



ASSOCIATION YEAR 1993-1994

AMERICAN BAR ASSOCIATION Section of Business Law

750 North Lake Shore Drive
Chicago, Illinois 60611
(312) 988-5588
Fax: (312) 988-5578

CHAIR

Richard M. Phillips
1800 M Street, NW
South Lobby, 9th Floor
Washington, DC 20036

CHAIR-ELECT

E Norman Veasey
Chief Justice
Supreme Court of the
State of Delaware
P O Box 1997
820 North French Street
Wilmington, DE 19899

VICE-CHAIR

Herbert S. Wander
Room 1600
525 West Monroe
Chicago, IL 60661

SECRETARY

George S. Frazza
One Johnson & Johnson Plaza
New Brunswick, NJ 08933

BUDGET OFFICER

Thomas E. Baker
P O Box 980937
Houston, TX 77098-0937

**SECTION DELEGATES
TO THE HOUSE OF DELEGATES**

Elliott Goldstein
Atlanta, GA

William O E Henry
Orlando, FL

Michael Hevman
Washington, DC

Frank R. Morris, Jr.
Columbus, OH

LAST RETIRING CHAIR

John J. McCann
New York, NY

COUNCIL

The Officers,
Last Retiring Chair and

David Albenda
New York, NY

Meyer Eisenberg
Washington, DC

Betty-Jane Kirwan
Los Angeles, CA

Maury B. Poscover
St. Louis, MO

Edward H. Fleischman
New York, NY

J. Pat Garrett
Houston, TX

Mary Ann Hynes
Riverwoods, IL

Merrill R. Francis
Los Angeles, CA

James H. Cheek III
Nashville, TN

Corinne Cooper
Tucson, AZ

Karl J. Ege
Tacoma, WA

Fredrick H. Miller
Norman, OK

J. Gordon Cooney
Philadelphia, PA

René Y. Grohl
Washington, DC

W. Loebler Landau
New York, NY

Lizabeth A. Moody
Cleveland, OH

BOARD OF GOVERNORS

LIAISON

J. Michael McWilliams
Baltimore, MD

YOUNG LAWYERS DIVISION

LIAISON

Robert Bakemeier
Seattle, WA

LAW STUDENT DIVISION

LIAISON

Cynthia M. Richardson
Knoxville, TN

SECTION DIRECTOR

Candy L. Simons
Chicago, IL

(312) 988-5605

April 13, 1994

The Honorable Donald W. Riegler, Chairman
Committee on Banking, Housing and Urban Affairs
5D-534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: Proposed Legislation on Accounting
for Stock Options
1993 S. 259
Corporate Executives' Stock Option
Accountability Act

Senate Concurrent Resolution 34

Dear Congressman Riegler:

The Section of Business Law of the American Bar Association respectfully submits the attached Statement Regarding Proposed Legislation on Accounting for Stock Options. The proposed legislation [or Concurrent Resolution] has, we understand, been prompted by the issuance by the Financial Accounting Standards Board of a controversial Proposed Statement of Financial Accounting Standards entitled Accounting for Stock-Based Compensation.

The Section takes no position on the question of how stock options should be accounted for. It does, however, strongly oppose S. 259 because it would undermine the ability of the Financial Standards Board to serve as the private sector body that sets accounting standards for American business.

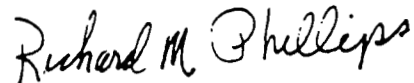
The Section requests that the attached Statement be included in the record of the hearings on the Bill held by your Committee, and that the Statement be considered in the Committee's deliberations on the Bill. The Statement was drafted by members of the Committee on Law and Accounting and of the Committee on Federal Regulation of Securities, both of the Section of Business Law, and is being presented on behalf of the Section. The Statement has not been approved by the House of Delegates or the Board of Governors of the American Bar

The Honorable Donald W. Riegle, Chairman
April 13, 1994
Page 2

Association, and accordingly should not be construed as representing the position of the American Bar Association.

