U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, D.C. 20515-6119

April 28, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

For more than a year, Members of the Committee on Energy and Commerce and the Subcommittee on Telecommunications and Finance have followed with great interest the significant and fiercely contested debate surrounding the Financial Accounting Standard Board's (FASB) proposal to change existing accounting rules for certain types of employee stock options. From my perspective as Chairman of the Subcommittee, the intense debate about this issue appears to demonstrate that the process is working largely as intended.[1] Nevertheless, attempts to prejudge the outcome of the lengthy process of

[1] There is at least one notable exception to this general observation. In early 1993, a member of the staff of the Subcommittee on Telecommunications and Finance was told that some members of the Financial Accounting Foundation (FAF), the group which provides financial support for the FASB and chooses board members, were threatening to withdraw their funding for the FAF if the FASB went ahead with its proposed rule for stock options. This information was passed on so the respective chairs of the Securities and Exchange Commission (SEC or Commission) and the FASB, and the Subcommittees received assurances that such threatened withdrawals were not without precedent when controversial issues were being considered, and __ in any case they would not affect the solvency of the FASB or the integrity of its mission.

establishing accounting standards, either by threats to FASB from its private sponsors or by legislation here in Congress,[2] have raised legitimate and important questions about the decision-making process itself. In light of these questions, I think it would be helpful to clarify the respective roles of the FASB and the SEC, and am writing you today for that purpose.

Many of the individuals and groups that have participated in good faith in the stock options debate have sharply differing views about the considerations that should (and should not) inform the process of establishing national accounting standards. One of the most important differences concerns the relevance of the broader consequences that might result from new accounting rules. More precisely, questions have been raised about whether possible adverse social and economic consequences should be considered at any point in the process of modifying existing national accounting standards or adopting new ones. For example, some proponents of changing the existing rule on fixed stock options are adamant in their conviction that many corporate executives receive enormous and often unjustified windfalls because the millions of stock options granted to them are not accounted for as compensation expenses.

Most opponents I have heard from do not disagree that many executives receive substantial sums from stock options, but they warn us not to throw the baby out with the bath water. *Opponents* contend that if the FASB's proposed rule change goes into effect, it will diminish the flow of capital to many of the economy's most promising entrepreneurs and small public companies, thereby stifling job creation and economic growth and damaging our ability to compete internationally. Indeed, they assert that those companies that use stock options most democratically – by awarding them to a majority of their employees -- are among the firms that will be most seriously affected by the proposal. Susan Eichen, a principal in William Mercer, Inc. who appears to support the logic of the FASB proposal, nonetheless has written that "the proposal may give us good accounting rule that end up encouraging questionable business practices. The hardest hit victims are likely to be high-tech companies and new public companies that use options extensively. . . . They may have little choice but to reduce drastically the number of employees who can participate or the size of grants." *Taking Account of Stock Options*, Harvard Business Review, (Jan.-Feb. 1994), p. 29.

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[2] Presently pending before both the House and Senate are resolutions expressing opposition to the stock options proposal, and urging the FASB to reconsider it, *see* H. Con. Res. 98. 103d cong., 1st Sess. (May 11, 1993) and S. Con. Res. 34, 103d Cong., 1st Sess. (June 30, 1993); legislative proposals to amend the securities laws to require accounting for stock options. *see* H.R. 2878, 103d Cong., 1st Sess. (Aug. 5, 1993) and S. 259, 103d Cong., 1st Sess. (Jan. 5, 1993); and legislative proposals directing the SEC to overturn the stock options rule if it is _____ by the FASB, *see* H.R. 2759, 103d Cong., 1st Sess. (July 27, 1993) and S. 1175, 103d Cong., 1st Sess. (June 29, 1993. We are also aware of letters prepared by the President and two cabinet secretaries to members of the Senate which address the stock options issue.

Both of these arguments merit careful and serious analysis. Yet both arguments are directed to the social and economic effects of the stock options proposal rather than to issues related to "pure" accounting. All of this raises the question of which body, the FASB or the SEC, is responsible for analyzing and responding to these arguments prior to final implementation of a new accounting standard.

THE FASB'S ROLE IN EVALUATING SOCIAL AND ECONOMIC CONSEQUENCES. The FASB itself clearly does not believe that it has the authority or the expertise to analyze the economic and social impact of its accounting proposals, and it apparently believes that it should be vested with such responsibilities. For example, in An Introduction To The FASB, the Board states that "[a]s a private entity, the FASB has neither the authority nor the competence to weigh various, and often conflicting, national goals. Nor does the FASB seek that authority or that competence. Its sole mission is to improve, through accounting standards, the usefulness of financial statements so that public and private decision makers can make better decisions."). And in testimony before the Senate Subcommittee on Securities of the Banking, Housing and Urban Affairs Committee last October, James J. Leisenring, Vice Chairman of the FASB, said that "[t]he FASB does not attempt to achieve particular economic results through accounting pronouncements. . . . [F]inancial reporting is not the appropriate arena in which to seek achievement of goals like job creation, improved U.S. competitiveness, or more successful start-up enterprises."

Despite these arguments, many participants in the stock options debate have forcefully asserted that the FASB's failure to consider the economic and social consequences of its decisions makes it an "ivory tower", isolated from and thus insensitive to practical economic realities. Commissioner Carter Beese, for example, contends that "the FASB's failure to consider these [social, economic or public policy] factors masks the true cost of its proposals. . . . Faced with these arguments, the FASB's rebuttal is simple: When it comes to accounting principles, economic consequences be damned; the truth will set investors free." *A Rule That Stunts Growth*, The Wall Street Journal, Feb. 8, 1994, p. A18.

I am inclined to think that the FASB's understanding of the limitations of its responsibility is generally the correct one, but would appreciate your views on this complex subject. In particular, I would be interested to learn whether you believe there are any circumstances which should cause the FASB to take economic and social factors into account. I note that you recently wrote in a letter to U.S. Senators that the FASB should be mindful of "national priorities as it promulgates new rules or modifies old ones. Would you elaborate on this observation?

THE SEC'S ROLE IN REVIEWING ACCOUNTING STANDARDS. In contrast to the FASB's narrow charter, the Commission clearly enjoys a broad mandate from Congress to promote the smooth functioning and effectiveness of our capital markets. Indeed, pronouncements by the FASB about accounting standards derive much of their significance from the fact that the SEC recognizes those standards as satisfying the disclosure requirements of federal securities laws. The SEC's recognition of the authoritative nature of these standards also has enormous practical implications for the economy. Most important, it has had the effect of requiring that virtually every publicly held company in the country comply with the FASB's standards when preparing financial statements, whether or not they actually file those statements with the Commission.

The Commission's responsibility and authority to review FASB decisions thus raises crucial public policy questions. The Congress depends on the SEC to provide assurance that standards developed by private sector bodies like the FASB are fair, effective, reliable, and responsive to the needs of the market and the public. Am I correct in assuming that the SEC's broad mandate from Congress requires that it consider accounting proposals in a broader context than does the FASB? Can you tell me whether any procedures, guidelines, policies or general principles or standards exist which guide the Commission when reviewing decisions made by the FASB? For example, does the SEC typically defer to the FASB's judgments about technical accounting questions or are these issues reviewed *de novo*? If the Commission does not take into account possible social and economic consequences when it reviews new accounting standards, would you explain the Commission's reasoning for declining to consider this type of information? If the Commission were to have concerns about the broader implications of a proposed FASB rule, would the SEC make its views known to the FASB during its deliberative process, or would the Commission wait until the FASB had taken final action?

I would appreciate a response to the questions raised in this letter by June 1, 1994. If you have any questions about this request, please have your staff contact Timothy J. Fords, Counsel to the Subcommittee, at 202-226-2424.

Sincerely,

Edward J. Markey
Chairman