THE FINANCIAL ACCOUNTING STANDARDS BOARD ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

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CONTENTS

THE FINANCIAL ACCOUNTING STANDARDS BOARD ACT

WEDNESDAY, JUNE 26, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Upton, Shimkus, Bryant, Bass, Fletcher, Tauzin (ex officio), Towns, Markey, Eshoo, and Dingell (ex officio).

Also present: Representatives Gillmor, Greenwood, and Luther.

Staff present: Brian McCullough, majority counsel; David Cavicke, majority counsel; Ramsen Betfarhad, policy coordinator and majority counsel; Shannon Vildostegui, majority counsel; Will Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. Good morning, everybody. The Subcommittee on Commerce, Trade, and Consumer Protection will come to order.

I want to thank personally all the distinguished witnesses for appearing before the subcommittee this morning. Of course all of us look forward to your testimony.

The leading headlines in the financial press no longer speak of the latest and greatest IPO offering, nor are the daily record highs achieved in the leading stock markets. Instead, my colleagues, we are confronted with a seemingly endless stream of bad financial news about companies, big and small, that have manipulated the public financial disclosures in their favor to the detriment of the American investor.

"Cooking the books" is not new in America's history, but the fact that major corporations engaged in such activity, and that no one within or outside of government raised red flags when it mattered, concerns us deeply.

I am a believer in the free market system. But in order for such markets to work, they must be free of deceit and fraud.

We cannot legislate to prevent individuals from ignoring rules and committing fraud. Those who are intent on doing so will violate the rules. But what concerns me, and I suspect many of my colleagues today, is that companies can comply fully with accounting rules and standards and yet completely distort their financial performance.

And yet another company, WorldCom, restates its earnings for 2001 by some $3.8 billion due to accounting irregularities. Enron did so last year to the tune of $1.2 billion. In the committee's investigation of Enron, we learned that several of the items that were restated were the results of mistakes that violated existing accounting standards on consolidation of special purpose entities.

We received testimony in our hearing in February, the SPE served an important and valid purpose. Yet Enron's restatement exposed the reality that enormous amounts of financial obligations and debt of a company can be removed from the balance sheet and hidden from its investors through SPE's under current accounting standards.

We also discovered companies can use, and in some cases bend, the existing financial accounting rules to give the appearance of rapid revenue growth. Revenue recognition has been a controversial issue for many years. But the degree to which similar transactions can produce vastly different results according to the manner in which they are accounted for can defy logic.

I understand that a model of, "one size fits all," is not always appropriate or accurate. But the problem of inconsistency appears to be pervasive enough to warrant a serious and timely examination. I emphasize timely, as a Financial Accounting Standards Board, FASB, has been considering the revenue recognition issue for 26 years. In my view, 26 years is too long of a time to spend on anything except, of course, raising your children.

It is no coincidence that investor confidence in both the markets and the financial statements of the companies is very low, admits to such uncertainty.

Until we can iron the wrinkles out of the current accounting system, investors will remain hesitant to invest, and companies will struggle to access needed capital.

A number of post-Enron reforms are working their way through Congress. Administrative agencies, self regulatory organizations and board rooms in most are a welcome improvement.

This subcommittee's jurisdiction is over accounting standards and the setting of those standards. In the draft legislation being considered today, while we do not address the enforcement of accounting rules, we have included certain underlying principles that must guide the promulgation of accounting standards and with which all specific accounting rules must be consistent.

These principles, we believe, are responsive to the inherent problems with today's rule-based system of accounting standards that many witnesses spoke to in our hearings in February.

It is our intent that adherence to those principles will bring about greater transparency in and understandability of companies' financial reports, diminishing opportunities for the obfuscation of financial facts through manipulation of accounting standards.

Our goal with the draft legislation is to improve the financial accounting system. It takes a very measured approach to addressing issues that are of utmost importance to the long term health of our economy.

The draft legislation primarily does three things. One, it gives FASB standards Federal recognition.

Two, requires FASB to promulgate a rule requiring accountants to apply all FASB standards consistently with the fundamental principles of transparency and understandability.

Three, directs FASB to promulgate rules in areas where current standards need improvements, specifically off-balance sheet accounting, revenue recognition, and market-to-market accounting.

One issue that is not addressed in the draft, but I wish to have witnesses comment on, is, "funding independence for FASB." I seek unanimous consent to enter into the record a letter by Paul Volker to me, where he states that, "it would be useful to find the means for more assured financing in future years for both FASB and IASB, the International Accounting Standards Board, free from threats of withholding funds as a result of either businesses or political pressures."

By unanimous consent, I will put his letter in the record.

[The letter follows:]

PAUL A. VOLCKER

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June 25, 2002

The Honorable Cliff Stearns
House of Representatives
Chairman, Subcommittee of
Commerce, Trade and Consumer Protection
2227 Rayburn Building
Washington, DC 20515

Dear Mr. Chairman:

I am glad to enclose a copy of the speech I am giving today on auditing reform. The middle part touches upon some questions of accounting standards, including the desirability of developing international standards on the points you raise and others.

Your call for addressing important issues exposed by the Enron affair (and so many others in recent months) is certainly timely and relevant. As you well understand, these are complicated and contentious matters. My sense is that in the end better progress will be made, better insulated from particular interests, if FASB and the IASB (that is the International Accounting Standards Board over which I and other International Accounting Standards Committee Trustees have oversight responsibilities) are committed and able to work together. That process has, I can report, already started, and I believe deserves congressional recognition and support.

Among other things, I think it would be useful to find the means for more assured financing in future years for both FASB and IASB, free from threats of withholding funds as a result of either business or political pressures. The Sarbanes Bill in the Senate goes some distance in that direction.

More generally, I welcome your interest in spurring action on the specific points you mention in your letter. I would even add to the list! However, I think it would be dangerous for the Congress itself to go further, to the point of being drawn into the substantivé decisions on technical, but inherently controversial, standards. I have máde the same point to the European Union authorities that have a strong interest in these matters, particularly in the light of their decision to adopt international standards in 2005.

All my experience in supervising banking and in accounting matters reinforces what the very public crisis in auditing tells us -- the time has come for effective reform. The market is demanding change. Boards of Directors, auditing committees and, finally, the SEC are responding. But I am convinced that adequate and lasting change will require legislation along the lines of the bill recently adopted by the Senate Banking Committee. Your attention to the need for dealing with particular issues is a helpful part of the process of reform.

I would be glad if you make this letter as well as any portion of my speech a part of the written record of your hearing.

I would also welcome the opportunity to stay in touch!

Sincerely,

Paul

Paul A. Volcker

Enclosure

FINALLY, A TIME FOR AUDITING REFORM
REMARKS BY PAUL A. VOLCKER
AT THE
CONFERENCE ON CREDIBLE FINANCIAL DISCLOSURES
KELLOGG SCHOOL OF MANAGEMENT
NORTHWESTERN UNIVERSITY
EVANSTON, ILLINOIS
JUNE 25, 2002

Permit me to start by offering congratulations. Whoever decided months ago to schedule this conference at precisely this time deserves a gold star for forecasting. The alarming exposure of a series of financial reporting and auditing lapses in recent months is finally forcing the Congress, the SEC and the investing public to face up to the need for reform. What better opportunity could there be to help form a consensus for action - truly effective and forceful action?

I congratulate too, the Kellogg School itself for maintaining a long-standing commitment to teaching and research in accounting. It has done so at a time when much business education has concentrated on other areas, areas more fashionable and more immediately remunerative for graduates. That tendency, I fear, has contributed to the loss of accounting discipline fundamental to the effective functioning of our market system.

How ironic that we are meeting near Arthur Andersen Hall with the leadership of the Leonard Spacek Professor of Accounting. From all I have learned, the Andersen firm in general, and Leonard Spacek in particular, once represented the best in auditing. Literally emerging from the Northwestern faculty, Arthur Andersen represented rigor and discipline, focused on the central mission of attesting to the fairness and accuracy of the financial reports of its clients.

The sad demise of that once great firm is, I think we must now all realize, not an idiosyncratic, one-off, event. The Enron affair is plainly symptomatic of a larger, systemic problem. The state of the accounting and auditing systems which we have so confidently set out as a standard for all the world is, in fact, deeply troubled.

The concerns extend far beyond the profession of auditing itself. There are important questions of corporate governance, which you will address in this conference, but which I can touch upon only tangentially in my comments. More fundamentally, I think we are seeing the bitter fruit of broader erosion of standards of business and market conduct related to the financial boom and bubble of the 1990's.

From one angle, we in the United States have been in a remarkable era of creative destruction, in one sense rough and tumble capitalism at its best bringing about productivity-transforming innovation in electronic technology and molecular biology. Optimistic visions of a new economic era set the stage for an explosion in financial values. The creation of paper wealth exceeded, so far as I can determine, anything before in human history in relative and absolute terms.

Encouraged by ever imaginative investment bankers yearning for extraordinary fees, companies were bought and sold with great abandon at values largely accounted for as "intangible" or "good will". Some of the best mathematical minds of the new generation turned to the sophisticated new profession of financial engineering, designing ever more complicated financial instruments. The rationale was risk management and exploiting market imperfections. But more and more it has become a game of circumventing accounting conventions and IRS regulations.

Inadvertently or not, the result has been to load balance sheets and income statements with hard to understand and analyze numbers, or worse yet, to take risks off the balance sheet entirely. In the process, too often the rising stock market valuations were interpreted as evidence of special wisdom or competence, justifying executive compensation packages way beyond any earlier norms and relationships.

It was an environment in which incentives for business management to keep reported revenues and earnings growing to meet expectations were amplified. What is now clear, is that insidiously, almost subconsciously, too many companies yielded to the temptation to stretch accounting rules to achieve that result.

I state all that to emphasize the pressures placed on the auditors in their basic function of attesting to financial statements. Moreover, accounting firms themselves were caught up in the environment - - to generate revenues, to participate in the new economy, to stretch their range of services. More and more they saw their future in consulting, where, in the spirit of the time, they felt their partners could "better leverage" their talent and raise their income.

I have a mental image of the role of an auditor. He's a kind of umpire or referee, mandated to keep financial reporting within the established rules. Like all umpires, it's not a popular or particularly well paid role relative to the stars of the game. The natural constituency, the investing public, like the fans at a ball park, is not consistently supportive when their individual interests are at stake. Matters of judgment are involved, and perfection in every decision can't be expected. But when the "players", with teams of lawyers and investment bankers, are in alliance to keep reported profits, and not so incidentally the value of fees and stock options on track, the pressures multiply. And if the auditing firm, the umpire, is itself conflicted, judgments almost inevitably will be shaded.

Of course, that is not a fair description of the whole of American business. But we've seen enough to know there is a problem. Doubts - increasing doubts - about the reliability of financial reporting, now appear to be infecting investor decisions and stock valuations themselves.

Plainly, it is time to act - act in the interests of the investing community, of all of us, so to speak, sitting in the stands interested in seeing a fair game -- to support needed reforms in financial reporting.

I realize change - constructive change - is underway in the marketplace.

Directors and audit committees of public companies a__ surely more sensitive to auditor conflicts and to the implications of "aggressive" accounting practices. CEO's and their CFO's have been put on notice that they should not expect to escape responsibility for lapses in financial controls and reporting. The accounting firms themselves are surely motivated to review their internal procedures. They have responded - to be sure none too happily - to client and investor concerns by shedding some consulting services, particularly high-tech IT systems work.

The issue we face is whether those reforms in the market can go far enough, and whether they will outlast the current spate of reported scandals. The past record affords little or no comfort on that score. In the face of earlier difficulties, the accounting firms and their trade association have clearly demonstrated their lobbying power and successfully resisted meaningful reform.

I cannot believe it is in the long-term interest of the auditing profession itself that we permit that pattern to be repeated.

Too much is at stake.

At its roots, we are dealing with an issue fundamental to the efficiency and effectiveness of the market for capital in the United States and elsewhere.

Out of the evident crisis, there is opportunity for constructive change.

I do not suggest there is a simple quick fix. Rebuilding faith in financial reporting will take time. It's an intellectual challenge, as well as business and political challenge.

Consider the challenge in terms of each of what I think of as the three pillars of reliable financial reporting:

- First are accounting principles and standards themselves. Do they set out, with clarity, logically consistent and comprehensive "rules of the game", rules that reasonably reflect underlying economic reality?

- Second are the business and auditing practices and policies that implement those accounting standards. Are the standards upheld by the auditors and translated into accurate, understandable, and timely reports by individual public companies?

- Finally are the institutional structures to support reliable accounting and auditing. Is there a framework of legislation, regulation, and corporate governance capable of providing and maintaining needed discipline?

The succession of accounting failures, beginning even before the Enron affair and continuing week by week, indicates unambiguously the need for improvement in every area.

<u>Standard Setting</u>

The general case for <u>international</u> accounting standards has been clear for a long time. In a world of global finance, we have a strong interest in encouraging high quality standards every place our companies do business. We want to be sure foreign-based companies desiring access to our well-developed market provide the kind of information our investors want and need. We want to avoid distortions in the international flow of capital because of mis-information, inconsistent information or lack of information. Not least, a single set of standards would minimize compliance costs for companies.

The United States has in practical effect long taken the position that those objectives could be reached by sticking to our GAAP and demanding that foreign companies wishing access to our large market follow our rules. I'd like to think our oft-stated view that the U.S. standards are the most comprehensive and best quality in the world is still true. But that mantra is no longer unchallenged. What has become indisputable is that standards themselves, national and international, need review: our goal must be not just consistent standards but better standards.

Enron's collapse amply illustrates the range of sophisticated issues before standard setters today - the almost inscrutable complexity of derivatives, options, and other new financial instruments; the emphasis on self-defined pro forma earnings; the subtleties of "fair value" accounting where there is no objective market; the proper treatment of share-based payments and of "special purpose vehicles".

Not surprisingly, it is those same areas that generate intense controversy and where standard setters meet the most resistance. Almost inevitably, there are claims of inadequate consultation. Those perceiving harm to their interests threaten withdrawal of financial support for the standard setters themselves and even turn to their legislators for preemptive action. In such a charged environment, change in the United States as elsewhere has been slow and suspicions of political compromise have damaged confidence in the process.

As Chairman of the Trustees of the restructured International Accounting Standards Committee, I, together with the other trustees, am responsible for appointing and financing the expert rule-making International Accounting Standards Board. We are dedicated to protecting the independence of its decision-making. Consistent with that duty I am required to resists the temptation to express personal views on the substance of the standards.

What I and the other Trustees can do is urge close collaboration among the international and national standard setters -- notably the U.S. FASB -- and all deliberate speed in those deliberations. I sense the past resistance in the United States to accepting international standards may be diminishing. What is more evident is that much of the rest of the world is prepared to work to that end; in particular, the European Union has made clear its intention to adopt international standards in coming years.

To be successful, and to be accepted in the United States, those standards will need to be of high quality and adapted to the business and financial realities of the 21st century. I trust the present efforts at collaboration between the international and national standard-setting boards, including FASB, will provide protection against parochial financial and political pressures undercutting progress.

Auditing Approaches and Policies

One of the main concerns of standard setters here and elsewhere is the extent to which the rules should be set out, and particular applications illustrated, in great detail. That's the present American approach. The alternative - the approach taken in the U.K. - is to emphasize the basic principle at stake, with the auditor responsible for its specific application.

The lesson drawn by many from the Enron debacle, with its abstruse game playing with the technical rules, has been the potential value of the "principle-based" approach. One thing is true for sure. To adopt that approach would be to increase further the burden on the auditor for disciplined, independent and dispassionate judgment.

Those are precisely the qualities that recent developments have brought into question. I fully recognize that neither an entire firm - certainly not an entire profession - should be damned by the weakness of a few, who have given way to the pressures I described. But neither can it simply be a pure coincidence that, within Arthur Andersen itself, the strong emphasis on non-auditing consulting work over the past decade paralleled an ultimately fatal loss of auditing discipline. I've seen enough of its marketing brochures, its compensation policies, its training approach and its emphasis on revenue generation to recognize the conflicts and distractions.

None of that would be a surprise to Leonard Spacek. He preached the professional responsibility of the auditor - the responsibility that justifies his exclusive license to perform the required audit of public companies - is to attest to the "fairness" and accuracy of a client's financial reports to the investing public. Activities that would place that responsibility in jeopardy are simply inappropriate.