On behalf of the Section, I urge your careful consideration of the Statement because it has been carefully prepared by knowledgeable practitioners in the area of fair presentation of financial information for purposes of full disclosure under the Federal Securities Laws. If you or any members of your Committee desire further information about the issues addressed in the Statement, members of the Committee on Law and Accounting and of the Committee on Federal Regulation of Securities would be pleased to make themselves available to your Committee.

Very truly yours,



Richard M. Phillips
Chair

RMP/klo
Attachment

40

WRITTEN STATEMENT OF THE
SECTION OF BUSINESS LAW OF THE AMERICAN BAR ASSOCIATION
REGARDING PROPOSED LEGISLATION
ON ACCOUNTING FOR STOCK OPTIONS

This statement is being submitted on behalf of the Section of Business Law of the American Bar Association. It was drafted by members of the Committee on Law and Accounting and members of the Committee on Federal Regulation of Securities of that Section. These views are being presented only on behalf of that Section; they have not been approved by the House of Delegates or the Board of Governors of the American Bar Association, and accordingly should not be construed as representing the position of the American Bar Association.

This statement is prompted by our review of proposed legislation¹ relating to the manner in which American business enterprises may be required to account for the issuance to their employees of stock options and other forms of stock-based compensation. The proposed legislation in turn has, we understand, been prompted by the issuance by the Financial Accounting Standards Board (the "Board" or the "FASB") of a controversial Proposed Statement of Financial Accounting Standards entitled Accounting for Stock-Based Compensation.

Summary

We wish to express herein our concern over statutorily mandated accounting standards: **we are strongly opposed to any legislation that would undermine the ability of the Financial Accounting Standards Board to continue in its role as the private-sector body that sets accounting standards for American businesses.**

Thus, the purpose of this Statement is not to express an opinion on the accounting issue of how stock options should be accounted for (in fact, the members of the Section of Business Law are widely divided on that question), but rather to convey to you our reasons why we believe that accounting principles should not be mandated by legislation.

Accounting standards are a complex, interrelated conceptual fabric, and a statute governing one detail would result in unexpected and unintended distortions of other aspects.

¹ 1993 H.R. 2878
1993 H.R. 2759
1993 S. 1175
1993 S. 259
1993 HConRes98
1993 SConRes34

In any proposed accounting standard of importance, oxen are gored. If the Congress should legislate stock option accounting, it could expect to receive appeals to arbitrate every major controversy arising from intensely complex accounting concepts, a wasteful expenditure of its capabilities and energies.

Proper Criteria for Standard Setting.

We believe that accounting decisions should not be made based on their popularity, or based on the way they promote specific economic, political, or social goals. Such a process, if followed, would result in an eclectic and inconsistent collection of accounting standards and practices, and would call into serious question the credibility of financial statements.

There are many parties interested in the content of accounting principles, such as the managements of businesses, investors, creditors, investment analysts, investment bankers, commercial bankers, independent auditors, academia, government regulators, and government legislators (and lawyers for many of the foregoing). It is virtually certain that no single standard will ever satisfy all such interested parties. Someone will always be unhappy with any rule, and the standard setter must therefore expect opposition on any issue it attempts to resolve.

While the impact on businesses affected can not be ignored when standards are set, it is also essential that conceptual, logical, and technical accounting considerations be factored in to the setting of standards. The real issue is striking a balance between the two approaches,² in attempting to set standards which will provide information that is useful to present and prospective investors and creditors and other users in making rational investment, credit and similar decisions. In striving to accomplish that goal, we believe that the key words of the standard auditors' report -- "present fairly" -- go right to the heart of the role of the standard-setter.

² Thus, in Statement No. 87, dealing with employers' accounting for pensions, the FASB adopted certain provisions concerning the delayed recognition of gains or losses and footnote disclosure of pension assets and liabilities - something less than what the Board believed to be conceptually ideal for reflecting economic realities - in order to accommodate constituent concerns about both dramatic changes in balance sheet presentations and undue earnings volatility. See Victor H. Brown, "Accounting Standards: Their Economic and Social Consequences," in Benefits, Costs, and Consequences of Financial Accounting Standards (Special Report FASB 1991), at page 75.

Need for Neutrality and Independence.

We believe that the importance of neutrality and objectivity to a credible and effective standard-setting process (aimed at "fair presentation" of financial information) cannot be over-emphasized. To be neutral, information must reflect economic realities as faithfully as possible without coloration for the purpose of attaining a predetermined result or influencing behavior in any particular direction. If a measurement system is viewed as not being neutral, or as biased to induce a particular result, the resulting information loses credibility.

The FASB operates under a "mission statement" which dictates that the Board must "be objective in its decision making" and "ensure, so far as possible, the neutrality of information resulting from its standards." The Mission Statement goes on to provide that

[The Board must] weigh carefully the views of its constituents in developing concepts and standards. The ultimate determinant of concepts and standards, however, must be the Board's judgment, based on research, public input, and careful deliberation, about the usefulness of the resulting information.

The FASB has many times, over the years, demonstrated its institutional will - and ability - to stand up to opposition to its proposals when it considers that opposition to be based on partisan pleading rather than concern for effective standards.

The Board members of the FASB are chosen by the Trustees of the Financial Accounting Foundation, an independent private-sector organization, who are directed to seek a Board make-up which includes a mix of backgrounds of highly competent individuals who have had major experience in public accounting, in business or industry, as a user of financial information, and as an accounting educator. Board members are required to sever all ties with the institutions they served previously; and under the bylaws of the Foundation, the Trustees cannot interfere in or attempt to influence the outcome of the standard-setting process.

The FASB'S System of Due Process.

Under its mission statement, the FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information.

The Board has established an elaborate system of due process in order to enable Board members to consider carefully all sides of the issues and listen to all constituents' views before

coming to any conclusions. All technical decision-making meetings are open to the public.

Early Deliberations. In the early stages of consideration of a problem, the staff of the FASB frequently establishes contact with constituencies through creation of a **Task Force** or an **Advisory Group**. The Task Force may assist the staff in publishing a discussion document - either a **Discussion Memorandum** or an **Invitation to Comment** - that solicits responses from the public. The Board may then arrange for a round of **public hearings**. Through announcements in **Action Alert** and in the discussion document itself, interested parties are invited to present their views to the Board and the staff.

Broad Communication with Interested Constituencies. The Board maintains frequent communication with the Securities and Exchange Commission ("SEC"), the AICPA, and other representative bodies such as the Financial Executives Institute, the Securities Industry Association, the American Bar Association, trade associations, and many other bodies.

Tentative Conclusions. Whenever a proposed solution to a problem has been tentatively reached, an **Exposure Draft** of a proposed Statement is published for public comment. Tens of thousands of copies are distributed, and often the Board will receive many hundreds of letters of comment.

FASAC. The Financial Accounting Standards Advisory Council, a group of some 30 to 40 influential persons representing groups of interested parties (also appointed by the Trustees of the Foundation) meets with Board members to discuss accounting issues, the agenda and proposals of the Board, and the suitability of its tentative conclusions.

Field Tests. When fairly radical changes in accounting practices would be required under a proposed change in an accounting principle, the Board often arranges for **field tests** of the proposal.

Further Deliberations. After a review and analysis of all responses to the Exposure Draft, the Board holds **open discussions**. (These are always at public meetings; the Board has adopted rules prohibiting it from meeting privately.) Any interim decisions made at these meetings will be reported on a weekly basis in the Board's **Action Alert**, mailed to all interested parties.

