Financial Accounting Standards Board
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August 3, 1993

Senator Joseph I. Lieberman
United States Senate
Hart Senate Office Building
Room 316
Washington, DC 20510

Dear Senator Lieberman:

Members of the Financial Accounting Standards Board (the FASB or the Board) and its staff routinely consult with members of Congress, their staffs, and other government officials on matters involving financial accounting. For example, FASB members and staff met with Senator Levin both before and after the introduction of his proposed legislation, Senate Bill 259, which also addresses accounting for employee stock options.

The attachment to this letter discusses the accounting issues (we have not addressed the tax issues) raised in your proposed legislation, Senate Bill 1175, and issues raised in remarks introduced in the *Congressional Record*. My comments in this letter address an issue that is more important than any particular legislation or any particular accounting issue: Why we have a defined process for setting financial reporting standards and why it is harmful to the public interest to distort accounting reports in an attempt to attain other worthwhile goals.

Financial Reporting

Markets are enormously efficient information processors--when they have the information and that information faithfully portrays economic events. Financial statements are one of the basic tools for communicating that information. The U.S. capital market system is well-developed and efficient because of users' confidence that the financial information they receive is reliable. Common accounting standards for the preparation of financial reports contribute to their credibility. The mission of the FASB, an organization designed to be independent of all other business and professional organizations, is to establish and improve financial accounting and reporting standards in the United States.

Investors, creditors, regulators, and other users of financial reports make business and economic decisions based on information in financial statements. Credibility is critical whether the user is an individual contemplating a stock investment, a bank making lending decisions, or a regulatory agency reviewing solvency. Users count on financial reports that are evenhanded, neutral, and unbiased.

An efficiently functioning economy requires credible financial information as a basis for decisions about allocation of resources. If financial statements are to be useful, they must report economic activity without coloring the message to influence behavior in a particular direction. They must not intentionally favor one party over another. Financial statements must provide a neutral scorecard of the effects of transactions.

Economic Consequences of Accounting Standards

The Board often hears that we should take a broader view, that we must consider the economic consequences of a new accounting standard. The FASB should not act, critics maintain, if a new accounting standard would have undesirable economic consequences. We have been told that the effects of accounting standards could cause lasting damage to American companies and their employees. Some have suggested, for example, that recording the liability for retiree health care or the costs for stock-based compensation will place U.S. companies at a competitive disadvantage. These critics suggest that because of accounting standards, companies may reduce benefits or move operations overseas to areas where workers do not demand the same benefits. These assertions are usually combined with statements about desirable goals, like providing retiree health care or creating employee incentives.

There is a common element in those assertions. The goals are desirable, but the means require that the Board abandon neutrality and establish reporting standards that conceal the financial impact of certain transactions from those who use financial statements. Costs of transactions exist whether or not the FASB mandates their recognition in financial statements. For example, not requiring the recognition of the cost of stock options or ignoring the liabilities for retiree health care benefits does not alter the economics of the transactions. It only withholds information from investors, creditors, policy makers, and others who need to make informed decisions and, eventually, impairs the credibility of financial reports.

One need only look to the collapse of the thrift industry to demonstrate the consequences of abandoning neutrality. During the 1970s and 1980s, regulatory accounting principles (RAP) were altered to obscure problems in troubled institutions. Preserving the industry was considered a "greater good."

Many observers believe that the effect was to delay action and hide the true dimensions of the problem. The public interest is best served by neutral accounting standards that inform policy rather than promote it. Stated simply, truth in accounting is always good policy.

Neutrality does not mean that accounting should not influence human behavior. We expect that changes in financial reporting will have economic consequences, just as economic consequences are inherent in existing financial reporting practices. Changes in behavior naturally follow from more complete and representationally faithful financial statements. The fundamental question, however, is whether those who measure and report on economic events should somehow screen the information before reporting it to achieve some objective. In FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (paragraph 102), the Board observed:

> Indeed, most people are repelled by the notion that some "big brother," whether government or private, would tamper with scales or speedometers surreptitiously to induce people to lose weight or obey speed limits or would slant the scoring of athletic events or examinations to enhance or decrease someone's chances of winning or graduating. There is no more reason to abandon neutrality in accounting measurement.

The Board continues to hold that view. The Board does not set out to achieve particular economic results through accounting pronouncements. We could not if we tried. Beyond that, it is seldom clear which result we should seek because our constituents often have opposing viewpoints. Governments, and the policy goals they adopt, frequently change.

Standard Setting In the Private Sector

While the SEC and congressional committees maintain active oversight of the FASB to ensure that the public interest is served, throughout its history the SEC has relied on the Board and its predecessors in the private sector to establish and improve financial accounting and reporting standards. In fulfilling the Board's mission of improving financial reporting, accounting standards are established through a system of due process and open deliberation. On all of our major projects, this involves open Board meetings, proposals published for comment, "field testing" of proposals, public hearings, and redeliberation of the issues in light of comments.

Our due process has allowed us to deal with complex and highly controversial accounting issues, ranging from pensions and retiree health care to abandonment of nuclear power plants. This open, orderly process for standard setting precludes placing any particular special interest above the interests of the many who rely on financial information. The Board believes that the public interest is best served by developing neutral accounting standards that result in accounting for similar transactions similarly and different transactions differently. The resulting financial statements provide as complete and faithful a picture of an entity as possible.

Corporations, accounting firms, users of financial statements, and most other interested parties have long supported the process of establishing accounting standards in the private sector without intervention by Congress or other branches of government. Despite numerous individual issues on which the FASB and many of its constituents have disagreed, that support has continued. The resulting system of accounting standards and financial reporting, while not perfect, is the best in the world.

Conclusion

We understand that there are a number of people who believe that their particular short-term interests are more important than an effectively functioning financial reporting system. We sincerely hope, however, that you and others in the Congress will review the reasons that have led generations of lawmakers and regulators to conclude that neutral financial reporting is critical to the functioning of our economic system and that the best way to achieve that end is to allow the existing private sector process to proceed. We respectfully submit that the public interest will be best served by that course. As former SEC Chairman Richard Breeden said in testimony to the Senate Banking Committee in 1990:

> The purpose of accounting standards is to assure that financial information 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.

The attachment to this letter discusses your proposed legislation. It also describes some aspects of our project on stock compensation and the steps in our due process precedures that remain before the project will be completed. In your remarks in the Congressional Record, you said that you will address future issues, including an examination of the current accounting treatment of employee stock options, over the next weeks and months. We would be pleased to meet with you or your staff to discuss these topics and the details of our project. I will phone your appointments person in the next two weeks to see if it is convenient for you to meet with me.

Sincerely,

Dennis R Beresford

Dennis R. Beresford

Enclosure

cc: The Honorable Connie Mack
The Honorable Dianne Feinstein
The Honorable Barbara Boxer
The Honorable Carl S. Levin
The Honorable Christopher J. Dodd
The Honorable Arthur J. Levitt

ATTACHMENT

ISSUES RAISED IN THE PROPOSED LEGISLATION

Inconsistent Accounting for Similar Economic Events

For many years, accounting principles have required that transactions effected through the issuance of equity securities be recognized in financial statements. Section 4 of Senate Bill 1175 (the Bill) would preclude recognition of any expense or other charge resulting from the grant, vesting, or exercise of an option or other right to acquire equity securities granted "in connection with the performance of services." We infer from this passage that options used to acquire an asset, perhaps a building or another company, would still result in the assets being recorded at fair value--as required by existing generally accepted accounting principles (GAAP). Thus, options used to acquire materials to construct a building would be recognized as a cost of the building, but options used to pay the architect to design the building would not. Yet, both are equally necessary to construct the asset. Why should one be recognized and not the other?

Accounting for Options Settled in Cash

Section 4 would apply to any "options or other rights to acquire" employer equity securities, including options that grant the holder a right "to receive property at the time of the exercise of the option" (Section 2). "Property" usually includes cash. Paying cash to an employee requires that the accountant record a decrease (or credit) in cash and a charge (or debit) to some other account. Because the proposed legislation precludes any expense or other charge, the only remaining alternative is a direct reduction in shareholders' equity. As a result, a cash bonus plan tied in some way to the price of the employer's stock would not decrease reported income. A cash bonus of the same amount but unrelated to stock performance would decrease reported income.

Amending the Securities Act of 1934

Section 4 would amend the Securities Act of 1934 and would direct the Securities and Exchange Commission (the SEC) to neither "require or permit" recognition of expense resulting from stock options. The securities acts apply only to public companies. The accounting for private companies would be unaffected. This would create an unfortunate double standard because private companies use stock options as part of employee compensation in the same way as public companies.

ISSUES RAISED IN THE *CONGRESSIONAL RECORD*

Comments in the June 29 issue of the *Congressional Record* raise additional accounting issues on which we wish to comment.

The Board Is Responding to Political Pressure

Several references are made to the Board's responding to political pressure and to publicity about "fat cats." Nothing could be further from the truth. Pressure on the Board, political and otherwise, has been largely directed against any accounting recognition of employee stock options. If the Board were responding to political pressure, it would either decline to address this issue altogether or find a more politically palatable solution. Further, we are aware of strong positions in different directions among members of Congress and our other constituents. It would be impossible to please everyone, even if we wanted to.

The Board added this project to its agenda in 1984 because the current rules for accounting for stock-based compensation, including stock options, are biased. Depending on the type of option issued, the accounting is substantively different. If a certain number of stock options are issued with an exercise price equal to market price, the type most commonly issued today, no expense is recognized. However, similar options could be issued with a performance condition, for example, a target level of sales must be achieved, before they are earned. The "performance option" would result in expense if the stock price rises.

This financial reporting result is simply not credible and has discouraged the use of performance-based options. All stock options, with or without performance conditions, are a form of compensation and that compensation should be included in an entity's reporting of its costs. The Board's proposal would apply the same basic accounting provisions to all types of options.

The Board's Proposal Increases the Cost of Stock Options

Some of the comments allege that the Board's Exposure Draft would increase the cost of employee stock options and make broad-based plans "prohibitively expensive." This is incorrect. The cost of a stock option would be exactly the same after an FASB Statement as it was before. The only difference is that the cost would then be recognized in the company's financial statements. One might make the same argument about any economic transaction. For example, some have argued that recognizing a company's obligation for retiree health care benefits makes the benefits prohibitively expensive. However, the obligation and the cost were there before GAAP required recognition.

All that has changed is that a company's financial statements now present a more complete picture of its obligations. Moreover, there should be no reason to reduce or eliminate stock option plans if the real economic benefits received from them exceed the cost to the company and its shareholders.

The Board's Proposal Requires Estimates of Future Value

The comments observe that, ". . . accurately estimating the future value (emphasis added) of employee stock options is nearly impossible." That is probably true, but the Board's Exposure Draft would require no such estimate. The objective would be to measure the value of the option **when granted**. That estimate does not require "predicting the company's future earnings, cash flow, market share, [and] capital spending, as well as future government policy." The option-pricing models described in the Exposure Draft do require some estimates, but so do most other accounting measurements. Accountants do not shrink from measuring the cost of pensions, the depreciation of fixed assets, collectibility of loans, insurance claim liabilities, or a host of other amounts because they require estimates. The measurements proposed in the Exposure Draft are no more subjective and difficult than many accounting measurements.

Compensation committees routinely use option-pricing methods in the design and administration of compensation packages. Without some notion of value, how can a company decide whether to issue 100, 1,000, or 100,000 options? Option-pricing methods are at the heart of many transactions in today's global marketplace. Option traders in financial markets and companies that use strategies to hedge certain risks often employ methods similar to the option-pricing models described in the Board's Exposure Draft.

To the extent it would affect financial reporting, the proposed legislation appears to be an attempt to change the measuring system to encourage the use of stock options. There is no question that there are significant benefits from the use of stock options or other forms of stock-based awards as compensation. The question is whether that form of compensation should be reported differently from all other forms of compensation and differently from all other stock or stock-related transactions. Employees also benefit from cash compensation. It would be equally inappropriate to encourage employers to pay more cash compensation to certain groups by omitting the cost from financial reports. The Board believes that complete reporting of an enterprise's financial activity must take precedence over encouraging one activity or another.

OTHER COMMENTS

The Board did not undertake its project for the sake of "accounting purity." Our goal is to have a financial reporting system in which all financial statement users can be confident that financial information reports the economic effects of a company's transactions in a neutral and unbiased manner. We believe that financial reporting will be improved by requiring the recognition of all compensation costs, including stock options.

We recently sent you a copy of our Exposure Draft on stock compensation, which includes not only the proposed accounting provisions, but also the basis for the Board's conclusions. Attached is a brief summary of the document. The Board has done a great deal of work to date, but the process is far from over at this point, and in some respects, it has only just begun. We provided for a six-month comment period, during which we, in conjunction with KPMG Peat Marwick, will be conducting a field test of the effects of adopting the proposal. We also will be speaking to organizations and meeting with interested parties to describe the proposed accounting and to learn about implementation issues. After the comment period and completion of the field test, we will hold public hearings to receive input from the most interested individuals and groups.

After Board members have read all of the comment letters, studied the results of the field test, and listened to public hearing testimony, we will redeliberate all of the issues in the Exposure Draft and reassess earlier decisions based on the additional information we receive. The stock compensation project is a controversial one, and we assure you that this is a serious issue for us. We will continue to keep an open mind as we progress with our due process.