Legislation, Regulation, and the Structure of Auditing Firms

The key to auditing reform is adequate support for the essential mission. One important aspect of that need is the willingness of clients to pay fees commensurate with the responsibility inherent in auditing and with attracting the talent required. My reading of the current evidence in that respect is mixed. More broadly, experience strongly suggests that the changes in attitudes and approaches that we are seeing by boards of directors, by management, and by auditing firms themselves will need to be supported and reinforced by legislation if they are to be effective and lasting.

Bills now in the Congress sponsored by Republicans and Democrats appear to accept the logic of a new oversight body, operating under the general authority of the SEC. Now, the SEC itself has reversed its previous passivity and proposed at its own initiative, and in general terms, an oversight body within its own jurisdiction.

In one way or another, all these approaches reflect the heightened concern about auditing discipline and related areas of corporate governance. But important differences exist among those approaches. These differences are crucial in determining whether we will have meaningful reform. In considering the alternatives, I have urged certain "litmus tests" be applied:

1. Does the proposed legislation provide real independence for the oversight board, with the majority membership representing the public interest rather than industry perspectives, and with an assured flow of financing?

2. Will the new oversight board have the authority to oversee and, as necessary, modify professional auditing standards and controls to assure their adequacy, to conduct investigations and to review particular audits, and to impose or recommend to the SEC a range of penalties ranging from reprimands to fines to loss of license?

3. Will the Board be able to determine limits on consulting or other services provided to audit clients or others when such activities undermine focus on the priority responsibility for disciplined auditing?

4. Does the legislation provide adequate funding for the SEC itself, given the need for skilled and experienced staff, adequate in numbers, to maintain effective review and supervisory responsibilities in today's active and complex market environment?

In my judgment, those criteria are fully met only by the Bill passed by the Senate Banking Committee last week at the initiative of its Chairman, Mr. Sarbanes, in a strong bi-partisan vote.

The window of opportunity may be closing. Fall elections shorten the Congressional timetable. We cannot count on industry support. I know there is room for honest debate on some of the specific legislation language. But the main points of a strong oversight body and the elimination of substantial conflicts should be inviolate to those seriously interested in reform.

The recent initiative of Mr. Pitt, and particularly his crystal clear recognition of the deadly threat to confidence in our financial markets, is a welcome and strong step forward. But I do not believe a regulatory approach, without specific legislative authority, will be satisfactory. It is not only a question about the ability of the SEC under existing law to delegate its authority to impose a range of penalties. More broadly, only fresh legislation is capable of clearly expressing the will of the Congress and the American public for meaningful and lasting reforms.

Given what is at stake for the credibility of our financial reporting, I trust that approach can and will be supported by the Administration and the SEC.

Corporate Governance

I recognize a natural complement to auditing reform is strong corporate governance. Questions in that area form a part of your agenda tomorrow, and I will limit myself to only a few words here.

There is today a consensus on the need for a strong, and technically competent, audit committee made up of independent members of boards of directors. I am also strongly attracted to another concept that seems to be gaining support but is far from a consensus: that is the desirability, for most large and complex public corporations to split responsibilities of the CEO from a non-executive chairman of the board.

Both approaches would, I believe, provide more effective oversight - a reasonable check and balance - on the strong and almost exclusive authority of the CEO typical of many American companies. As our Secretary of the Treasury, Paul O'Neill, has in his characteristically forthright way emphasized, the prime responsibility for financial reporting lies with the boss. It is the CEO that sets the tone, nurtures the culture, and appoints the staff. If and when there is a failure to report fully and accurately he should bear the consequences.

There is much to say for that approach. The question is how to implement it. An independent auditing committee and non-executive chairman can provide a needed element of oversight, a counterweight to the pressures on management to dress up reported results.

More important than either of those particular reforms of corporate governance, in my view, are the excesses and abuses in the use of stock options for management of established public companies. It is not too much to say that an approach originally justified as a means of aligning management with stockholders interests has too often been distorted into a means of aligning stockholders to the interest of management. The value of one-way options capriciously reflects general market influences as much or more than the long-term success of management. In bull markets, they reward even sub-par performance. We have seen instances of huge payoffs even as a company heads for bankruptcy. In my judgment, one-way options simply cannot sensibly be defended in the amounts granted by some companies.

My larger point is that we cannot count on changes n corporate governance to substitute for needed reforms of the accounting and auditing disciplines. After all, boards of directors are, and should be, collegial bodies typically closely attuned to, and sympathetic with, the chief executive officer. They are necessarily heavily dependent on management for information. Their independence and experience is invaluable, particularly on strategic issues and organizational questions. But their attitudes and aptitudes are not those of skeptical auditor, acting at arm's length in the interest of the investment community.

We have today an all too rare opportunity for significant and lasting reforms. The stage is set for an international effort to bring accounting standards up to date. The need for internal change in accounting firms to focus on their auditing responsibilities is better recognized. A legislative process is well underway.

The market itself, visible in its own erratic performance, is calling for action.

There cannot be any point in resisting change, not at the expense of further undermining market confidence. Amid all the pressures to which they are subject, the auditing profession most of all, needs a clear Congressional restatement of its primary responsibility to the investing public.

Inevitably, the legislative process is both difficult and time constrained. What it particularly needs at this point, is the considered judgment and visible support of those dispassionately and professionally concerned with the guarding the integrity of our financial markets.

What better setting could their be for that effort than here at the Kellogg School, at its Accounting Research Center, carrying on a tradition set long ago in happier days by Arthur Andersen and Leonard Spacek themselves.

Mr. STEARNS. My colleagues, although radical reforms could have gained wide support a few months ago in the heat of the Enron investigation, we have chosen to add value where it is appropriate and recognize the positive characteristics of the current system.

FASB is a private sector standard setter and has performed well, given the enormity of its responsibilities. That said, I wish to personally thank Mr. Jenkins, the Chairman of the Financial Accounting Standards Board, for his service and his willingness to participate today.

For those who may not be aware, Mr. Jenkins' term as Chairman ends this week. He is gracious enough to accommodate us one last time, and for that, I am grateful.

Mr. Jenkins has elevated the dialog with Congress to a level that previously, in my opinion, did not exist. So I welcome the witnesses today and I look forward to hearing their comments.

And with that the distinguished ranking member of the subcommittee, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me thank you also for holding this hearing.

Corporate fraud and accounting scandals have rocked investor confidence in our capital markets and tarnished reputations in board rooms, accounting firms, and on Wall Street.

The markets have sputtered along as headlines make clear abuses thought to be unique to Enron are more widespread.

This committee conducted a bipartisan investigation into the Enron scandal and identified three important areas of reform: No. 1, corporate governance, accounting governance and accounting standards.

As far as corporate governance is concerned, the New York Stock Exchange stepped up to the plate with significant changes to its listing requirements.

The House recently passed a bill addressing some of the accounting governance issues. I think we will see more reform in this area when this issue goes to conference and this bill addresses the following component accounting standards.

I commend Chairman Stearns for his hard work on this issue and for holding this important legislative hearing today.

For reform to be complete, we must address the critical accounting standards issues. The FASB Act does three main things. It recognizes FASB's standards as authoritative; introduces a primary accounting principle to improve transparency of financial reporting; and requires FASB to revise accounting standards most abused by Enron and Andersen.

It accomplishes this while maintaining FASB's private sector status as an independent, something this committee has always respected.

I support the policies underlined in the FASB Act as Chairman Stearns' efforts to provide more transparency in financial reporting.

I thank the witnesses for their testimony today. I want to give a special, special welcome to the New York connected members of the panel. Of course, I look forward to the testimony from all the witnesses, but especially those from New York.

Thank you very, very much.

Mr. STEARNS. I thank my colleague.

Now the distinguished chairman of the Oversight Committee that did the investigation of Enron, the gentleman from Pennsylvania, Mr. Greenwood.

Mr. GREENWOOD. Thank you, Mr. Chairman.

I appreciate the opportunity to sit in as a non-member of this subcommittee.

By now, we are all familiar with the story that led us here. On December 2, 2001, Enron Corporation filed for protection from its creditors under Chapter 11 of the bankruptcy laws. Two days later, they laid off 4,000 employees.

By mid-December, what had once been the Nation's largest energy supplier had been reduced to a penny stock and Enron employees and former employees, who had heavily invested in the company's stocks through their 401(k) retirement plans, saw most of their life savings wiped out.

Outside investors, too, suffered heavy losses as nearly $70 billion in assumed equity value simply vanished.

There were many disturbing features to the Enron debacle, but as I noted at the time, few were as disturbing as what it might portend for the future if left unaddressed.

For whatever else may be said of the meteoric rise and fall of Enron, no one can claim that it went unobserved. On the contrary, few corporations were more admired and few corporate cultures were more extolled than Enron's.

Yet all the while, Enron's corporate team was busy ginning up the numbers. As a result, millions of individuals, from the most sophisticated Wall Street mavens to the most innocent small town investors, were systematically being deceived.

What we did not know then is the number of other firms that would so quickly follow in Enron's wake: Tyco International, Adelphia Communications, Global Crossings, and now ImClone.

Nor was the public sector immune from this new accounting disease. Amtrak's recent discovery that it had $200 million more in losses than it had previously thought serves as an example.

But this morning's news tops them all. WorldCom has announced that it was guilty of a $3.8 billion accounting error.

To an increasing number of investors, the who's who of American corporate executives is beginning to look more and more like a rogue's gallery. I would hope that this morning's revelations are enough to convince even those who still cling to the belief that these failures are merely aberrations, that they will not be quickly remedied by the self-correcting mechanisms of the market alone. Not even the street believes this any more.

As the writers at Fortune magazine wrote in their June 24 cover story, "Phony earnings, inflated revenues, conflicted Wall Street analysts, directors asleep at the switch, this isn't just a few bad apples we are talking about here. Nearly every known check on corporate behavior, moral regulatory, you name it, fell by the wayside, replaced by the stupendous greed that marked the end of the bubble and that has created a crisis of investor confidence the likes of which has not been seen since the Great Depression."

In looking back at the more than 600 audited financial statements of publicly traded companies that had to be recalculated downwards in the past 3 years, it is increasingly clear, that Enron was simply the most egregious example of the use of ledger domain by corporate management teams in hiding the truth about a company's actual financial health.

This committee and this Congress are now challenged with the mission of developing remedies to the accounting and auditing lapses so that in the future such occurrences are rare.

At the heart of this matter lies one document, the probity of which is essential to the credibility of the entire securities and exchange industry: the annual audited financial report of a publicly traded company.

The process by which this document is produced is central to this committee's role in developing new investor safeguards. That is why I have joined with my colleague, Chairman Stearns, to introduce legislation that would bring new vitality, a clearer mission, and greater independence to the Financial Accounting Standards Board, the body that sets the standards for auditing.

Our goal is straightforward. To be of genuine value corporate accounting practices and standards must be transparent and fully disclosed all the relevant facts needed by investors to acquire a true understanding of a firm's economic health.

While I am convinced that this is as much as this committee can do, given the limits of our jurisdiction, I am also convinced that this is not all that Congress needs to do. Bernard Baruch once observed that when the market makes the front page, sell. I expect there will be a great deal of selling in the coming days.

The success of market rests fundamentally on the ability of the buyer to trust the seller. I am hard-pressed to believe that the true trust relationship of the markets can be restored without significant congressional action.

The core of that trust relationship is more than an honest accounting, although that is an essential part. Sound corporate governance begins with corporate managers, extends to the board of directors, and finally to the accountants who keep the company's books.

As Fortune magazine so plainly stated, "This market is suffering from a systemic breakdown."

For that reason, I will shortly be introducing legislation to establish a market integrity commission, to examine and make recommendations to Congress and to the business community on what reform measures are needed to improve the corporate governance of our Nation's publicly traded companies and to reestablish investor confidence in our markets.

For while I still hold that most of the reforms of our capital markets should be undertaken by the private sector, I also believe that Congress has a responsibility, just as it did after the market crash in 1929, to insist on the timely introduction of genuine reforms in corporate governance to improve the way in which publicly traded companies are governed, for shareholders and employees, and to strengthen and safeguard our Nation's economic health.

Thank you, Mr. Chairman.

Mr. STEARNS. I thank my colleague.

The gentlelady from California, Ms. Eshoo.

Ms. ESHOO. Good morning, Mr. Chairman and members of the committee, and welcome to distinguished panel.

Thank you for holding the hearing, Mr. Chairman.

In attempting to prepare for today's hearing, it was difficult to get our hands on what the language of the bill is and what exactly is being proposed. As I understand it, the legislation will give FASB standards a Federal recognition.

Of course, we would like to hear from the distinguished Chairman of FASB what that means and what kind of prescription this is for what ails us.

It requires FASB to develop a rule requiring accountants to apply all FASB standards consistently with the fundamental principles of transparency and understandability. We are not doing any of that now? And if we are, then how does this language apply? How, again, is it going to be a prescription for what ails us?

It directs FASB to develop rules in areas where current standards need improvement, specifically off balance sheet accounting, revenue recognition, and mark-to-market accounting.

I think that FASB needs to weigh in and explain forthwith how much this is being accomplished today, where this takes us. Is it strong enough?

My sense is that while the Congress has been, of course, on the scandals beginning with Enron, that has really rocked our country, it has shaken the confidence and I think the sense of decency that the American people believe ultimately prevails.

I think, my sense, as of today, is that we are coming up short on what we are to do. I want to be sure that what is being proposed is the right dosage because we can decry what is going on. An example in terms of energy, the House Energy and Commerce Committee, to date, has still not weighed in on Enron and energy suppliers and the abuses that have taken place that are documented by a Federal agency, the Federal Energy Regulatory Commission.

So I know the distinguished Chairman and others will weigh in and that is what I would like to hear.

I would also like to weigh in on an issue that is related. And I recognize that while Congress has the responsibility to address these abuses, and I think that we have to come up with strong prescriptions myself through sensible legislation.

There are some that are using the scandals, starting with Enron, as a battle cry for what I believe are ill-conceived proposals like changing the way stock options are valued. The financial fraud that led to the collapse of Enron, in my view, had nothing to do with stock options.

By proposing that stock options be counted as an expense against corporate earnings or expensing them, as the phrase is used, Congress, I think, is addressing the problem that does not exist with a solution that does not work.

Financial reports will become less, not more accurate. There is simply no way to accurately value the potential worth of employee stock options. And if someone has a way of doing that, I would like to hear them state it.

Unlike salaries, options are not cash transactions. To place a value on them, companies would have to make predictions. Predictions. I think some of these predictions have gotten us into hot water about the future price of stock, which employees will stay with the company long enough to exercise their options, and who would actually choose to do so, and at what price?

The second negative consequence I think is even worse. Faced with the exorbitant cost of expensing options, most companies would simply decide to stop offering them.

I think what is left out of this secondary debate that I am pointing to, Mr. Chairman, is the following. At the top of companies and corporations, those at the top will always somehow do well. I think we would all acknowledge that.

But I have seen over the 10 years—I can't believe that I have been here for 10 years, but this is my tenth year—I have seen the rank and file employees win, and win well, under what I have just described, their stake, their share in their company and their company's future.

So perhaps this is going to be a part—I am sure it will be—part of future debates, but I wanted to raise it. I think it is important. I think we have to separate wheat from chaff. And I know that our distinguished panel today, I hope and I trust that they will be forthright with us.

We need solid direction on coming up with solid proposals, not just political proposals, that the Congress can somehow go home and say, we had hearings; we brought this up; and now this is going to be fixed.

I am not an accountant. I guess I am glad that I am not today, but they must be thought less of than, or running neck and neck, I think, with politicians. But at any rate, I think you know my point.

I really would like to know forthwith, without hurting anyone's feelings, if you think this is actually the strongest medicine that really needs to apply. We have a huge infection in our system and it needs to be cured.

Thank you.

Mr. STEARNS. I thank the gentlelady.

And now the distinguished chairman of the full committee, Mr. Tauzin.

Chairman TAUZIN. Mr. Chairman, I really appreciate this hearing and what I hope that we might be able to accomplish as a result of it and the hearings we have had on the abuses of both Enron and Arthur Andersen.

The news this morning that another Arthur Andersen client, WorldCom, has apparently played with the rules and with the consent of their accountants in the field apparently misstated current debt by trying to capitalize it over a longer period of time and in the process overstated income, all to the detriment of investors, who are entitled to get good information about companies, like WorldCom and Enron, and others.

And again, we see a common thread here of an accounting firm, that among the top five accounting firms in America, the only one that apparently allowed its local auditors the power to overrule its own quality review boards on the national level and, therefore, put its own auditors in the field into the kind of vulnerable situation where a strong and powerful corporate executive could, in fact, influence their decisions in bending the rules and reshaping the rules to fit the corporate intent.