Public Hearings. On most important projects, the Board will schedule public hearings, at which interested parties may schedule presentations of their views. (In the case of the stock option Exposure Draft, the Board also conducted a series of seven seminars organized by the Financial

Executives Institute around the country, and has scheduled a roundtable meeting for invited parties to discuss approaches to valuation of employers' stock options.) The Board may decide to issue a revised Exposure Draft; or it may move on to a final Statement.

Subsequent Review. The Board monitors acceptance of each new Statement, particularly for controversial projects. It may decide to issue a Technical Bulletin or an Interpretation to resolve a minor problem; it may supplement a Statement or cover a related problem with an additional Statement; or it may amend or even drastically alter the original pronouncement.

We believe, and the SEC has acknowledged, that the FASB has a program of due process that is objectively fair and equitable.

The Role for Congress

We believe the present method of establishing accounting standards is preferable to Congress establishing accounting standards.

As stated above, we are wary of the setting of an accounting standard in order to achieve economic, political or social goals, no matter how worthy. The promulgation by legislative fiat of an accounting standard aimed at accomplishing such a public policy goal would tend to destroy the credibility of statements of financial condition as being "fairly presented," and would have a ripple effect on accounting for other analogous transactions (such as other forms of stock issuances for other purposes), thus making the FASB's task of setting even-handed standards doubly difficult. And Congressional action on accounting for stock options would undoubtedly induce a constituent to race to Congress to request a legislative "fix" every time it feels itself affected adversely by a controversial FASB proposal.

A particular accounting rule must be fitted into an entire system or pattern of accounting principles in order to make sense and not result in distortion; and setting even one particular standard requires a knowledgeability of a complicated and highly interwoven and interactive web of principles and practices. It would drastically interfere with the fair over-all presentation of financial information to have accounting rules adopted piecemeal by a legislature, with at least some members not expert in accounting, seeking to accomplish various public policy goals.

Furthermore, a Congressional enactment of an accounting principle would be difficult to change. Accounting rules constantly evolve, and as noted above in the description of the

FASB's system of due process, the subsequent review process of the FASB allows both for modest corrections of prior pronouncements as well as wholesale revisions of pronouncements that did not work. Accounting is an arcane issue which except for an infrequent public outcry would not hold the attention of most members of Congress; it would be very difficult for a statutory accounting rule to be corrected for an oversight or kept up to date as business techniques, and accounting for them, evolve.

On the other hand, Congress already has a powerful tool in its jurisdiction over the tax code. It is entirely appropriate for the Congress, if it so views the national interest, to provide special assistance to an industry through tax breaks, subsidies, regulatory forbearance, or any other substantive means, and for regulators to impose requirements in the way of supplying financial data for regulatory purposes, but we believe it would be entirely inappropriate for the Congress to tinker with the accounting numbers in a way that spills over into financial statements that purport to *present fairly* financial information.

On March 31, 1988, Charles A. Bowsher, the Comptroller General of the United States, sent an open letter to David Ruder, the then Chairman of the SEC, in which he summarized his interpretation of the views expressed at an October 1987 roundtable discussion sponsored by the University of Southern California. The topic was the advisability of using regulatory accounting practices (called "RAP") in place of generally accepted accounting principles ("GAAP"). In particular, Mr. Bowsher said:

Departures from GAAP promote misleading public disclosure of important financial information and do not serve the best interests of regulators, the American taxpayer, or the public at large. . . . [T]he ability to "play games" with important financial information by hiding critical facts from regulators and the public merely postpones the inevitable day of reckoning.³

The SEC's Position: A Successful Approach

In considering the proposals now pending, it is significant, we feel, that the Congress made a considered and definitive statement of its views as to the determination of accounting principles when it passed the Securities Act of 1933

³ Quoted in Paul B.W. Miller, Neutrality: The Not-to-Be-Forgotten Concept in Accounting Standards Setting, in the FASB Special Report, supra note 2, at page 84. Professor Miller concluded that "If regulators encourage or merely allow biased information to be reported, they will be unable to protect the public from the risks and losses that the information would have revealed if they had not tampered with it."

and the Securities Exchange Act of 1934. Neither of these statutes set forth any substantive accounting standards, but both gave to the SEC unlimited power by rule to define and specify the required disclosures of financial accounting information⁴.

The SEC, however, confronted with the daunting task of exercising the Congressional authorization, decided against attempting, itself, to develop such a set of accounting standards and instead has, for over 50 years, favored relying upon a private standard-setting body to determine what constitutes "generally accepted accounting principles." Since the formation of the FASB over 20 years ago, the SEC has consistently concluded that the FASB performs its tasks well, and has several times restated its reliance upon the FASB as the proper standard-setting body.⁵

At the same time, however, the SEC has maintained very active oversight of the activities of the FASB through frequent meetings with the Board, attendance at their deliberative meetings, and participation by the Chief Accountant in the meetings of FASAC. The SEC not infrequently will urge the Board to take action with respect to a particular problem; and if the SEC should fundamentally disagree with a final FASB pronouncement, it has been known to adopt its own rules setting forth requirements for publishing financial information.

And this system has worked well: the independent standard-setting system has allowed the United States to be attractive for both domestic and global capital formation. The disclosure system enacted by the Congress is the envy of most other countries. The financial statements required by that legislation and the regulations of the SEC are commonly recognized

⁴ See Securities Act of 1933, §19(a) and Schedule A, Items (25) through (27); and Securities Exchange Act of 1934, §§3(b) and 12(b)(1)(J) through (L).

⁵ The SEC's Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards reads in part as follows: "In meeting [its] statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. . . . The body presently designated by the Council of the AICPA to establish accounting principles is the FASB. . . . [T]he Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors." Accounting Series Release 150 (December 20, 1973), Financial Reporting Release No. 1, §101.

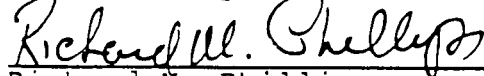
to be the heart of the disclosure system; and the "generally accepted accounting principles" required by the SEC (and formulated by the FASB) are widely recognized as the most comprehensive and most effective accounting standards in the world.

The fact that a number of the Board's proposals have initially aroused considerable controversy is no argument against the FASB as the standard-setter: controversy will usually follow from the Board's activities, because the Board deals only with difficult issues on which reasonable and informed people have different views.

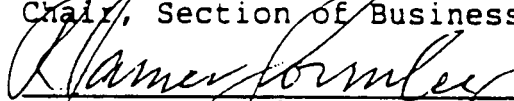
Conclusion.

For the reasons stated, we believe that accounting principles in general (and accounting principles applicable to stock-based compensation in particular) should not be mandated by legislation.

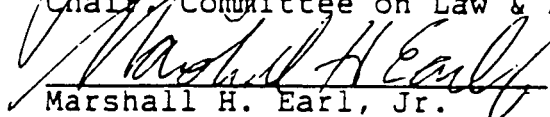
Respectfully submitted,



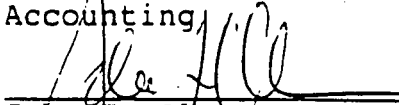
Richard M. Phillips
Chair, Section of Business Law



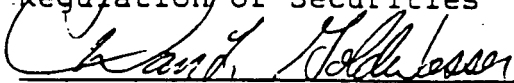
R. James Gormley
Chair, Committee on Law & Accounting



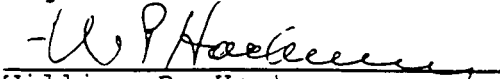
Marshall H. Earl, Jr.
Chair, Subcommittee on Accounting Principles, Committee on Law & Accounting



John F. Olson
Chair, Committee on Federal Regulation of Securities



Dan L. Goldwasser
Chair, Task Force on Securities Matters of the Committee on Federal Regulation of Securities



William P. Hackney
Chair, Drafting Committee