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THE CHAIRMAN

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

May 25, 1994

The Honorable Edward J. Markey
Chairman
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Markey:

Thank you for your letter of April 28, 1994 regarding the Securities and Exchange Commission's ("SEC" or "Commission") and the Financial Accounting Standards Board's ("FASB" or the "Board") consideration of the social and economic consequences of proposed accounting standards. Your letter poses several specific questions. To assist in answering those questions, it may be helpful initially to describe briefly the relationship between the SEC and the FASB and how the FASB's standards are applied by Commission.

As you know, the Commission has statutory authority to set accounting principles.[1] In 1938, however, the Commission decided against the development of its own treatise on accounting and instead decided it would look to the accounting profession for leadership in establishing and improving accounting standards. The Commission also directed its staff, when reviewing registrants' filings, to presume that financial statements in those filings that are prepared in accordance with accounting principles that do not have "substantial authoritative support" to be misleading, despite clarifying disclosures in the audit report or in the footnotes to the financial statements.[2]

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1 *See, e.g.*, sections 7, 19(a) and Schedule A, Items (25) and (26) of the Securities Act of 1933 (the "Securities Act"), and sections 12 (b) and 13 (b) of the Securities Exchange Act of 1934 (the "Exchange Act").

2 Accounting Series Release No. 4 (April 25, 1938), which states,

> In cases where financial statements filed with the Commission pursuant to its rules and regulations under the Securities Act or the Exchange Act are prepared in

The FASB, formed in 1973, is the current private-sector body designated by the accounting profession to set accounting standards. Under the auditing literature, FASB standards are designated as the primary authority for generally accepted accounting principles ("GAAP").[3] In Accounting Series Release No. ("ASR") 150, the Commission endorsed the establishment of the FASB and stated that the standards and interpretations issued by the FASB would be considered by the Commission as having "substantial authoritative support" and those contrary to such FASB promulgations would be considered to have no such support.[4] ASR 150 emphasized that the Commission was not abdicating its authority to set accounting standards and that the Commission staff would continue to take appropriate actions to resolve registrants' specific problems of accounting and reporting as they arose on a day-to-day basis.

In 1980, the Commission adopted Rule 4-01 of Regulation S-X [5] to codify its position that financial statements filed with the Commission that are not prepared in accordance with GAAP would be presumed to be misleading unless the Commission otherwise has

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accordance with accounting principles for which there is no substantial support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant.

[3] AICPA, Statements on Auditing Standards No. 69, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles* in the Independent Auditor's Report," ¶ 5 (January 1992).

[4] ASR 150 (December 20, 1973).

[5] 17 CFR § 210.4-01.

provided.[6] Rule 4-01 also states that, regardless of GAAP requirements, registrants must provide the disclosures required by the Commission's accounting regulations.

As a result of the Commission's policy of having its staff, during the review of a registrant's filing, presume that the registrant's financial statements included in that filing are misleading if they are inconsistent with GAAP, registrants conform to FASB pronouncements as they exist on the date of the filing. In other words, investors may assume that registrants are applying the accounting principles recognized by the profession on the date of the filing, and if the registrant follows different principles the registrant presumably is misleading those investors. Changes in or additions to FASB statements automatically come within the body of literature deemed to have "substantial authoritative support" and to be part of GAAP. Accordingly, under ASR 150 and Rule 4-01, no Commission action or review is necessary at the time of the FASB's adoption of a new standard.

In setting standards, the FASB follows a thorough deliberative process. That process requires open meetings where additions to the FASB's agenda and proposed standards are discussed. Prior to taking final action on any significant accounting standard, the FASB issues for public comment a discussion memorandum or similar document exploring all the issues, public hearings are held, an exposure draft of the proposed standard 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 monitors all FASB standard-setting projects. The SEC staff selectively reviews the comment letters, selectively 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 is being conducted for the stock-based compensation project, as it is for all others.

<u>THE FASB'S ROLE IN EVALUATING SOCIAL AND ECONOMIC CONSEQUENCES</u>

Your letter notes that you are inclined to think that the FASB's understanding, as expressed in Congressional testimony and in its own publications, of the limitations on its responsibility to consider economic and social consequences is generally correct.

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[6] ASR 280 (September 2, 1980).

You state that you would appreciate my views on whether I believe there are any circumstances that should cause the FASB to take economic and social factors into account, noting that in a recent letter to Senators Boren, Daschle, Durenburger, Levin, and Simpson, I indicated that the FASB should be mindful of "national priorities" as it promulgates and amends accounting standards.

My letter to the Senators stated, in part:

> 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 repercussions on the credibility of the financial information that fuels our securities markets.[7]

These statements are in general agreement with the position of the Commission announced in 1978 during its deliberation of Commission accounting requirements for oil and gas producing activities. At that time, the Commission stated:

> While the potential economic impact of financial accounting standards should be assessed in the process of establishing new standards, the objective of providing useful information to investors should be overriding.[8]

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7 Letters dated January 10, 1994 to Senators Boren, Daschle, Durenburger, Levin, and Simpson, at 6 (emphasis added).

8 ASR 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

The Commission further noted in that release,

> ... 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.[9]

It has been the general position of the Commission that the securities markets, investors, regulators, policy makers, and the general public are best served by factual, neutral reporting that is uncolored by subjective determinations related to social or economic policies. The FASB follows this approach. The FASB's Mission Statement states:

> 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.

The FASB's Mission Statement also contains certain precepts for the conduct of the FASB's activities. These include:

> To be objective in its decision making to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

When the Departments of Treasury, Labor, and Commerce issue national statistics regarding the state of the economy, the cost of living, the unemployment rate, and similar matters, the general public reasonably expects that the information will be presented

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> 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.)

[9] *Id.* at n. 32.

in an unbiased manner - i.e., that it will not be distorted or biased to support the Administration's policy objectives. In the same sense, the investing public expects that public companies will prepare financial statements, in accordance with FASB statements, that report factual information in a neutral manner that is unaffected by political, economic, or social goals.

The relevant consideration may be whether there can be an issue of such national importance that neutral and unbiased information should not be presented in companies' financial statements. It is impossible to say that such a circumstance may not arise. It did not exist, however, when the FASB and the Commission considered other significant accounting issues of national importance, such as the accounting for oil and gas exploration activities during the 1970s, or when the FASB more recently considered pension and other benefits for retirees.

As indicated in my letter to the Senators, I do not believe that "national priorities" should require the FASB to halt a project because that project may conflict with the social, economic, or political goals of a specific industry or group. The FASB should be mindful of, and weigh in its decision-making, all of the costs and benefits of its proposed rules, including the potential economic impact of its proposals. In balancing economic interests, however, it should be kept in mind that there is a profound economic benefit to companies' providing neutral, unbiased information for the use of investors, regulators, policy makers, and the public in general. The provision of such information is a fundamental concept under, and a paramount purpose for, the Federal securities laws and contributes greatly to the credibility of the securities markets. As noted above, when balancing economic interests, the objective of providing useful information to investors should be an "overriding" principle.[10]

As you may know, the FASB recently began its consideration of the volumes of materials it received during the comment process and at both the public hearings and the recent roundtable on employee stock option measurement techniques. The FASB has assured the Commission that it intends to redeliberate all of the issues raised in the exposure draft on employee stock-based compensation. At this point in time, it is difficult to predict where that analysis may lead or the timing for the issuance of a final standard, if any. The Commission staff is continuing its oversight of this project.

10 ASR 253, *supra*.

THE SEC'S ROLE IN REVIEWING ACCOUNTING STANDARDS

Your letter asks whether (i) the SEC's broad mandate from Congress requires that it consider accounting proposals in a broader context than does the FASB, (ii) any procedures, guidelines, policies, or general principles or standards exist that guide the Commission when reviewing decisions made by the FASB, (iii) the Commission conducts a *de novo* review of accounting issues, (iv) the Commission takes into account possible social and economic consequences when it reviews new accounting standards and, if not, the Commission's reasoning for declining to consider this type of information, and (v) the SEC would make known to the FASB any concerns it may have about the broader implications of a proposed FASB rule during the FASB's deliberative process or not until the FASB had taken final action.

Both the Commission and the FASB consider accounting proposals in the context of ensuring investor protection and providing unbiased information to the securities markets. The Commission does have a broader mission, which includes, among other things, enforcement of the Federal securities laws, market regulation, and facilitation of capital formation. The Commission's overriding concern of providing "relevant, reliable, comparable, and unbiased" information to the securities markets,[11] is consistent with these broader mandates. For example, the increased transparency provided by unbiased financial reporting generally has been considered to facilitate capital formation, not diminish it.

As described above, accounting standards issued by the FASB become part of GAAP and, under ASR 150 and Rule 4-01, unless registrants comply with GAAP their financial statements will be presumed to be misleading. No Commission action, therefore, is required for FASB statements to be applicable to Commission registrants. This approach makes sense due to the Commission staff's close oversight of the FASB process as explained above. Duplication of the FASB process by the Commission would be costly, time consuming, and cause uncertainty for both the government and registrants.

If the FASB issues a standard with which the Commission has some concern, the Commission has a variety of options. If the Commission did not want the standard to be incorporated automatically into the Commission's rules through Rule 4-01 and ASR 150, then some action by the Commission might be necessary. This action might be in the form of a Staff Accounting Bulletin or a Commission policy statement, interpretation, or rule. If the Commission determined to pursue rulemaking, then the Paperwork

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11 ASR 253, *supra*.

Reduction Act,[12] the Regulatory Flexibility Act,[13] and section 23(a) of the Exchange Act,[14] among other provisions, would require that the Commission consider the increased compliance burden on registrants, the possible impact of the proposed rule on small entities,[15] and any burden on competition resulting from the rule. Also, in releases soliciting public comment on proposed rules, the Commission typically requests general comments on the relative costs and benefits of its proposals.

It should be noted, however, that *de novo* Commission reviews of FASB statements are rare. Generally, such action is not necessary because the Commission staff oversees the development of FASB standards and the Commission and its staff have the opportunity to express their views to the FASB before the FASB issues a final standard. For example, on November 17, 1993, the Commission and the FASB held a public meeting to discuss items of mutual interest. At that meeting, the Commissioners expressed directly to the FASB members their individual views on, among other topics, the FASB's project on the accounting for stock-based compensation. Commissioner Beese in particular stressed what he sees as the broader economic implications of the FASB's proposed rule.

CONCLUSION

The FASB is continuing its deliberations on the accounting for employee stock options. Until the FASB issues a final statement, it is impractical to speculate regarding the type of formal Commission review, if any, that may be necessary and, if a review is undertaken, how the Commission may evaluate the relative costs and benefits of that FASB statement. Because one alternative is for the Commission ultimately to engage in rulemaking, it must be careful not to prejudge cost/benefit and other issues in order that it meaningfully may consider the public comments received in any rulemaking process.

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12 44 U.S.C. § 3501 *et seq*.

13 5 U.S.C. § 601 *et seq*.

14 U.S.C. § 78w(a)(2).

15 The Commission has adopted several provisions specifically designed to ease the burden on small issuers. These include Regulations S-B, A, and D, which provide for reduced disclosure requirements for either small issuers or limited securities offerings.

These issues are complex and will require intensive deliberation by the FASB. I appreciate your soliciting my views on this important topic, however, and if you would like to discuss any of the issues addressed in this letter, I would be pleased to do so.

Sincerely,

Arthur Levitt
Chairman