If what I read about WorldCom in the Post today is correct, this fits the pattern, once again. And it calls upon us in our limited jurisdiction over FASB to do something basic about changing that pattern.

I appreciate all of you coming today. The last time we had a session with accounting professors, we learned that the basic thing wrong with FASB, among all its problems, was that it was trying to do like the IRS was doing. It was trying to write intricate rules about what you could not do in accounting.

And so accounting firms, like Arthur Andersen, who allowed their auditors to be less than fully independent, are vulnerable to the pressures of a corporate executive who might want to do something improper, will love to find ways to get around the FASB rules, to find out how what they did might not be prohibited by the FASB rule.

We learned from the professors that it would be much wiser for FASB to be placing strong, clear accounting principles out there under which accountants must fit what they do in the field and what they approve in corporate reporting of their assets and their income and their debts.

I hope that we can agree upon legislation, again within our limited jurisdiction on FASB, that will force that result, get FASB to do a better job of making sure that accounting firms from now on find ways to comply with the rules rather than constantly be looking for ways to get around a prohibition.

Second, I hope our legislation does something else. I would appreciate all of you gentlemen commenting on the suggestion that we give FASB a new authority; that we not only tell them to change the way they do business, to make sure that this common thread, if you will, of violations of accounting principles stops and ends and then investors get better treated than they have been treated here, but that they also have a power to do something that I think is critical and I would love for all of you to comment on it.

We have come to the conclusion that if FASB does not have the power to do forensic audits. If they cannot from time to time do what other rulemaking bodies do, and that is go into the field and actually check to see whether their standards are being properly applied, to see whether accounting firms are in fact following the rules rather than trying to get around them; to see whether or not their standards are up to date or whether they need to revise them. Because in an information age, there are changes in the way you look at assets and income and debt.

If they do not have the power to go in and check the performance of their standards in the field from time to time, they will always be behind the eight ball, always be late updating their rules, always be too slow, always be in a position where some smart accountant and some bright executive are ahead of them doing something they should not be doing.

And that, I think, is one of the critical reforms I think we need to make again within the limited jurisdiction we have on this issue. I think it flows from all of what we have learned in the Enron hearings up until this date.

So I know I have very limited time, but I would love if any of you would—are we in question and answer period yet?

We are not.

Mr. STEARNS. Just in opening statements.

Chairman TAUZIN. I would love if any of you, during the question and answer period, would focus some attention on that central question. Should we give FASB that authority? Without that authority, can FASB do its job?

Let me make one final point because the paper talks about this in a political sense as well. Anyone who believes in the capital markets, as we do, anyone who supports the notion of capitalism and free markets and the business economy of this country, which has been a leader in the world, anyone who supports the principles under which free enterprise operates ought to be more offended by corporate misbehavior than by anyone who does not.

And those of us who do are incredibly offended when we see corporations run by people who put avarice ahead of the good of the investors in the corporation. And all of us are offended when accounting firms operate in a fashion that they allow independence to go out the window and they permit the kind of simple and fundamental violations of the rules, as we have seen in the paper today, where you would capitalize current charges just to inflate income and hide debt and, therefore, hurt investors of your company and hurt your company in the long run.

All of us are offended by that. And anybody who think that those of us who support capitalism and support the free markets in this country are less offended by it than anybody else is wrong. In fact, perhaps more so.

It is like a member of your own family doing something wrong instead of the neighbor. You get a little more upset about it. And so I hope we disabuse that notion in this country. I think our hearings on Enron, our hearings on Arthur Andersen, and I hope the work we do in reforming FASB make that case over and over again. The Democrats and Republicans are equally offended by what we have seen, and it has got to come to an end for the good of the markets and for the good of investor confidence again, in this economy if we are going to get it rolling again as we hope to get it rolling.

Thank you, Mr. Chairman.

[The prepared statement of Hon. W.J. "Billy" Tauzin follows:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON COMMERCE

One year ago, "transparent reporting and "auditor independence were not household phrases. Today they are. The Enron implosion ushered in a process in which many Americans who previously paid little attention to the intricacies of accounting became more concerned and more attentive to important, if nuanced, accounting issues. Let me be clear—the behavior of Enron and Andersen was truly atrocious. Yet the sunlight that has been shed on the deficiencies in our market system, much of it by this Committee, will ultimately work to improve that system. As investors digested the news about corporate managers helping themselves to shareholder assets while the shareholder's watchdogs looked the other way and Wall Street analysts continued to hype tanking stocks, they began to demand strong oversight of the standards for recording and reporting public companies' financial information.

This Committee held a series of hearings exposing the abuses at Enron and Andersen and exploring deficiencies in current accounting practices. In fact, some of the same witnesses we heard from early in the process are here again today. I thank them for returning. I also thank the rest of our panel for taking the time to provide guidance on our accounting standards legislation. Chairman Stearns and Chairman Greenwood have worked tirelessly to get to the root of the problems and develop a viable solution and I thank them too, for all of their important efforts.

Our somewhat limited jurisdiction made meaningful reform of accounting standards in this committee alone difficult. We worked hard to fulfill our oversight obligations and help protect the investing public from the deficiencies in transparency and comprehensibility of financial information.

That said, the Committee Print of the Financial Accounting Standards Board Act makes important improvements to financial reporting. The bill introduces the benefits of a principles-based accounting system into our rule-based system by requiring FASB check the accounting standards against the principles of transparency and comprehensibility. It also requires FASB to draft a primary standard that must be used to ensure the application of accounting rules complies with those same principles of transparency and comprehensibility. Any deviation in the application of a rule from the principles articulated in the bill must be explained and justified. The bill also requires FASB to finish work on accounting projects that have been ongoing for too long. Those projects include work on revenue recognition, which I understand has been under some consideration by FASB for 26 years, and off-balance sheet accounting that has been open for more then ten years. The legislation also calls upon FASB to complete it work on its fair value project.

Off "balance sheet accounting was subject to great abuse by Enron and all members are united in the view that it is imperative to reform these rules.

The Committee has an obligation to exercise, not only its oversight jurisdiction, but also its legislative jurisdiction in the area of accounting standards. The legislation we consider today will lead to improvements in the transparency of financial information. Once again, I thank the witnesses for their testimony and assistance and look forward to hearing what each has to say.

Mr. STEARNS. I thank the chairman.

The distinguished ranking member of the full committee, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I thank you for recognizing me.

I commend you for holding this hearing on legislation to improve the accounting standards setting process. You, our Chairman, Mr. Tauzin, Ranking Member Towns, and I all support the work of the Financial Accounting Standards Board, FASB. And we care deeply about its independence, which we think is necessary for a strong, truthful, respected and trustworthy accounting industry.

I, therefore, strongly support the goals of this committee print and the bipartisan efforts to strengthen FASB.

The jurisdictional constraints that the House rules impose on this committee—and we have jurisdiction over the FASB standard setting process, but no jurisdiction over the central role of the Securities and Exchange Commission in development of standards and its oversight of FASB—severely complicate the efforts of this committee to address the crucial implementation issues, such as those identified in Professor Dharan's excellent testimony.

I look forward to the testimony of all the witnesses this morning. And I want you to know that I will try to work with them and you, Mr. Chairman, and others on this committee to perfect and strengthen this bill so it does what has to be done.

I and others have often said that Enron was not unique, that there were other ticking time bombs out there. Subsequent events have born that regrettable warning out. In the latest blow to our economy and investor confidence in the stock market, we were met this morning with news in the paper that says WorldCom's audit committee has uncovered what could be the largest accounting fraud in history, the discovery that $3.8 billion in expenses was improperly booked as capital expenditures.

I would note that appears to be either an act of severe criminality or an event which, very frankly, could not have been committed by a beginning student of accounting.

I would note this committee should immediately commence a full investigation, and I pledge my help in that work.

Chairman Levitt of the SEC warned loud and long about corrupt financial management and their complicit auditors. His campaign against earnings management, or falsifying revenue to boost stock prices, was documented by Fortune magazine in such articles as "Presto Chango, Sales are Huge," and "Lies, Damned Lies and Earnings Management," or perhaps it might have been just "Lies, Damned Lies and Accounting."

In any event, very few people wanted to hear what he had to say because they were too busy making too much money on the resultant run-up in stock prices. Regrettably, that party is over and we all have a hangover. And we must all do our part to clean up this sorry mess.

In April, the House passed a bill which could best be denominated as halfhearted or perhaps half-witted reform. As Business Week warned in a June 3 editorial, "Halfhearted reform is bad for the public, bad for the economy, and even bad for the accounting industry, which needs to establish its credibility." That is why it is so important for the Congress to now take up and pass the Sarbanes bill at the earliest opportunity.

FASB is not responsible for the wave of accounting scandals. These companies and their auditors violated existing accounting and auditing standards. Crooks are going to be with us always. We must nonetheless look to see what we can do to enhance and strengthen FASB and to improve the standard-setting process. I stand ready to assist in that process.

I would just note one thing else. I have warned industry time after time that this country has a most unique and wonderful asset in our financial markets: they are trusted by the American people.

I warned the financial industry of something else. Everybody thought that this system ran on money. It does not. It runs on public confidence. As long as the public has confidence, there will be much money made by all.

I would just read one last point that shows that everybody has a stake in this matter, and that is on page 1 of the Washington Post. I would urge the reading of this article, "Corporate Scandals Taking Toll On the Markets." They are skimming a bunch of innocent people in the marketplace, people who trusted corporate managers, accountants, the Federal agencies to regulate, the Congress to pass good laws and see that they are properly enforced. All of the above have failed in a most noteworthy fashion. And until we can straighten out this sorry mess and get people to have confidence, we should not look to much confidence in the market, nor should we look to the fact that good times are going to be here again in the financial services industry.

I thank you, Mr. Chairman.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHICAN

Mr. Chairman, I commend you for holding this important hearing on legislation to improve the accounting standards-setting process. You, Chairman Tauzin, Ranking Member Towns, and I all support the work of the Financial Accounting Standards Board (FASB) and care about its independence. I therefore strongly support the goals of this committee print and bipartisan efforts to strengthen FASB.

The jurisdictional constraints that the House Rules impose on this Committee—we have jurisdiction over FASB's standard setting process but no jurisdiction over the central role of the Securities and Exchange Commission in the development of standards and its oversight of FASB—severely complicate our efforts to address critical implementation issues such as those identified in Professor Dharan's testimony. I look forward to the testimony of all of the witnesses this morning, and I will continue to work to perfect and strengthen this bill.

I and others have often said that Enron was not unique, that there were other ticking time bombs out there. Subsequent events have borne that warning out. In the latest blow to our economy and to investor confidence in the stock market, we were met this morning with news that WorldCom Inc.'s audit committee has uncovered what could be one of the largest accounting frauds in history, with the discovery of $3.8 billion in expenses improperly booked as capital expenditures. This Committee should immediately commence a full investigation, and I pledge my help in that work.

SEC Chairman Arthur Levitt warned loud and long about corrupt corporate financial management and their complicit auditors. His campaign against earnings management or falsifying revenue to boost stock prices was documented by Fortune magazine in such articles as "Presto Chango! Sales are Huge!" and "Lies, Damned Lies, and Earnings Management." Perhaps it should have been entitled "Lies, Damned Lies, and Accounting."

Very few people, however, wanted to hear what he had to say because they were too busy making too much money on the resultant runup in stock prices. That party is over and we all have a hangover. We must do our part to clean up this sorry mess. In April, the House passed halfhearted, some say half-witted, reform. As Business Week warned in a June 3 editorial: "Halfhearted reform is bad for the public, bad for the economy, and even bad for the accounting industry, which needs to reestablish its credibility." That is why it is so important for Congress to take up and pass the Sarbanes bill at the earliest opportunity.

FASB is not responsible for the wave of accounting scandals. These companies and their auditors violated existing accounting and auditing standards. Crooks will always be with us. We must nonetheless look to what we can do to enhance and strengthen FASB and improve its standard-setting process. I stand ready to assist in that task.

I have warned time after time that the market is not driven by money, but rather by public confidence. I would note an article on the front page of the Washington Post today entitled, "Corporate Scandals Taking Toll On Markets" that details how corrupt accounting has turned profits by skimming off innocent people in our financial markets and that, in turn, has begun to weigh heavily on the stock market, the dollar, and the U.S. economy. The United States has a unique financial system that is trusted by the American people. If Americans lose faith in the system, we should not look for good times in the future.

Mr. STEARNS. I thank the ranking member.

The gentlemen from New Hampshire, Mr. Bass.

Mr. BASS. Thank you, Mr. Chairman.

I appreciate you holding this important hearing on accounting standards and featuring the Financial Accounting Standards Board.

A very tiny percentage of the total accounting community has potentially committed serious crimes and they ought to pay for those crimes. They ought to go to jail, if that is what is determined by the judicial system.

I agree with much of the discussion or statements that have been made by the ranking member of the committee, as well as the chairman, about the system needing reform. Perhaps the reform measures that we have undertaken have not done everything that needs to be done, but I am concerned about the criticism of, "half-hearted reform" versus over-reform or overregulation which could have not only unintended consequences, but also create significant costs to the business community that 99.9999 percent of the business community that is trying to operate aboveboard.

I would also observe that the rest of the financial services community has an affirmative responsibility to be more attentive and more inquisitive about the accounting practices of the corporations that they choose to become associated with in the form of investments.

So FASB needs to remain independent, but there is an affirmative responsibility that FASB respond to the crises that we are facing every day now from certain major corporations. But we, as Members of Congress, have to be careful not to create monsters that are worse than the ones that we are facing today.

And I yield back.

Mr. STEARNS. Thank you, gentlemen.

The gentlelady from Colorado, Ms. DeGette.

Ms. DEGETTE. Thank you, Mr. Chairman.

When I was in college, I took accounting, and I remember at that time accounting was perceived as just a cut and dried, almost a trade type of class. In fact, they had debates within my liberal arts institution whether they should even teach accounting because it was just a matter of keeping the books.

And what we have learned in the many years since I graduated from college is that there are a few people within the corporate community in this country, who have elevated accounting to a spectacular new art form and, in fact, have used the FASB standards and generally accepted accounting principles in a way that masks the true financial condition of companies and serves not only to mislead investors, but to undermine the markets, which Mr. Dingell spoke so eloquently about.

The question this committee has to address is what can we do; what kind of order can we put to this, so that these new artists, who have become so skilled in manipulating accounting standards can be stopped and that we can have true transparency in corporate financial statements.

This committee has done a commendable job following the collapse of Enron in holding hearings to decide what will work and what will not work. Of course, with this announcement about WorldCom overstating its earnings by $3.8 billion, the sense this committee should have of urgency is even greater.

Having said that, I think it is important that Congress not rush to make dramatic changes without deliberative and careful analysis. The reason is simply acting will not solve the problem.

And as I look at the bill that we are considering today, the Financial Accounting Standards Board Act, I fear that it will at best essentially reform current practices, but at worst it could inhibit the standard-setting obligations of FASB.

The bill purports to increase the effectiveness of FASB by giving accounting standards Federal recognition. But the SEC currently has statutory authority to recognize accounting standards and, in fact, has recognized the standards set by FASB as being authoritative.

Furthermore the SEC requires companies to use GAAP in developing their financial statements. And so that is, in essence, Federal recognition of FASB standards.

On the other side, this bill could potentially harm FASB because if it were passed into law, then FASB would be required to report on the use of standards by the business community.

And as we saw in Mr. Jenkins' preview of his testimony, this requirement could be costly to FASB and drain away precious resources that would be more appropriately used on other things.

The requirement that FASB promulgate a primary standard could have the same financial and resource depleting effects. FASB would be forced to use precious resources to develop a very vague standard based on a set of principles that companies could wiggle their way out of with ease.

So rather than passing a bill that simply restates the status quo and then having us all very smugly go back and say, "We fixed the problem," I think we should look long and hard at H.R. 3970, the Truth and Accountability in Accounting Act that was introduced in March by Mr. Dingell and several other members of the committee, including myself.

The bill does not directly affect FASB, but there is one provision relating to FASB that requires the SEC to report annually on FASB's progress in resolving these unfinished issues.

Instead what this bill does is increase corporate accountability by requiring the CEO and CFO of every company to attest to the fair representation of their financial statements. Enron's Board of Directors and senior officers claimed they did not know what was in the financial statements. They were just off the truck, I guess, from the farm and they did not know what was going on.

This provision in H.R. 3970 would ensure that senior executives knew, and more importantly, were accountable for what they were reporting to the SEC or the public, or they would face criminal penalties.

H.R. 3970 also establishes a new independent board to develop auditing standards for the accounting profession. Every accounting firm would be required to register with the board in order to audit corporate financial statements. This, along with other provisions of the bill, would make it much more difficult for accounting firms to shirk their duties.

There are many other fine provisions of the legislation, which is why I think we should bring folks in to talk about that bill, auditor independence, adequate resources, dues, and on and on.

So, therefore, Mr. Chairman, I would respectfully submit that we would accomplish more or at least as much if we had hearings on H.R. 3970 and tried to make progress in improving transparency, investor confidence and corporate governance.

And I yield back the balance of my time.

[The prepared statement of Hon. Diana DeGette follows:]

PREPARED STATEMENT OF HON. DIANA DEGETTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Thank you, Mr. Chairman. Following the collapse of Enron, this subcommittee and the Subcommittee on Oversight and Investigations examined how it was that Enron duped the market and so severely over-stated its earnings. We found a combination of problems.

Enron took advantage of certain unresolved accounting issues to purposely omit information from its financial statements. Additionally, Enron violated certain existing generally accepted accounting principles. And, apparently, Enron wasn't alone. Last night, WorldCom announced that it had overstated its earnings by $3.8 billion. Thankfully, Mr. Chairman, this committee realized that something must be done, and took prompt action by holding a series of very important and productive hearings. And I thank you for scheduling this hearing to continue the very important work of this committee in developing ways to increase investor confidence, transparency on financial statements, and corporate governance.

In order to correct what went wrong with Enron, I believe it is important that Congress not rush to make dramatic changes without deliberative and careful analysis. However, we also must act. We cannot simply turn our heads from the problem, or even worse, pass bills that would not provide solutions.

I believe the "Financial Accounting Standards Board Act" would, at best, essentially reaffirm current practice and at worst, inhibit the standard-setting obligations of the Financial Accounting Standards Board (FASB). The bill purports to increase the effectiveness of FASB by giving accounting standards federal recognition. Yet, the SEC currently has statutory authority to recognize accounting standards, and has recognized the standards set by FASB as being authoritative. Furthermore, the SEC requires companies to use GAAP—generally accepted accounting principles—in developing their financial statements. This is essentially federal recognition of FASB standards.

I fear that this bill could potentially *harm* FASB. If the bill were passed into law, FASB would be required to report on the use of its standards by the business community. As Mr. Jenkins will testify, this requirement would be costly to FASB and could drain away precious resources that would be more appropriately used on other things.

The requirement that FASB promulgate a "primary standard" could have the same financial and resource-depleting effects. FASB would be forced to use precious resources to develop a very vague standard based on a set of principles that companies could wiggle their way out of following.

Rather than considering a bill that would simply re-state the status quo, I believe this subcommittee should be considering H.R. 3970, the "Truth and Accountability in Accounting Act" that was introduced in March by the ranking member of the full committee, Mr. Dingell, and several other members of the committee, including myself. This bill would not directly affect FASB. In fact, the only provision relating to FASB is one that requires the SEC to report annually on FASB's progress in resolving unfinished issues.

Instead, H.R. 3970 would increase corporate accountability by requiring the CEO and CFO of every company to attest to the fair representation of their financial statements. Enron's board of directors and senior officers claimed they did not know what was in their financial statements. This provision would ensure that senior executives know and be accountable for what they are reporting to the SEC and the public, or they will face criminal penalties.

H.R. 3970 would also establish a new independent board to develop auditing standards for the accounting profession. Every accounting firm would be required to register with the board in order to audit corporate financial statements. This, along with other provisions in the bill, would make it much more difficult for accounting firms to shirk their duties.

Additionally, H.R. 3970 would ensure that the independent board has adequate resources by requiring each accounting firm to pay annual dues. One of the problems that the witnesses here today will point out in the FASB Act is the lack of a truly independent funding system for FASB. H.R. 3970 would not require the independent board to seek its own funding; it would require each accounting firm to pay fees to help fund its operations.

Finally, the bill would mandate auditor independence through an approval mechanism by the board. In our Enron investigations, we saw that auditors became too cozy with big corporations to effectively fulfill their obligations to the investor. By prohibiting certain consulting services and requiring auditor rotation, H.R. 3970 would make accounting firms more accountable to the public.

Therefore, Mr. Chairman, I respectfully submit that this subcommittee would accomplish more if it were to hold hearings on H.R. 3970 and make progress in improving transparency, investor confidence, and corporate governance.

Mr. STEARNS. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman.

Let me begin by expressing my sincere appreciation to FASB Chairman Ed Jenkins, who will soon be stepping down. Chairman Jenkins, I have had the please of meeting with you on numerous occasions over the last several years, and I have always been impressed by your commitment to the public interest, to high standards of fairness and accuracy in accounting, and above all, to your commitment to maintaining the independence and impartiality of FASB, often in the face of intense lobbying by corporate America or by the Congress, for you to allow opaque and confusing accounting principles.

You have been at the helm of the FASB during a difficult period, and we thank you for your service to the institution. The crisis we are in today is less a reflection of FASB standard setting and more a reflection of the accounting profession's systems dramatic efforts to evade the principles upon which FASB is based.

And make no mistake, we are in a crisis, a crisis of corporate irresponsibility; a crisis of investor confidence. This crisis threatens the very foundations of our financial markets, the markets that serve as the engine of our national economy and which provide the productive capital needed to finance new products, develop new technologies, create new jobs, and drive future economic growth.

Each day, the papers bring us new revelations of "cooked books," imperious and unaccountable corporate chieftains who have looted their companies and mislead their investors with fraudulent, misleading, or inflated financial statements. From Enron to Global Crossings to WorldCom, we are learning more and more about the financial house of cards that certain companies erected during the stock market bubble.

Now that this bubble has burst, investors are questioning whether they can trust the financial statements and disclosures they are receiving.

This loss of investor confidence is broad and deep. And it is directly contributing to the broad collapse in stock prices that we have seen over the last several months, a collapse that has wiped out all the gains made since the markets tumbled in the aftermath of September 11.

The accounting profession has played a central role in this crisis. And the profession bears much of the blame for the sorry state we now find ourselves in.

Years ago, the big accounting firms decided that they wanted to trade in their green eye-shades for the lucrative profits available to the consulting business. They decided that they wanted to simultaneously serve as referees and players in the game of business and finance.

In doing so, the big accounting firms abandoned their public responsibility to investors for private gains.

CPA used to stand for Certified Public Accountant. Now CPA stands for Corporate Piracy Accomplices.

Arthur Andersen appears to have been an active and witting accomplice to Enron's fraud, and it and the other major firms appear to have aided and abetted many of the other frauds that we have learned about in recent months.

It has done so by gaming the accounting standards established by the FASB, to justify virtually every shady deal or unscrupulous scheme proposed by greedy and corrupt corporate managements.

How else can we understand Andersen allowing Enron's special purpose entities to keep off the company's balance sheets.

Today we consider legislation to reform FASB. I look forward to hearing the testimony on how this can be best accomplished. But as we consider reforms in the accounting area, I also think we need to look beyond FASB.

We need to establish a strong accounting oversight and regulatory body with real investigative and enforcement powers to root out wrongdoing. The toothless legislation passed by the House a few months ago fails to create the kind of body we need to police the profession.

In addition, we need to revisit the ill-conceived security's litigation reform legislation adopted by the majority on this committee as part of Newt Gingrich's Contract with America.

That legislation's Catch-22 discovery stay, its heightened pleading standards, its eliminating of joint and several liability has seriously impaired the rights of defrauded investors. We need to restore the right of investors to sue aiders and abettors of securities frauds, a right which the Supreme Court wrongly denied investors in the Central Bank of Denver decision.

Today the SEC can sue aiders and abettors, but defrauded investors cannot. The Andersen and many other of the Enron defendants are trying to hide behind this loophole to escape full liability for their misdeeds. We should not let that happen to defrauded investors.

Today's hearing will help us to connect the dots so that we can place the responsibility where it belongs. And then, we must take the corrective action that protects tens of millions of families who have lost money because they do not have right now the protections in place to ensure that their families are protected.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Edward J. Markey follows:]

PREPARED STATEMENT OF HON. EDWARD J. MARKEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Thank you, Mr. Chairman, for calling today's hearing.

We are in a crisis. A crisis of corporate irresponsibility. A crisis of investor confidence. This crisis threatens the very foundations of our financial markets—the markets that serve as the engine of our national economy and which provide the productive capital needed to finance new products, develop new technologies, create new jobs, and drive future economic growth.

Each day, the papers bring us new revelations of cooked books, imperious and unaccountable corporate chieftains who have looted their companies and mislead their investors with fraudulent, misleading, or inflated financial statements. From Enron to Global Crossing, to Worldcom, we are learning more and more about the financial house of cards that certain companies erected during the stock market bubble. Now that this bubble has burst, investors are questioning whether they can trust the financial statements and disclosures they are receiving. This loss of investor confidence is broad and deep, and it is directly contributing to the broad collapse in stock prices that we have seen over the last few months—a collapse that has wiped out all of the gains made since the markets tumbled in the aftermath of September 11th.

The accounting profession has played a central role in this crisis, and the profession bears much of the blame for the sorry state we now find ourselves in. Years ago, the big accounting firms decided that they wanted to trade in their green eyeshades for the lucrative profits available in the consulting business. They decided that they wanted to simultaneously serve as referees and players in the game of business and finance. In so doing, the big accounting firms abandoned their public responsibility to investors for private gains. CPA used to stand for "Certified Public Accountant." Now CPA stands for "Corporate Piracy Accomplices."

Arthur Anderson appears to have been an active and witting accomplice to Enron's fraud, and it and the other major firms appear to have aided and abetted many of the other frauds that we have learned of in recent months. They have done so by gaming the accounting standards established by the Financial Accounting Standards Board to justify virtually every shady deal or unscrupulous scheme proposed by greedy and corrupt corporate managements. How else can we understand Anderson's allowing Enron's "special purpose entities" to be kept off the companies balance sheets?

Today, we consider legislation to reform FASB. I look forward to hearing the testimony on how this can be best accomplished. But as we consider reforms in the accounting area, I also think we need to look beyond FASB. We need to establish a strong accounting oversight and regulatory body with real investigative and enforcement powers to root out wrongdoing. The toothless legislation passed by the House a few months ago fails to create the kind of body we need to police the profession. In addition, we need to revisit the ill-conceived securities litigation "reform" legislation adopted by the Majority on this Committee as part of Newt Gingrich's "Contract with America." That legislation's "Catch 22" discovery stay, it's heightened pleading standards, and its elimination of joint and several liability has seriously impaired the rights of defrauded investors. We also need to restore the right of investors to sue "aiders and abettors" of securities frauds, a right which the Supreme Court wrongly denied investors in the *Central Bank of Denver* decision. Today, the SEC can sue aiders and abettors, but defrauded investors cannot. Anderson and many of the other Enron defendants are trying to hide behind this loophole to escape full liability for their misdeeds. We should not allow that to happen.

Today's hearing will help us connect the dots to place the responsibility where it belongs. Hopefully, we will soon be able to come up with some solutions that will help restore the investor confidence that is so necessary to the functioning of our nation's markets.

Thank you.

Mr. STEARNS. I thank the gentleman.

Now let's go to our first and only panel.

We have Mr. Edmund Jenkins, who is Chairman of the Financial Accounting Standards Board.

We have Dr. Bala Dharan, J. Howard Creekmore Professor of Management, the Jesse H. Jones Graduate School of Management at Rice University.

John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School.

Baruch Lev, Philips Bardes Professor of Accounting and Finance, Department of Accounting Taxation and Business Law and Department of Finance, the Director of the Vincent C. Ross Institute of Accounting Research, Stern School of Business, at NYU.

And Honorable Ned Regan, President of Baruch College in New York.

Thank you very much for your patience. We would like to have your opening statements.

Mr. Jenkins, I will go from my left to my right.

STATEMENTS OF EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD; BALA G. DHARAN, J. HOWARD CREEKMORE PROFESSOR OF MANAGEMENT, JESSE H. JONES GRADUATE SCHOOL OF MANAGEMENT, RICE UNIVERSITY; JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL; BARUCH LEV, PHILIPS BARDES PROFESSOR OF ACCOUNTING AND FINANCE, DEPARTMENT OF ACCOUNTING TAXATION AND BUSINESS LAW & DEPARTMENT OF FINANCE, DIRECTOR, VINCENT C. ROSS INSTITUTE OF ACCOUNTING RESEARCH, STERN SCHOOL OF BUSINESS; AND NED REGAN, PRESIDENT, BARUCH COLLEGE

Mr. JENKINS. Thank you, Chairman Stearns, Ranking Member Towns, and members of the subcommittee.

I appreciate the invitation to share my thoughts on the discussion draft of the Financial Accounting Standards Board Act. I am going to refer to it in my remarks as the discussion draft, if I may.

I have brief prepared marks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into——

Mr. STEARNS. By unanimous consent, so ordered.

Mr. JENKINS. Thank you.

The Financial Accounting Standards Board as you have acknowledged is an independent private sector organization. We are not part of the Federal Government. Our independence from the Federal Government reporting enterprises, and auditors is fundamental to achieving our mission. That mission is to set accounting and reporting standards to protect consumers of financial information, most notably, investors and creditors.

Those consumers rely heavily on credible, transparent, and comparable financial reports for effective participation in the capital markets.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with officers and directors of the reporting enterprise, with the auditors of the financial statements of those enterprises, and for public companies, ultimately with the SEC.

The FASB also has no authority with respect to auditing, including auditor independence. Chairman Greenwood commented on that. Nor do we have any responsibility with respect to scope of services.

Rather, our responsibility relates solely to establishing accounting and reporting standards.

I understand and appreciate the important role that this subcommittee has with respect to the FASB. I believe it is entirely appropriate and beneficial to the FASB, consumers, and to the capital markets for this subcommittee to exercise its oversight authority to ensure that we are fulfilling our mission and responsibilities in the public interests.

I, therefore, do not oppose, as I explain in the full text of my testimony, certain of the provisions of the discussion draft that address the FASB's process.

I, however, also strongly believe, as I believe do most of our constituents, including most consumers and most Members of Congress, and it has been mentioned here this morning already, several times that it is inappropriate and potentially harmful to consumers in the capital markets for Congress to mandate the subject matter, the content, the technical aspects or the timing of our technical decisions on standards. I, therefore, cannot support, again, as explained in the full text of my testimony, certain other provisions of the discussion draft that address the FASB's technical activities.

Just during my 5 years as Chairman of the FASB, on two different occasions in which the FASB was proposing major improvements to the transparency of financial reports, several Members of Congress either introduced, or threatened to introduce, legislation, legislation that if enacted would have, at a minimum, significantly delayed the needed improvements the FASB was proposing.

In other cases, the legislation, if enacted, would have essentially eviscerated the FASB.

On both occasions the FASB, with the support of many constituents, including consumers, and members of this subcommittee, successfully responded to those challenges, and final standards were issued that dramatically improved the transparency of financial reports. Responding to those challenges, however, diverted some of the limited resources of the FASB, resources that otherwise would have been devoted to the FASB's primary mission of improving accounting standards to protect consumers.

Thus, my experience as Chairman of the FASB, has led me to conclude that this subcommittee's oversight and input can be quite valuable to the Board. Members of Congress, however, must avoid the urge to legislate technical accounting standards and must reject the facile arguments and emotional appeals sometimes made by constituents claiming that FASB proposals will destroy Western civilization as we know it.

Over 60 years of history conclusively demonstrate that accounting standards that result in more transparent financial reporting enhance, rather than hinder, the US economy.

I am very confident that my successor as Chairman of the FASB, Bob Herz, will demonstrate to this subcommittee and all who participate in the capital markets that he has the leadership and technical skills necessary to ensure that the FASB continues to provide the markets with high quality accounting standards, standards that will result in more transparent and credible financial reports in the months and years ahead.

Before I conclude, let me comment briefly on WorldCom. From what I read in the papers today, WorldCom seems to be another example, like Enron, where there was a failure on the part of company's management, perhaps its auditors, to follow existing generally accepted standards.

These issues seem to me, with all due respect, to be issues related to corporate governance, the tone at the top, rather than primarily issues related to accounting standards as they exist today.

That does not mean that we do not need to improve existing accounting standards. We do. We are. And we have other things in process that will continue that process.

Thank you again, Mr. Chairman. I very much appreciate your interest in, and support of, the independence of the FASB.

I also want to thank you, Mr. Chairman, Ranking Member Towns, and all of the members of the subcommittee for the personal support you have graciously provided to me over the past 5 years, and for the comments you made this morning.

Thank you.

[The prepared statement of Edmund L. Jenkins follows:]

PREPARED STATEMENT OF EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Chairman Stearns, Ranking Member Towns, and Members of the Subcommittee: I am pleased to appear before you today on behalf of the Financial Accounting Standards Board ("FASB" or "Board"). My testimony includes a brief overview of the FASB and our structure and process, a summary of the Board's significant technical activities since I last testified before this Subcommittee on February 14, 2002, and a summary of some of the Board's other current projects. My testimony includes a brief summary of the FASB's views on the June 18, 2002, Discussion Draft of the Financial Accounting Standards Board Act ("Discussion Draft"). My testimony also includes a brief discussion of Enron Corp.'s ("Enron") failure to comply with existing accounting requirements. Finally, my testimony concludes with some brief summary remarks.

WHAT IS THE FASB, WHAT DOES IT DO, AND WHAT HAS IT DONE LATELY?

The FASB is an independent private-sector organization. We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the markets because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, and comparable financial information.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For more than 60 years, the SEC has looked to the private sector for leadership in establishing and improving those standards. The SEC maintains active oversight of private sector accounting standard setting, including oversight of the FASB. The SEC issues an annual report to Congress describing those oversight activities.

The FASB's standards govern only the information contained in enterprises' financial reports—financial statements and accompanying notes. Those reports are only one element of the broader universe of information provided by enterprises to the public. Other important information for consumers includes management's discussion and analysis, information (in addition to the financial statements and accompanying notes) provided in an enterprise's annual report, presentations to analysts, fact books, and information provided on an enterprise's website.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with the FASB's standards rests with the officers and directors of an enterprise, the auditors of the financial statements, and for public enterprises, ultimately with the SEC. Generally, when an enterprise restates its financial reports, it publicly acknowledges that it has failed to comply with existing accounting standards.

The FASB also has no authority or responsibility with respect to auditing standards and issues, including the independence of auditors and the scope of services of auditors. Moreover, we have no authority or responsibility with respect to the ethical code or requirements of the accounting profession. Rather, our responsibility relates solely to establishing financial accounting and reporting standards.

The focus of the FASB is on consumers—users of financial reports, such as investors, creditors, and others. We attempt to ensure that financial reports give consumers an informative picture of an enterprise's financial condition and activities and do not color the image to influence behavior in any particular direction.

The US capital markets continue to be the deepest, most liquid, and most efficient markets in the world. The unparalleled success and competitive advantage of the US capital markets are due, in no small part, to the high-quality and continually improving US financial accounting and reporting standards. As Federal Reserve System Chairman Alan Greenspan stated:

> Transparent accounting plays an important role in maintaining the vibrancy of our financial markets . . . An integral part of this process involves the Financial Accounting Standards Board (FASB) working directly with its constituents to develop appropriate accounting standards that reflect the needs of the marketplace.[1]

As an update since I last testified before the Subcommittee on February 14, 2002, some of the FASB's more significant technical activities have included the following:

- Issuance of a standard that updates, clarifies, and simplifies several existing accounting requirements, including requirements relating to the accounting for leases.[2]
- Issuance of a proposal that would increase the consistency of the reporting for derivatives.[3]
- Issuance of a proposal that would increase the consistency of reporting for acquisitions of financial institutions.[4]
- Issuance of a proposal that would improve the disclosure of guarantees (see below the discussion, "What Are the Board's Current Projects to Improve the Transparency of Financial Reports?").[5]
- Pending issuance (in early July) of a standard that will improve the transparency of costs associated with disposal activities.
- Pending issuance (in early July) of a proposal that would resolve problems encountered in present practice relating to the consolidation of special-purpose entities ("SPEs") (see below the discussion, "What Are the Board's Current Projects to Improve the Transparency of Financial Reports?").

WHAT IS THE FINANCIAL ACCOUNTING FOUNDATION ("FAF"), AND WHAT IS THE FAF'S RELATIONSHIP TO THE FASB?

The FASB is an operating unit of the Financial Accounting Foundation ("FAF"). The FAF is a not-for-profit foundation that was incorporated in 1973 to operate exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code.

The FAF is separate from all other organizations. Its 16-member Board of Trustees is composed of prominent individuals with a broad range of backgrounds. Each of them shares a common understanding of the importance of independent private-sector accounting standard setting to the efficiency of the US capital markets.[6]

The FAF Trustees have several important responsibilities with respect to the FASB.

Those responsibilities include:

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[1] Letter from Federal Reserve System Chairman Alan Greenspan to SEC Chairman Arthur Levitt (June 4, 1998).

[2] See FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (April 2002). See Attachment 1 for News Release, *FASB Issues Financial Accounting Statement No. 145* (April 30, 2002).

[3] See Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (May 2002). See Attachment 1 for News Release, *FASB Exposure Draft Amends Definition of a Derivative and Statement 133 to Provide for More Consistent Accounting* (May 1, 2002).

[4] See Exposure Draft, *Acquisitions of Certain Financial Institutions* (May 2002). See Attachment 1 for News Release, *FASB Publishes Exposure Draft, Acquisitions of Certain Financial Institutions, That Amends Statements 72, 144 and Interpretation 9* (May 13, 2002).

[5] See Exposure Draft, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (May 2002). See Attachment 1 for News Release, *FASB Issues Exposure Draft That Expands Disclosure Requirements for Guarantees* (May 22, 2002).

[6] See Attachment 2 for a list of the current FAF Trustees.

1. Oversight of the FASB's process to ensure that the FASB is fulfilling its stated mission (see below the discussion, "What Process Does the FASB Follow in Developing Accounting Standards?")
2. Selection of the FASB Board members
3. Arranging for the financing of the FASB.

FAF Trustees select the FASB Board members based on their technical expertise in financial accounting and reporting. Board members, however, have diverse backgrounds. Of the seven current members of the Board, three are from the accounting profession, two from the business community, one from the analyst community, and one from the academic community.

Each of the Board members is a full-time employee of the FAF and is required to be independent of all other business and professional organizations. Thus, upon joining the FASB, Board members are required to sever all financial ties with former employers. Board members can serve no more than two full five-year terms.

Approximately two-thirds ($15 million in 2001) of the FASB's financing results from the public sale and licensing of the FASB's publications. The remaining one-third ($6 million in 2001) results from the fundraising efforts of the FAF Trustees who solicit donations from a broad range of consumers, preparers, and auditors of financial reports.

To ensure the independence and objectivity of the FASB, the Board members are prohibited from participating in the FAF Trustees' fundraising efforts, and the FAF Trustees are prohibited from participating in the Board members' technical decisions on establishing and improving accounting standards.

In recent months some have raised questions about the funding of the FASB and the potential impact of the current funding structure on the appearance of the Board's independence. In my five years as Chairman of the FASB, no contribution to the FAF, or threat of withholding a contribution, if any occurred, had any impact, in any way, on any of the decisions of the Board. The FAF Trustees and the FASB remain confident that the FAF's current funding structure sufficiently insulates the Board from any possible influence from funding sources.

The FASB, however, has expressed support for recent efforts by Congress to develop a secure and adequate non-discretionary funding source for the FAF that might serve to strengthen the appearance of independence of the FASB.[7] The FAF and the FASB stand ready to work constructively with Congress, including the Subcommittee, and the SEC to attempt to develop such a funding structure. It is essential, however, that any such structure be designed with care in order to avoid substantive conditions and governmental control that would invite political interference with the Board's decisions, and consequently weaken, rather the strengthen, both the reality and appearance of the Board's independence.

WHAT PROCESS DOES THE FASB FOLLOW IN DEVELOPING ACCOUNTING STANDARDS?

Because the actions of the FASB affect so many organizations and are so important to the efficient functioning of the US capital markets, its decision-making process must be open and thorough. An open and thorough process is essential to ensuring the credibility and quality of the resulting standards. An open and thorough process also reduces the possibility that standards will create unintended consequences inconsistent with transparent financial reporting.

Our Rules of Procedure require an extensive and public due process that is broader and more open in several ways than the Federal Administrative Procedure Act, on which it was modeled. The FASB process involves public meetings, public hearings, field tests, and exposure of our proposed standards to external scrutiny and public comment. The Board makes final decisions only after carefully considering and understanding the views of all parties, including consumers, preparers, and auditors of financial information.

The FASB and the FAF, in consultation with the Board's constituents, periodically review the FASB's due process to ensure that the process is working efficiently and effectively. Beginning in January of this year, in response to constituent requests, including requests from our Financial Accounting Standards Advisory Council,[8] the FAF and FASB have undertaken several actions to improve the Board's due process procedures, as well as improve the ease of access to our standards and related accounting literature, reduce the complexity of our standards, and modernize financial accounting and reporting.

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[7] See Attachment 1 for News Release, *FASB Chairman Comments on Proposed Legislation* (March 19, 2002).

[8] See Attachment 3 for information about the Financial Accounting Standards Advisory Council.

Those actions include the following:

- Reducing the Board voting requirement from a 5-to-2 supermajority to a 4-to-3 majority to make the process more efficient without compromising the quality of the FASB's standard-setting process.[9]
- Reorganizing the FASB's research and technical activities staff by reallocating the staff functions across three distinct areas versus one that had previously been in place. The reorganization is designed to address increasing demands on staff and other resources of the FASB.[10]
- Implementing an improved approach to determining what new major topics should be added to the FASB's technical agenda. That approach involves issuing a proposal for public comment before the Board decides whether to add a particular project to its agenda. The proposal discusses the problem to be addressed (that is, the reason for the project), the proposed scope, relationship to the conceptual framework and relevant research, the main issues and alternatives the Board expects to consider, and how practice might be affected. The proposal also explicitly reviews the Board's agenda decision criteria.[11] The Board believes this improved approach provides additional discipline to the Board's project management capabilities, particularly in the area of defining and refining the scope of a new agenda project. Scope expansion during the life of a project has sometimes been a significant impediment to the timeliness of the Board's standard setting.
- Implementing a more rigorous project planning and management process, which requires the establishment of clear project milestones and plans for meeting them, resource budgets, and status reporting in terms of previously established milestones.
- Working with the Emerging Issues Task Force ("EITF"),[12] the American Institute of Certified Public Accountants, and the SEC to more clearly define and coordinate their accounting-standard-setting roles with those of the FASB with an eye toward streamlining certain activities.
- Making it easier for constituents to find all of the appropriate accounting requirements for a particular topic by including references to all applicable US accounting literature in the FASB's future standards and in the FASB's Current Text, a compilation of all FASB accounting standards categorized by subject. In addition, the FASB is seeking to partner with others in developing an online database that will include all of the US accounting literature.
- Reducing the complexity of accounting literature by (1) seeking to determine if the FASB can issue standards that are less detailed and have few, if any, exceptions or alternatives and (2) more actively engaging FASB constituents in discussions about the cost-benefit relationship of proposed standards.
- Working with the SEC in its initiative to modernize financial reporting and disclosure.

Finally, in addition to the above actions, the FAF Trustees have asked my successor, newly named FASB Chairman Robert H. Herz, after he has assumed his new post on July 1, 2002, to review the FASB's operations and make additional recommendations for improvements.[13]

WHAT ARE THE BOARD'S CURRENT PROJECTS TO IMPROVE THE TRANSPARENCY OF FINANCIAL REPORTS?

The FASB has 18 current agenda projects designed to improve the transparency of financial reports.[14] A brief description of six of the more significant of those projects follows:

Interpretative Guidance on Consolidation of SPEs

As evidenced by Enron, transactions involving SPEs are becoming increasingly prevalent and complex. The complexity of their structure makes it difficult to determine if another enterprise has a controlling financial interest in the SPEs that would result, under existing accounting requirements, in that other enterprise consolidating (reporting the assets and liabilities of) the SPEs. Preparers of financial reports, their auditors, and analysts and other users of financial reports have indi-

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[9] See Attachment 1 for News Release, *Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency* (April 24, 2002).

[10] Ibid.

[11] See Attachment 2 for information about the Board's agenda criteria.

[12] See Attachment 2 for information about the EITF.

[13] See Attachment 1 for News Release, *Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency* (April 24, 2002).

[14] See Attachment 4 for a list and detailed description of the FASB's agenda projects.

cated that additional guidance is needed for determining when SPEs should be consolidated by another enterprise.

Since November 2001, the Board has been working with constituents to develop, at public meetings, interpretative guidance that would require that many SPEs that are currently not consolidated, be consolidated by the enterprise they support. The interpretative guidance would result in a more representationally faithful depiction of enterprises' assets and liabilities.

The Board plans to issue proposed interpretative guidance in early July.

Interpretative Guidance on Guarantees

The FASB has observed that there are differing practices about the need for disclosures by enterprises, like Enron, that guarantee the debt and other obligations of SPEs and other enterprises. The FASB has also observed that there are differing practices about the need for the guarantor enterprise to recognize an initial liability for its obligation under the guarantee.

Since February 2002, the Board has been working with constituents to develop, at public meetings, interpretative guidance that would require that enterprises recognize a liability at fair value for the obligations they undertake when issuing a guarantee, and that they provide additional disclosures about the guarantee. The interpretative guidance would result in a more representationally faithful depiction of enterprises' assets and liabilities and improved transparency of enterprises' obligations and liquidity risks related to guarantees issued.

Last month the Board issued the proposed interpretative guidance.[15]

Disclosures about Intangible Assets

For many enterprises, the amounts of intangible assets reflected in their financial reports are very small. In a recent article in *Financial Executive* (March/April 2002, p. 35), a prominent researcher indicated that "... in the late 1990s, the annual U.S. investment in intangible assets—R&D, business processes and software, brand enhancement, employee training, etc.—was roughly $1.0 trillion, almost equal to the $1.2 trillion total investment of the manufacturing sector in physical assets. Further, intangible capital currently constitutes between one-half and two-thirds of corporate market value ..." The FASB has observed that there is very little information—quantitative or qualitative—about those intangible assets in financial reports.

In January 2002, the Board added a project to its agenda to expand the disclosures required about intangible assets. The FASB Board and staff are currently gathering additional information from constituents to determine, at public meetings, what qualitative and quantitative disclosures about intangible assets would be most relevant for consumers.

The Board plans to issue a proposed standard in the fourth quarter of this year.

Fair Value

In connection with its development of a standard on accounting for derivative instruments and hedging activities,[16] the Board observed that financial statements would be more useful and transparent if all financial instruments were carried in the statement of financial position at fair value. The Board, however, also acknowledged that there were many difficult conceptual and practical issues that needed to be resolved before that goal could be achieved. As the initial steps in resolving those issues, the Board issued two preliminary documents for public comment in December 1999[17] and December 2000.[18]

In November 2001, the Board reaffirmed its ultimate goal of requiring essentially all financial assets and liabilities to be measured at fair value in financial statements. The Board, however, also determined that it should pursue an intermediate objective of replacing the existing standard that requires that all financial instruments be reported at fair value in the financial statement footnotes.[19] The proposed standard would describe more specifically how to determine fair value for financial instruments and improve the form and content of the footnote disclosures.

The Board plans to issue a proposed standard addressing the intermediate objective next year.

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[15] See Attachment 1 for News Release, *FASB Issues Exposure Draft That Expands Disclosure Requirements for Guarantees* (May 22, 2002).

[16] See Statement FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998).

[17] See Preliminary Views, Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value (December 1999).

[18] See Special Report, *Financial Instruments and Similar Items* (December 2000).

[19] See FASB Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (December 1991).

Financial Performance Reporting by Business Enterprises

The FASB has observed that increased reporting of numerous and inconsistent alternative (pro forma) financial measures has heightened investor confusion and has raised significant questions about the credibility of financial reporting.

In October 2001, the Board added a project to its agenda to (1) improve the quality of information displayed in financial reports so that consumers can better evaluate an enterprise's financial performance and (2) ascertain that sufficient information is contained in the financial reports to permit calculation of key financial measures used by investors and creditors.

Since adding the project to the Board's agenda, the Board and its staff have conducted a series of interviews with more than 50 individuals who use financial reports—investors, creditors, and their advisors (equity and credit analysts)—to assist the FASB in identifying key financial measures that they use in evaluating the performance of an enterprise. A summary of the findings resulting from those interviews is available on the FASB website. The FASB has discussed the results of the user interviews with its project task force of constituents. The FASB plans to coordinate the project with a similar project being conducted jointly by the International Accounting Standards Board ("IASB") and the UK's Accounting Standards Board.

The Board has begun its public discussions of the project issues and plans to issue a proposed standard next year.

Revenue Recognition

The FASB has observed that enterprises and auditors have continually received and raised questions about revenue (and related liability) recognition issues. In addition, recent studies on financial reporting indicate that revenue recognition is the largest category of fraudulent financial reporting and restatements of financial reports.

In May 2002, the Board decided to add a project on revenue recognition to its technical agenda.[20] As part of that project, the Board will seek to eliminate inconsistencies in the existing accounting literature and accepted practices, fill voids in the guidance that have recently emerged, and provide further guidance for addressing issues that arise in the future. The Board also decided that, in the interim while the standard is being developed, the EITF should continue to provide guidance on issues of revenue recognition based on the existing authoritative literature.

The Board plans to issue a proposed standard next year.

WHAT ARE THE FASB'S VIEWS ON THE JUNE 18, 2002, DISCUSSION DRAFT OF THE FINANCIAL ACCOUNTING STANDARDS BOARD ACT?

The FASB understands and appreciates the important oversight role of the Subcommittee. The FASB has fully cooperated with, and has been responsive to, the requests of the Subcommittee in connection with their development of the Discussion Draft. The FASB's comments on earlier drafts of the Discussion Draft have emphasized the critical importance of the FASB's independence and open and thorough due process to the development of high-quality financial accounting and reporting standards.

The FASB is supportive of the Discussion Draft's clear statements on (1) the authority of FASB standards, and (2) the duty of the FASB in Sec. 3 and Sec. 4, respectively. In addition, the FASB is supportive of the (1) general principles for promulgating and revising standards, and (2) objectives for conducting the FASB's activities in Sec. 5(a) and Sec. 5(b), respectively. Those provisions contain language essentially the same as language contained in the FASB's mission statement and conceptual framework.[21]

As explained earlier in my testimony (see above the discussion, "What is the FASB, What Does It Do, and What Has It Done Lately?"), the FASB's authority and expertise does not extend to auditing or ethical standards for the accounting profession. Thus, the FASB is not the appropriate organization to promulgate the primary standard in Sec. 5(c) of the Discussion Draft. Similarly, the requirement in Sec. 7(2)(B) that the FASB transmit a report containing an evaluation of the compliance of financial statements with accounting standards is beyond the Board's scope of authority, and the cost of such an evaluation would likely be far beyond the Board's limited resources.

[20] See Attachment 1 for News Release, *FASB Adds Revenue Recognition Project to Its Agenda* (May 20, 2002).

[21] See Attachment 2 for information about the FASB's mission statement and conceptual framework.

The FASB also would have concerns about the Discussion Draft's requirements in Sec. 5(d) mandating the development of standards addressing certain specific issues, and in Sec. 5(e) mandating the completion of certain projects on the FASB's current agenda within specified time periods. Those provisions restrict the Board's ability to make objective and unbiased decisions on technical matters and, therefore, compromise the ability of the FASB to produce high-quality standards.

The FASB's limited resources necessitate that we carefully prioritize the projects and issues that we address and the specific scope of those projects and issues. Mandating the development of standards addressing certain specific issues inevitably means that the FASB cannot develop standards addressing other specific issues that might have a higher priority in terms of the needs of consumers. Moreover, mandating completion of certain agenda projects within specified time periods would likely shortcut the FASB's open due process on those projects. In order to comply with the artificial deadlines the resulting standards would likely have to be issued without the benefit of a full opportunity for open input, discussion, and analysis of constituent views.

Both mandates also would have an adverse impact on the FASB's goal of converging financial accounting and reporting standards around the world. To ensure convergence, the FASB, the IASB, and other national accounting standard setters must have significant flexibility over our respective agendas and the timing of projects so that common projects and issues can be addressed concurrently.

Finally, the FASB also would have concerns that mandating the development of standards addressing certain specific issues would create a dangerous precedent. For example, the provisions could lead to future Congressional or governmental mandates that certain specific accounting issues *not be addressed*—a clear threat to the FASB's independence.

The FASB would not oppose the Discussion Draft's provisions to transmit reports containing an assessment of the FASB's resources, or the progress made on the projects included on the FASB's technical agenda in Sec. 7(a)(2)(A) and Sec. 7(a)(2)(C), respectively. Of note, the required contents of the report of the General Accounting Office in Sec. 7(b) appears to be redundant to the responsibilities currently carried out by the FAF. More specifically, the required assessment of the independence of the FASB, and the evaluation of the procedures followed by the FASB in Sec. 7(b)(2)(B) and Sec. 7(b)(2)(C), respectively, might be more appropriately included in the required report of the FASB in Sec. 7(a)(1).

My five years as Chairman of the FASB has reaffirmed my opinion, shared by most of our constituents, including, I believe, by most Members of Congress, that resolution of accounting issues in an independent and objective manner is absolutely essential to maintaining and enhancing the highest quality standards in the world.

The standards developed by the FASB for over the past quarter century have provided the backbone for our nation's vibrant capital markets because of the transparent, credible, and reliable nature of the information that results from their proper application. Those standards can, and should, be improved. Those standards, however, for the reasons stated above, would not be improved by the enactment of certain provisions contained in the Discussion Draft. Those provisions would impair both the reality and the appearance of the FASB's independence. Thus, the Discussion Draft could have both a short and long-term negative impact upon the credibility and quality of financial information and, consequently, on the longstanding competitive advantage that, even under the current environment, US capital markets continue to enjoy.

DID ENRON'S FINANCIAL STATEMENTS COMPLY WITH EXISTING GAAP? [22]

Enron publicly acknowledged in its November 8, 2001, Form 8-K and November 19, 2001, Form 10-Q filings with the SEC that it had failed to comply with existing accounting requirements in at least two areas. First, Enron indicated that with respect to four SPEs that it created during 2000, it issued Enron common stock to the SPEs in exchange for notes receivable from the SPEs. At the time, Enron reported an increase in assets and shareholder's equity to reflect those transactions. Longstanding accounting requirements, however, provide that notes receivable arising from transactions involving an entity's own capital stock are generally required to be reported as deductions from stockholders' equity and not as assets.[23]

[22] See Attachment 5 for *The FASB's Role in Serving the Public, A Response to the Enron Collapse,* By Edmund L. Jenkins, Chairman, Financial Accounting Standards Board (2002).

[23] See EITF Issue No. 85-1, "Classifying Notes Received for Capital Stock," and SEC Staff Accounting Bulletin No. 40, Topic 4-E, *Receivables from Sale of Stock.*

As a result of this error, Enron indicated that it had overstated both total assets and shareholders' equity in its financial statements for the second and third quarters of 2000, and its annual financial statements for 2000, by $172 million. It also indicated that it had overstated both total assets and shareholders' equity in its financial statements for the first and second quarters of 2001 by $1.0 billion.

Second, Enron indicated that the assets, liabilities, gains, and losses of three previously unconsolidated SPEs should have been included in Enron's financial statements under existing accounting requirements. As a result of that error, Enron indicated that it had overstated reported net income by approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000. It also indicated that it had understated net income by $17 million and $5 million in the first and second quarters of 2001, respectively, and overstated net income by $17 million in the third quarter of 2001. Finally, Enron indicated that as a result of this error, it also had understated debt (or liabilities) by approximately $711 million in 1997, $561 million in 1998, $685 million in 1999, and $628 million in 2000.

In commenting on Enron's restatements in testimony before Congress, former SEC Chief Accountant Lynn Turner stated:

> New accounting rules were not needed to prevent the restatements of Enron's financial statements or improve the quality of some of its disclosures. Compliance with and enforcement of the accounting rules that have been on the books for years would have given investors a timely and more transparent picture of the trouble the company was in.[24]

In February 2002, a committee of three outside members of Enron's own board of directors filed a public report ("Powers Report") that stated that its investigation "identified significant problems beyond those Enron has already disclosed."[25]

Those further problems included entering into transactions that Enron

> could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off its balance sheet; but the transactions did not follow those rules.[26]

The Powers Report suggests that "other transactions" resulted in "Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported."[27]

The Powers Report also states that Enron's disclosures about its transactions with the partnerships were "obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships."[28]

More recently, Enron publicly acknowledged in its April 22, 2002, Form 8-K with the SEC that it may have failed to comply with existing accounting requirements relating to the "valuations of several assets the historical carrying value of which current management believes may have been overstated due to possible accounting errors or irregularities."[29] The 8-K indicates that the amount of the overstatement may be in the billions of dollars.

Finally, in connection with the federal government's recently completed trial of Andersen in Houston, Texas, partners from Andersen's professional standards group testified that "seriously flawed accounting methods and misleading documentation [was] prepared by the Enron team to justify the accounting."[30] They also testified that the Enron audit team "disregarded and misrepresented" the professional standards group's advice about the appropriate accounting required.[31]

CONCLUSION

During my five years as Chairman of the FASB, on two different occasions in which the FASB was proposing major improvements to the transparency of financial

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[24] Written statement by Lynn Turner in testimony before the Committee on Governmental Affairs, United States Senate (January 24, 2002), page 3.

[25] William C. Powers, Jr., Chair, Raymond S. Troubh, and Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (February 1, 2002), page—3.

[26] Ibid., page 4.

[27] Ibid.

[28] Ibid., page 17. See Attachment 6 for additional excerpts from the Powers Report on Enron's failure to follow existing accounting requirements.

[29] Enron Corp., Form 8-K (April 22, 2002), page 2.

[30] Susan Schmidt, "Tensions Flare at Trial of Andersen: Enron Auditors Said to Have Ignored Advice," *The Washington Post* (May 10, 2002), page E4.

[31] Ibid., page E1.

reports, several Members of Congress either introduced, or threatened to introduce, legislation. The legislation, if enacted, would have, at a minimum, significantly delayed the needed improvements the FASB was proposing. In other cases, the legislation, if enacted, would have essentially eviscerated the FASB.

On both occasions the FASB, with the support of many constituents, including consumers, and Members of this Subcommittee, successfully responded to those challenges, and final standards were issued that dramatically improved the transparency of financial reports. Responding to those challenges, however, diverted some of the limited resources of the FASB; resources that otherwise would have been devoted to the FASB's primary mission of improving accounting standards to protect consumers. 1Thus, my experience as Chairman of the FASB, has led me to conclude that the most effective way this Subcommittee and individual Members of Congress can promote the timeliness and efficiency of the FASB, the quality of accounting standards, and the transparency of financial reports, is simply to permit the FASB to do its job. Members of Congress must reject the facile arguments and emotional appeals sometimes made by constituents claiming that FASB proposals will destroy Western civilization. Over 60 years of history conclusively demonstrate that accounting standards that result in more transparent financial reporting enhance, rather than hinder, the US economy.

I am very confident that my successor, Bob Herz, will demonstrate to the Subcommittee, and all who participate in the capital markets, that he has the leadership and technical skills necessary to ensure that the FASB continues to provide the markets with higher quality accounting standards that will result in more transparent and credible financial reports in the months and years ahead.

Thank you again, Mr. Chairman. I very much appreciate your interest in, and support of, the independence of the FASB. I also want to thank you Mr. Chairman, Ranking Member Towns, and all of the Members of the Subcommittee for the personal support you have graciously provided to me over the past five years.

I would be happy to respond to any questions.

Mr. STEARNS. I thank you.

Mr. Dharan.

STATEMENT OF BALA G. DHARAN

Mr. DHARAN. Chairman Stearns, Ranking Member Towns, and members of the subcommittee, I am honored to be given this opportunity to testify here today.

I have submitted my written testimony and I will be presenting here a brief overview of what is in the written testimony.

Mr. STEARNS. We can make your entire statement part of record, if you like.

Mr. DHARAN. Thank you.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. DHARAN. The proposed H.R. bill, the Financial Accounting Standards Board Act, or as I am going to refer to it, the draft bill, comes in the context of a crisis of trust that several members have already mentioned that we see in the financial markets. This crisis has been brought about by the weakened credibility of the U.S. financial reporting system.

Restoring the credibility and strengthening the financial reporting environment requires legislative and corporate action on several fronts, including an improved corporate governance process, having better accounting rules, stronger enforcement of accounting rules, stronger oversight of independent auditors and the auditing profession, stronger investor protection, and so on.

But these steps would be incomplete unless we also use the opportunity presented by the current crisis to examine ways to strengthen our accounting standard-setting process.

We are, of course, starting from a strong base of well-respected, well-functioning and independent standard setting body, namely the FASB.

Nevertheless, the power of the FASB to set accounting standards comes from a tenuous relationship between the SEC and the FASB, starting with a historic and discretionary decision by the SEC in the late 1930's to allow the private sector to set accounting standards while retaining the power to overrule them.

While the partnership between the SEC and the FASB has shown to be fairly workable over the years, the fact that the FASB has no independent legal basis affects the effective functioning of the FASB in many practical ways.

For example, it was a critical factor, in my judgment, in the FASB's lost battles of stock option accounting during the 1990's.

Thus, any legislation to strengthen the standard-setting process must start with an unambiguous show of support from Congress for a strong and independent FASB by providing an independent, legal basis for its existence. The proposed bill goes in the right direction toward this goal.

Second, by proposing a path-breaking requirement that the FASB issue a primary standard requiring adherence to principles, this legislation takes the right step in moving the standard-setting process in the United States toward a principles-based approach, as opposed to the current approach to issuing standards and interpretations of high specificity, which has been described by critics as rules-based.

This part of the legislation is innovative.

Providing the FASB an independent legal basis for existence and moving the standard-setting process toward a principles-based approach are the primary strengths of the bill. However, trying to achieve these goals will also require addressing several key implementation issues.

The foremost, and I think the most daunting implementation issue is a clear delineation of the roles of the FASB and the SEC in the development of accounting standards.

The second, and related, implementation issue is the development of a viable, long-term funding mechanism for the activities of the FASB.

Below, I am going to expand just a little bit on the two key issues I mentioned just now.

The first one, strengthening the FASB's legal basis. The rich history of the development of accounting standard setting in the U.S. has been recounted elsewhere, and also I have stated some references in my written testimony.

However, a brief review of the complex relationship that exists between Congress, the SEC and the FASB here would help eliminate the theme that the FASB in the standard-setting process can benefit much from the granting of an independent legal status for the FASB's existence.

The SEC has long accepted and encouraged the role of the private sector, and specifically the FASB, in developing accounting standards, starting with its Accounting Series Release No. 4, which was issued in 1938.

While the FASB has generally received the open support of the SEC to continue to set accounting standards, this support has not been without problem. The SEC, after all, does have the statutory power to overrule the FASB.

Business executives and others potentially affected by the accounting standards, the constituents that Chairman Jenkins referred to, are fully aware of this underlying weakness in the power of the FASB.

The constituents of the FASB, in effect, know that the buck does not stop here, and they can try to go around the FASB by seeking intervention from the SEC or Congress whenever the FASB ventures into areas of rulemaking that are detrimental to their interests.

Further, the SEC and Congress have demonstrated, albeit only rarely, their willingness to pressure the FASB to reconsider its decisions for what might well be political reasons rather than conceptual reasons. Again, in my written testimony, I have given specific examples of this, especially the stock option accounting.

In summary, despite the current working relation between the SEC and the FASB, the lack of a strong legislative basis for the FASB's existence will generally mean that the FASB will always, in the long run, face the risk of being second-guessed by regulators.

The main beneficial effect of the proposed bill or draft bill would be that it would result in Congress putting into law unequivocally what has been the official position of the SEC since 1938.

The statement in Section 3 of the bill that the standards of financial accounting and reporting promulgated by the FASB shall be authoritative for the purpose of determining compliance with generally accepted accounting principles essentially codifies in almost exact language what is already present in the SEC's Financial Reporting Release Number 1 and formerly Accounting Series Release Number 150.

It seems clear that this elevation of the FASB's current role as stated in the SEC's rules into an independent legislative fact will help considerably strengthen the FASB and consequently the standard-setting process.

Let me answer and very briefly talk about the principles-based standards. A surprising provision in the bill is the section titled "Primary Standard Requiring Adherence to Principles" in Section 5. This provision requires the FASB to promulgate a primary standard requiring the application of general principles.

The principles listed here are not new. In fact, they are identical to what the FASB has already proclaimed as its guiding principles in its Statement of Financial Accounting Concepts Number 1.

So one might ask: if the bill essentially codifies what is already in the FASB's Concepts Statement Number 1 and other concept statements, what exactly is new in this bill?

Surprisingly, the newness is contained in the additional requirement in the section that the primary standard should not be violated even if a company can claim that it has followed the letter of all other standards.

One could, thus, interpret the requirement of the proposed bill as a new responsibility requirement for corporations to ensure that their financial reports are not misleading to investors, regardless of whether they have technically followed all the other rules of the FASB.

Both the FASB, which conducted the conceptual framework project in the 1970's to create the concept statements, and more recently the International Accounting Standards Board, or the IASB, have generally been in favor of issuing principles-based standards.

In my written testimony, I have given quotations from the IASB to support this also.

This bill makes such a process both mandatory for the FASB and, additionally, requires regulatory compliance by corporations with the principles. The provision does raise significant implementation questions, which I am going to talk about next.

Providing a stable legal basis for the FASB's standard-setting process raises the issue of whether a legislative enactment of what is already in the SEC's rules will, in effect, change the statutory powers of the SEC with respect to standard setting. I will leave the discussion of this issue to others on the panel having expertise in legal matters such as this.

But it is at least clear to me that the bill needs to include an explicit reconciliation of the SEC's statutory authority with the new provision and a statement of how the FASB's standards would be enforced.

The potential implementation problem is that the SEC has the statutory authority to both set and enforce standards, whereas the FASB, under this new bill, will only have authority to set accounting standards.

There is a possibility, then, that the SEC and the FASB may both set standards which might potentially be in conflict, with only the SEC having the power to enforce those standards.

A second major implementation issue is whether the FASB will have the funds available to take on the responsibilities set forth in the bill, especially the newly designated legal standing for standard setting.

In particular, the bill requires the FASB to submit an annual report to the President and to Congress, which may turn out to be expensive to comply with because of a key provision in the bill that the report should include an evaluation by the FASB of the extent of compliance of all financial statements by corporations.

Now, I personally support this requirement, since it only means that the FASB needs to keep track of the compliance with its own rules. However, the provision may require extensive and continuous monitoring by the FASB of the corporate world's use and abuses of financial reporting rules, which would be very expensive to implement.

Considering these future commitments, it would be useful if the bill includes a proposal, or proposals, for more stable and independent funding plan for the FASB. The plan may well be similar to what the SEC Chairman Harvey Pitt refers to as "direct, involuntary and independent funding system."

In the same testimony in Congress where the SEC Chairman referred to this, he also referred to or specifically addressed the funding of the FASB and called for "involuntary funding for the private-sector standard setter." In Chairman Pitt's words, the funding "should be more secure and should strengthen both the reality and the appearance of independence. Funding should be made involuntary."

I fully support that statement.

Finally, when it comes to commenting on the current U.S. accounting standard setting environment, it seems almost mandatory for all speakers and writers to mention that we have the best and the most trusted financial reporting system in the world. Whether such a claim is true or not, it is a fact that the Enron meltdown and the various accounting and reporting scandals in the last few months have shaken investors' faith in this claim and in our financial reporting system.

It is now time to fix the mess and restore investor credibility in the financial reporting system.

This bill's proposal to codify the current SEC position on the role of the FASB is a step in the right direction, and so is its push to make the standard setters move toward a principles-based standard.

However, the bill does raise significant and daunting implementations issues and some new and poorly understood conceptual issues as well. These issues need to be raised effectively and discussed effectively as the bill moves forward in your committee and Congress.

Thank you for the opportunity to present my views before your committee. I will be glad to answer any questions.

[The prepared statement of Bala G. Dharan follows:]

PREPARED STATEMENT OF BALA G. DHARAN, J. HOWARD CREEKMORE PROFESSOR OF MANAGEMENT, RICE UNIVERSITY

Chairman Stearns, Ranking Member Towns, and members of the Subcommittee, I am honored to be given this opportunity to testify here today.

The proposed H.R. Bill, the Financial Accounting Standards Board Act (The draft Bill), comes in the context of a crisis of trust that we see in the financial markets brought about by the weakened credibility of the US financial reporting system. Restoring the credibility and strengthening the financial reporting environment requires legislative and corporate action on several fronts, such as improving the corporate governance process, having better accounting rules, stronger enforcement of accounting rules (including improved staffing and funding of the Securities and Exchange Commission), stronger oversight of independent accountants and the auditing profession (including the creation of a new independent accounting board for enforcement), improved education of managers about the need for transparency in disclosures, stronger investor protection, and so on. But these steps will be incomplete unless we also use the opportunity presented by the current crisis to examine ways to strengthen our accounting standard-setting process.

We are, of course, starting from a strong base of a well-respected, well-functioning and independent standard setting body, namely the Financial Accounting Standards Board. Nevertheless, the power of the FASB to set accounting standards comes from a tenuous relationship between the SEC and the FASB, starting with a historic and discretionary decision by the SEC in the late 1930s to allow the private sector to set accounting standards while retaining the legal power to overrule them. While the partnership between the SEC and the FASB has shown to be fairly workable over the years, the fact that the FASB has no independent legal basis does affect the effective functioning of the FASB in many practical ways. For example, it was a critical factor in the FASB's lost battles of stock option accounting during the 1990s. Second, it has led to a suboptimal private funding mechanism in which the FASB is increasingly dependent on selling its publications at high cost to fund itself. Thus, any legislation to strengthen our standard-setting process must start with an unambiguous show of support from Congress for a strong and independent FASB by providing an independent, legal basis for its existence, followed by solutions for its funding. The draft Bill is a step in the right direction toward this goal. I provide additional discussion of this issue below.

Secondly, by proposing a path-breaking requirement that the FASB issue a "primary standard requiring adherence to principles," this legislation takes the right step in moving the standard-setting process in the United States toward a "principles-based" approach, as opposed to the current approach to issuing standards and interpretations of high specificity, which has been described by critics as "rules-based". This part of the legislation is innovative, and below I discuss the financial engineering environment that has led to the current plethora of complex accounting rules, and the advantages of adopting a conceptual or principles-based standard setting approach taken in this draft Bill.

Providing the FASB an independent legal basis for existence and moving the standard-setting process toward a principles-based approach are the primary strengths of the draft Bill. However, trying to achieve these goals will also require addressing several key implementation issues. The foremost, and most daunting, implementation issue is a clear delineation of the roles of the FASB and the SEC in the development of accounting standards. Since the SEC already has the statutory authority (under the Securities Act and the Securities and Exchange Act) to develop as well as enforce accounting standards, it important for the draft Bill to include provisions that reconcile any newly recognized statutory role of the FASB to issue accounting standards with the powers already present in the SEC. The second, and related, implementation issue is the development of a viable, long-term funding mechanism for the activities of the FASB so that its current dependence on selling its own rules to fund its operations is eliminated. If the FASB were to have additional public responsibilities to set accounting standards and periodically report to Congress on the implementation of standards by corporations, then a funding plan to execute these public responsibilities must be addressed as well. The plan might be similar to the "direct, involuntary and independent funding" system proposed by the SEC for its planned Public Accountancy Board. Below I discuss in more detail what needs to be addressed in the draft Bill to better help achieve its goals.

STRENGTHENING THE FASB'S LEGAL BASIS

The rich history of the development of accounting standard setting in the US has been recounted elsewhere.[1] However, a brief review of the complex relationship that exists between Congress, the SEC and the FASB would help illustrate the theme that the FASB and the standard-setting process can benefit much from the granting of an independent legal basis for the FASB's existence.

The SEC has long accepted and encouraged the role of the private sector in developing accounting standards. In Accounting Series Release No. 4 issued in 1938, the Commission stated its policy that financial reports that followed accounting practices for which "there was no substantial authoritative support" were presumed to be misleading. After the formation of the FASB in 1973, the SEC has reaffirmed this position and has stated in Accounting Series Release No. 150 (now part of Financial Reporting Release No. 1) that "principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."[2] This view has also been expressed frequently by SEC commissioners and accountants in speeches and testimonies over the years.

Without this strong and unwavering support from the SEC, there would be no private sector standard setting and there would be no FASB. This is because only the SEC has the statutory power to ensure that its corporate registrants follow the accounting rules set forth by the FASB. Thus, even if the SEC were to leave the standard setting activity completely in the hands of the FASB subject to its oversight, the effectiveness of the FASB to develop accounting standards depends on the willingness of the SEC to enforce the resulting standards.

While the FASB has generally received the open support of the SEC to continue to set accounting standards, this support has not been without problems. The SEC, after all, does have the statutory power to overrule the FASB, and not surprisingly, business executives and others potentially affected by accounting standards (sometimes referred to as the constituents of the FASB) are fully aware of this underlying weakness in the power of the FASB. The constituents of the FASB, in effect, know that "the buck doesn't stop here," and so they try to go around the FASB by seeking intervention from the SEC or Congress whenever the FASB ventures into areas of

[1] For a good reference, one should start with the writings of my colleague Professor Stephen A. Zeff of Rice University. I gratefully acknowledge my discussions with him related to this testimony.

[2] Accounting Series Release No. 150, December 20, 1973; Financial Reporting Release No. 1, 1982.

rule making that are detrimental to their interests. Further, the SEC and Congress have demonstrated, albeit only rarely, their willingness to pressure the FASB to reconsider its decisions for what might well be political reasons rather than conceptual reasons.

The most glaring example of such an intervention was with respect to FASB's project on stock options accounting, when the US Senate passed a non-binding resolution in opposition to the FASB's position that the cost of stock options should be shown by corporations as an expense.[3] Responding to efforts in Congress to overturn the FASB's accounting rule, SEC effectively advised the FASB to shelve its accounting rule requiring the expensing of stock options in favor of a weaker rule requiring just footnote disclosures. The then SEC Chairman, Mr. Arthur Levitt, described the SEC's role in this episode in a recent media interview as follows: "My concern was that if Congress put through a law that muzzled FASB, that would kill independent standard setting. So I went to FASB at that time, and I urged them not to go ahead with the rule proposal. It was probably the single biggest mistake I made in my years at the SEC . . ."[4]

There were other, more frequent, cases of regulatory interventions during the earlier period of the FASB, such as the oil and gas accounting controversy in the 1970s and the inflation accounting controversy in the 1980s. It is true that these early episodes quickly led to a more stable and functioning arrangement in which the SEC has evolved into an ever-present and influential behind-the-doors partner during the standard-setting process. The SEC actively participates during the discussions that lead to major standards, and also participates in the meetings of the Emerging Issues Task Force.

Despite the current working relationship, the lack of a strong legislative basis for the FASB's existence will generally mean that the FASB would always face the risk of being second-guessed by regulators. The main beneficial effect of the draft Bill would be that it would result in Congress putting into law unequivocally what has been the official position of the SEC since 1938. The statement in section 3 of the draft Bill, that the "standards of financial accounting and reporting promulgated by the FASB shall be authoritative for the purpose of determining compliance with generally accepted accounting principles by any person under any Federal regulatory program," essentially codifies in almost exact language what is already present in SEC's Financial Reporting Release No. 1 and formerly Accounting Series Release No. 150.[5] It seems clear that this elevation of the FASB's role as stated in SEC's FRR No. 1 into an independent legislative fact would help considerably strengthen the FASB and consequently its standard-setting process.

PRINCIPLES-BASED STANDARDS

A surprising provision in the draft Bill is in section 5 subsection (c), titled "Primary Standard Requiring Adherence to Principles." This provision requires the FASB to promulgate a "primary standard requiring the application of the principles articulated in subsection (a) of this section to financial accounting and reporting." In turn, subsection (a), titled "General Principles", calls for the FASB to follow certain principles when promulgating its standards. The principles listed here are identical to what the FASB already has proclaimed as its guiding principles in its Statement of Financial Accounting Concepts No. 1.[6] In essence, the "objectives of financial reporting" of the FASB Concepts Statement No. 1 require that financial reports should provide information that is useful to investors and other users in making rational investment, credit, and similar decisions." The draft Bill codifies this and the related objectives of Concepts Statement No. 1.

So one might ask: if the draft Bill essentially codifies what is already in the FASB's Concepts Statements, what exactly is new in section 5 (c)? Surprisingly the newness is contained in the additional requirement in the section: "Except as provided in paragraph (2), such primary standard shall prohibit the application of any other standard of financial accounting and reporting promulgated by the FASB in a manner, or with a result, that fails to comply with such principles." In essence,

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[3] For a history of this resolution See Stephen A. Zeff, "The U.S. Senate Votes on Accounting for Stock Options," in Stephen A. Zeff and Bala G. Dharan, *Readings and Notes on Financial Accounting,* pp. 507-517 (McGraw-Hill, 1997).

[4] See interview with Levitt in "Bigger than Enron", Frontline, PBS, June 22, 2002. For excerpts, see http://www.pbs.org/wgbh/pages/frontline/shows/regulation/congress/

[5] See my earlier quote for the exact language from the SEC's FRR 1.

[6] Statement of Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," FASB, November 1978. This Statement and six others issued by the FASB resulted from a comprehensive "Conceptual Framework" project undertaken by the FASB upon its inception. See the text below for additional discussion.

this provision says that a company's financial reports must be prepared in such a way that the "primary standard" of providing information that is useful and comprehensible to investors should be paramount, and should not be violated even if the company can claim that it has followed the letter of all other standards. One could thus interpret the requirement of section 5 (c) as a new responsibility requirement for corporations to ensure that their financial reports are not misleading to investors, regardless of whether they have technically followed all the other rules of the FASB.

The provision also can be interpreted to impose a new standard for the FASB to follow as it makes new accounting standards—namely that such standards should not violate the primary standard. However, a history of the development of the Concepts Statement No. 1 would show that the FASB itself had always treated the various Concepts Statements as similar guides. The Concept Statement No. 1 and six other related Concepts Statements resulted from a so-called Conceptual Framework project undertaken by the FASB soon after its inception in 1973. The project was supposed to help the FASB develop a unified framework of financial reporting that can guide its subsequent standard-setting efforts and provide a measure of theoretical consistency to the resulting standards.

The FASB's Conceptual Framework project was the first such major effort by any standard setter to develop a principles-based standard-setting process. More recently, the International Accounting Standards Board (IASB) has generally expressed an interest in following a principles-based approach to standard setting. For example, Sir David Tweedie, Chairman of the IASB, spoke favorably of a principles-based approach in a testimony to the US Senate on February 14, 2002, as follows:[7] "Both international standards and U.S. GAAP strive to be principles-based, in that they both look to a body of accounting concepts. U.S. GAAP tends, on the whole, to be more specific in its requirements and includes much more detailed implementation guidance . . ." Chairman Tweedie went on to state his view of how the IASB would set accounting standards:[8]

> "The IASB has concluded that a body of detailed guidance (sometimes referred to as *bright lines*) encourages a rule-book mentality of "where does it say I can't do this?" We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information.—We [instead] favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle.—Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures."

While the FASB and the IASB both seem committed to issuing principles-based standards, this draft Bill makes such a process both mandatory for the FASB and additionally requires regulatory compliance by corporations with the principles. The provision does raise significant implementation questions, since the burden of monitoring compliance with the provision and of making sure that financial statements follow the new primary standard would presumably fall on external auditors and the SEC. Given the lack of adequate public discussion in the US about what a principles-based approach would mean for standard setting or for enforcement, my belief is that these provisions of the draft Bill, while innovative, will require further deliberations by the Subcommittee as to its enforcement and funding implications.

IMPLEMENTATION ISSUES

Providing a stable legal basis for the FASB's standard-setting process raises the issue of whether a legislative enactment of what is already in the SEC's FRR No. 1 will in effect change the statutory powers of the SEC with respect to standard setting. I will leave discussion of this issue to others having expertise in legal matters such as this, though it is at least clear to me that the draft Bill needs to include an explicit reconciliation of the SEC's statutory authority with the new provision, and a statement of how the FASB's standards would be enforced. The potential implementation problem is that the SEC has the statutory authority (under the Securities Act and the Securities and Exchange Act) to set and enforce accounting standards, while the draft Bill additionally recognizes the role of the FASB in setting accounting standards. There is the possibility, then, of both the SEC and the FASB setting standards which might potentially be in conflict, with only the SEC having

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[7] Prepared testimony of Sir David Tweedie, Chairman of International Accounting Standards Board, to US Senate Committee on Banking, Housing, and Urban Affairs, February 14, 2002.

[8] *Ibid.*

the power to enforce standards. Hence the draft Bill needs to set forth a clear, functioning structure that can guide the working relation between the FASB and the SEC.

A second major implementation issue is whether the FASB will have the funds available to take on the responsibilities set forth in the draft Bill, especially if the newly designated legal standing for standard setting leads to increased standard-setting responsibilities. In addition, the draft Bill requires the FASB to provide an annual report to the President and to Congress, which may turn out to be expensive to comply with because of a key provision in the draft Bill that the report should include "an evaluation by the FASB of the extent of the compliance of financial statements" by corporations. This provision may well require extensive and continuous monitoring by the FASB of the corporate world's use and abuses of financial reporting rules—similar to what is currently done by hundreds of staff members at the SEC's Corporation Finance Division.

The development of a viable, long-term funding mechanism for the activities of the FASB is certainly an issue that merits discussion because the current operating budget of the FASB comes mainly from two sources. According to the 2001 Annual Report of the Financial Accounting Foundation (the parent organization of the FASB), the FASB received $5.1 million in 2001 from "net contributions" from donors and $14.8 million from "subscription and publication sales." Netting the "direct cost of sales" of these publications of $1.6 million, the FASB received $13.2 million from the sale of subscriptions and publications dealing with its accounting standards. This means that 72 percent of FASB's operating revenues in 2001 came from the sale of publications describing or explaining its rules. The FASB may even need to keep issuing new and more complex rules to keep the funds inflow needed for its operations. The FAF 2001 annual report notes this reality as well, and states that the revenue from publications is "dependent upon the results of activities of the [Board's] technical agendas."

It would be useful if the draft Bill addresses this situation by including proposals for a more stable and independent funding plan for the FASB to execute its public responsibilities. The plan might be similar to the "direct, involuntary and independent funding" system proposed by the SEC Chairman Harvey Pitt, in a testimony to the US Senate, for the SEC's planned Public Accountancy Board.[9] In the same testimony, Chairman Pitt also specifically addressed the funding of the FASB and said that it "should be more secure and should strengthen both the reality and the appearance of independence. Funding should be made involuntary."

CONCLUSION

When it comes to commenting on the current US accounting standard setting environment, it seems almost mandatory to mention that we have the best and the most trusted financial reporting system in the world. Whether such a claim is true or not, it is a fact that the Enron meltdown and the various accounting reporting controversies that have followed this year have shaken investors' faith in our financial reporting system. It is now time to fix the mess and restore investor credibility in the financial reports. While the SEC and Congress are addressing needed changes in the areas of corporate governance, investor protection, prosecution of management fraud, and regulation of independent accountants, the issue of improving our financial standard-setting process does need the attention of Congress as well.

The draft Bill's proposal to codify the current SEC position on the role of the FASB in standard setting is a step in the right direction, and so is its push to make the standard setters move toward principles-based standards. However, these proposals do raise several daunting implementation issues and some new conceptual issues as well. These concerns need to be addressed effectively as the draft Bill moves forward in your Committee and Congress. Thank you for the opportunity to present my views before your Committee. I will be glad to answer any questions from the Committee members.

Mr. STEARNS. Thank you.
Professor Coffee.

STATEMENT OF JOHN C. COFFEE, JR.

Mr. COFFEE. Thank you for inviting me here.

[9] Prepared testimony of Harvey L. Pitt, Chairman of the SEC, to US Senate Committee on Banking, Housing and Urban Affairs, March 21, 2002, Section 2.1.3.

In light of WorldCom, investors and the market can only mutter again and again Yogi Berra's famous phrase, "It is deja vu all over again." Why does this story keep repeating itself?

Now I cannot fully answer that question, but I can tell you that it is likely to continue to reoccur with similar examples unless two very different kinds of reforms are pursued.

The first is procedural reform, and both the House and the Senate are zealously pursuing that course, admittedly on somewhat different paths, but at least the issue is getting fundamental attention.

This is the world of enforcement powers and closer regulation of the accounting practitioner.

The other kind of reform that I think is at least as necessary, is substantive reform, substantive reexamination of GAAP accounting principles in light of Enron and similar scandals. This has received far less attention and I would applaud this committee for being the first committee in Congress to clearly focus on it.

The basic point is this: even honest, zealous gatekeepers can only measure compliance with the standard. And if that standard is in some ways defective, or more likely ineffable and open-ended, then there is going to be a failure in what the gatekeeper can do.

My starting point here is that our current substantive system of accounting principles, which is rule-based and quite technical, has shown itself to be vulnerable, unacceptably vulnerable, to exploitation by those who are willing to game the system.

Now, it is certainly not FASB's responsibility that people are gaming the system. And I clearly consider FASB to have been over the last 20 years much more on the side of the angels. But I think if we talk about reform, we have got to talk about how we can establish a more principle-based system, rather than a rule-based system of accounting, which is less vulnerable to exploitation by those seeking to game the system.

I also believe that there is an emerging bipartisan consensus on this point because both SEC Chairman Harvey Pitt and his chief accountant have called for a more principled system of accounting.

What that should focus us all on is what systems of accounting today exist that appear to be more principled, and I think it is usually the British system that is pointed to as the exemplar of a more principled system of accounting. At the end of my talk, I want to talk about one or two changes that could be brought into the principles that you endorse in your Section 5 or your proposed legislation.

Now, let us talk first about how do we get there toward a more principled system of accounting, in terms of fundamental steps. Here I speak not as an accountant—I am not one—but as a law professor who specializes in governance. And we are talking about a governance issue here, given the unique and unparalleled complex relationship between FASB, the SEC, and the accounting industry and the users and investors who rely on certified financial statements.

The first point that I must make is that Congress cannot do it itself. Congress cannot write technical accounting rules, nor should it micro manage. And indeed, the intervention of Congress in technical accounting rules has not always been salutary. Sometimes things have been made worse.

What then can Congress do? The first thing I would say is that it can assure the objectivity and independence of the standard-setting process by giving FASB assured and independent financing.

Today FASB, and this may be undiplomatic, but it is frankly a somewhat low-budget operation that receives 2/3 of its financing from the sale of its publications and is dependent for the additional third of its financing on charitable contributions that are made to its parent foundation, FAF, from auditing firms and, in the language of the recent panel report by the Panel on Auditing Effectiveness, from entities interested in accounting principles.

Well, that is where the rub lies. Those interested in accounting principles often have a perverse interest in accounting principles. Enron and WorldCom are very interested in accounting principles. And while FASB has resisted pressures, I think it is an undesirable system to force FASB to solicit financing from those who have a strong interest in the standard-setting process.

Moreover, if additional duties are imposed on FASB, as this legislation would do, the financing problem will become more critical, and thus, I think you need to move to a system that better assures FASB of independent financing.

I would suggest that the appropriate model here is the National Association of Securities Dealers, which is the self-regulatory body for the securities industry, and it basically taxes the industry.

A tax system here is fairly simple to implement because you could tax the auditing profession in terms of their proportionate share of audited reports filed with the SEC, and they, in turn, can pass that cost on to the corporate issuers in their audit fees. That is step one, independent financing.

Step two, I think Congress can try to assure greater openness and disclosure in the standard-setting process. With Brandeis, I am a great believer in his statement that sunlight is the best disinfectant and electricity the best policeman.

Not only should accounting principles be transparent, but the process by which they are formulated could also use somewhat more transparency.

As I described in my written statement, the most controversial accounting rule to surface in the Enron saga was the so-called 3 percent rule under which a special purpose entity, or SPE, did not have to be consolidated with the financial statements of its parent, if there were independent investors who held a, "controlling position" and made a, "substantial," equity investment.

Now FASB, itself, has never defined what is a substantial independent investment, but its organ, the Emerging Issues Task Force, EITF, has done so. And it defined a substantial investment as 3 percent.

Frankly, if you were to leave this room and walk out on Constitution Avenue and talk to investors, I think you would find that the average investor would not agree that an entity that owns 97 percent of another entity, which has a 3 percent independent investment, was thereby independent of the parent. I think you would get the view that 97 percent control is virtually total control and there is not an independent substantial investment.

Now my point here, the relevant point here is not the particular rule, but it is that the EITF's procedures do not permit public exposure of its draft documents. They are given as authoritative opinions in response to a request for advice and the process does not have what I think is the optimal level of exposure or disclosure.

This private approach to policy formulation might have been all right at a prior time when there was no controversy over accounting rules, but frankly, those days are past.

Thus, I would submit that they should both be pre-issuance exposure for public comment of all FASB interpretations, including those of the EITF, and that there should be consultation with the SEC, both over specific issues and over the future agenda of FASB.

I believe the SEC should be able to at least place issues on FASB's agenda and require, or request at least, a timely response for critical issues. That would be the optimal relationship between the SEC and FASB.

Now one more point about this 3 percent rule that I just referred to. If you will look at the Powers Report, which is the most authoritative document we have today, and it was done after months of study by skillful, independent directors, assisted by excellent counsel; the Powers Report could not ultimately determine whether or not Arthur Andersen got it right when it attempted to measure and when it did certify that Enron had complied with the FASB pronunciations on off balance sheet accounting.

We are not talking now about the violation of the 3 percent rule. We are talking about the interpretation of that rule as it applied to all of these SPE's.

They said there were a number of interpretative questions, but they just could not tell. That tells us we may have a problem in terms of the open-ended character of some critical rules.

Now, here I come to my next point, timetables. As long as I have been in this field, and that goes to well before the creation of FASB, the whole topic of off balance sheet accounting has been under review. It is likely to remain under review if nothing else happens.

That is not really a criticism of FASB. And again I speak as someone who is much more an admirer, than a critic of FASB. It is rather because whenever rules in this area are formulated, they are bound to gore someone's oxen.

And as a result, rather than have an adverse determination, interest groups are going to pursue and prefer a dilatory response as opposed to an adverse response. And there will be interest groups that always want to delay the process. I think it probably is desirable in that light for, on occasion, particularly on critical occasions like the current environment poses, for Congress to set some timetables.

Okay. Now last, I opened by talking about principle-based accounting. I think there is an agreement in the country today that we would like a more principled-based system of accounting and certainly the SEC has advocated that.

Section 5(a) attempts to provide some general principles, but I think that there is more content that could be put in Section 5(a). I do not think it goes much beyond, as was just pointed out, what FASB already says.

I think there could be a stronger endorsement of both the concept of transparency and what I will call the British concept of principled accounting. Basically, British accountants must certify that the issuer's financial statements provide a, "true and fair view," of the issuer's overall financial position.

Now this idea of fair presentation used to be there in U.S. accounting principles, but it has been downsized over recent decades into the far more limited certification which U.S. auditors today provide with the issuer's financial statements, "fairly present its financial position in accordance with GAAP."

It is not quite the strong statement that the British require, that the financial statements provide a true and fair view of the company's financial position. Personally, I believe, that the auditors at Arthur Andersen, or any other of the Big 5 firms, would have been more reluctant and more wary about certifying the financial statements of an Enron if they had to certify that these financial statements provide a, true and fair view, or fairly present a holistic picture of the company's financial position.

And I think you could make a statement, that is, at a minimum, it would be useful if nothing else were done to indicate and provide in Section 5(a) that the purpose of GAAP is to provide a fair presentation of the issuer's financial position that gives the investor an accurate and a holistic sense of the issuer's financial position.

This is not micro managing, and I do not advocate micro managing. But in terms of general principles of the kind that you could announce in Section 5(a), I think you can put a clearer statement in of the desirability that GAAP provide what I will call a fair and holistic picture of the company's overall financial position, not just that it has complied with the rule book of 10,000 technical rules.

Those are my basic suggestions, and again, I am not trying to address the specific accounting principles. I am trying to address what I will call the governance picture of how FASB should fit into this system.

Thank you.

[The prepared statement of John C. Coffee Jr. follows:]

PREPARED STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

I. INTRODUCTION

In less than a month, between October 16, 2001 and November 8, 2001, Enron Corporation reduced its shareholders' equity by over $1.7 billion (roughly 18% of its previously reported equity of $9.6 billion as of September 30, 2001) as the result of earnings restatements and related adjustments. Less than a month later, on December 2, 2001, Enron filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code in what was easily the largest U.S. corporate bankruptcy.[1] Correspondingly, Enron's common stock fell from a high of approximately $90 per share in mid-2000 to under $1 per share by the end of 2001; in short, a market capitalization of nearly $11 billion evaporated. Since that time, the U.S. Securities markets have been traumatized (both by Enron and by the discovery that Enron was not unique and that other companies—Adelphia, Tyco, Global Crossings and others—were following similar accounting practices and policies). Many firms, including unquestionably reputable companies, such as General Electric, have seen their stock subjected to a "transparency discount" as investors have learned to fear

[1] Enron had reported assets of $63.4 billion on its bankruptcy, thus easily beating Texaco, the second-largest bankruptcy, which filed with assets of $35.9 billion.

and distrust what they do not fully understand from the face of the company's financial statements.

Understandably and predictably, much fingerpointing has occurred since Enron's fall, and much will continue. Reasonable people can disagree, for example, about the appropriate reforms that are needed to improve the regulation of the accounting profession, and not surprisingly, quite different proposals are currently pending in the House and Senate. But while reasonable (and sometimes even heated) disagreement is possible on many questions, there should be consensus on one fundamental point: our current substantive system of accounting principles—rule-based and hypertechnical—has shown itself to be vulnerable to exploitation by those willing to "game" the system. Indeed, I believe there is already a bipartisan consensus on this need for accounting principles that rest on a stronger and more principled substantive foundation. Both SEC Chairman Harvey Pitt and the SEC Chief Accountant Robert Herdman have expressed concerns that much of the FASB's guidance is both too rule-based and too complex to be comprehensible or useful to investors.[2] They have further suggested that the SEC needs to play a greater monitoring role with regard to FASB projects on an ongoing basis and determine if any such projects are needlessly languishing.[3]

Complex rules are by definition not transparent rules. This does not mean that complexity can always be avoided, but it implies that "procedural" reforms that look only to whether the auditor has faithfully complied with existing standards and honestly determined that the client's financial statements are in comformity with "generally accepted accounting principles" ("GAAP") are inherently incomplete. Such "procedural" reforms (which term includes most of the accounting reforms that have recently been proposed) are no doubt important, but they will fail to have much real impact if the inventory of GAAP principles remains so broad and open-ended that issuers can find a GAAP principle to justify any desired result. Thus, "substantive" reform is necessary, which means that the content of GAAP principles must be reexamined in light of Enron and related crises. Of all the Committees of Congress currently considering Enron-related reforms, this is the only committee to my knowledge to have advanced this critical task to the point of legislation. Thus, if only as a spectator on the sidelines, let me applaud your decision to focus on this essential, if perhaps unglamorous task.

Still, it takes only a moment's reflection to recognize that Congress cannot itself write accounting rules. The task is too technical, and such rules need to be framed so as to be consistent with the growing international convergence in accounting policies. Hence, some independent, technocratic body must be delegated the task. Conceivably, the SEC could handle this responsibility (and originally, it did), but former SEC Chairman Arthur Levitt has convincingly argued that to assign this task to the SEC would expose it to more political pressure than it can safely handle. Hence, a more insulated body is desirable. But to insulate any standards-drafting body from lobbying pressures so that it can reach disinterested judgments requires as a prerequisite that the body be given financial independence. If the industry has control over the drafting body's funding, one can predict that the threat to cut off funding will be used (perhaps subtly, perhaps not). The troubled history of the Public Oversight Board, which was the accounting industry's principal self-regulatory body in charge of discipline, ethics and monitoring for the last twenty years until this year (when its members resigned en masse), reveals this pattern clearly.[4] When the industry was displeased with the POB, it turned down the funding spigot. As a partial result, the POB never came close to fulfilling the role initially envisoned for it, even though it was consistently staffed by first-rate and independent board members.

In short, the first point to be made about the "substantive" reform of GAAP is that it is a process worth initiating only if the drafting body undertaking that review is sufficiently independent of the industry—both in terms of its members' conflicts and its financial independence—that the outcome will not simply be the logrolling process by which budgets are passed in most legislative bodies. Since 1973, the SEC has delegated to the Financial Accounting Standards Board ("FASB") the primary responsibility for setting standards with respect to the substantive accounting policies to be followed in the preparation of financial statements in the private sector. FASB, as part of the Financial Accounting Foundation ("FAF"), is "a not-for-

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[2] See Letter dated May 3, 2002, from David M. Walker Comptroller General of the United States to the Honorable Paul S. Sarbanes Chairman Committee on Banking, Housing and "Urban Affairs, United States Senate ("GAO Report on Accounting Profession") at pp. 9-10.

[3] Id. at p. 10.

[4] The history of the Public Oversight Board is briefly set forth in the Report of the Panel on Audit Effectiveness, