The Honorable David L. Boren

Page 6

Discussion

The existing process for setting accounting standards, with its emphasis on providing neutral, unbiased information to investors and policy makers, has been successful and should continue. Working in partnership, the SEC and the FASB have established what are widely recognized as the most comprehensive accounting standards in the world, providing transparency of the economic conditions, events, and transactions affecting public entities. The financial statements prepared in accordance with these standards allow investors to decide how the underlying facts should affect security prices and the allocation of capital. I believe that the commitment in this country to a financial accounting and reporting system that has the objective of providing complete, transparent, and unbiased financial information to investors has helped make the United States' securities markets attractive for both domestic and global capital formation.

As noted above, the true role of accounting standards-setting bodies should not be to judge whether an economic goal or political or social policy is good or bad, but to create the means for communicating reliable and complete information to investors and to the public in general. This information should permit knowledgeable investment decisions, assist in public debates, and allow public policy makers to formulate well-informed and real solutions to problems facing the nation. In that regard, the FASB's Mission Statement says,

The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

It certainly is appropriate for Congress to have an interest in accounting issues, particularly one that may have far-reaching implications such as the accounting for employee stock options. For the reasons noted above, however, I believe that it is inappropriate for Congress to prescribe accounting standards through legislation. And, while I believe that the FASB should not view its proposals in a vacuum and should keep national priorities in mind, I also believe that it would not be appropriate to require the FASB to halt the development of an individual project because it may conflict with the economic, political, or social goals of a specific industry or group. I am concerned that if the FASB's agenda is limited to those projects that meet Congressionally favored goals, then the process no longer may be perceived as standards setting by an independent body within the accounting profession. The notion that reported information may be biased toward fulfillment of political or social goals may have serious

The Honorable David L. Boren

Page 7

repercussions on the credibility of the financial information that fuels our securities markets.

Moreover, if the FASB is required to select, reject, or decide projects based on its members' views of whether an ultimate standard may affect such goals adversely then, by that process of selection, the FASB would assume the role of making economic, political, and social decisions. This is a task that the FASB does not want, is not charged with, and is not qualified to perform.

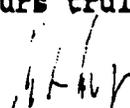
The FASB was created to make, and should make, accounting standards decisions. In making these decisions, the FASB must listen to the concerns of all of its constituencies and then be free to write and issue, without bias or favoritism, cost-effective accounting standards that are designed to reflect economic conditions, events, and transactions as objectively as possible.

#### Conclusion

The Commission has given this project serious and careful consideration, and there may be a diversity of views among individual Commissioners on whether the Commission should act now to bring a halt to the FASB's project.<sup>11</sup> On balance, however, for the reasons stated in this letter, I believe that the FASB should continue its consideration of the accounting for employee stock options, which it started almost ten years ago.

I appreciate your soliciting my views regarding this important topic, and if you would like to discuss any of the issues raised in this letter, I would be pleased to do so. I look forward to working with you in this and other areas.

Yours truly,

  
Arthur Levitt  
Chairman

---

<sup>11</sup> See generally, letter from Chairman Arthur Levitt to The Honorable Anna G. Eshoo (Oct. 18, 1993), address by Commissioner Mary L. Schapiro, "Remarks Before the National Investor Relations Institute" (April 28, 1993), and addresses by Commissioner J. Carter Beese, Jr., "Remarks Before the Association for Public Companies" (Dec. 1, 1993) and "Stock Option Accounting and Securities Litigation Reform" before The Association of Publicly Traded Companies (Nov. 15, 1993).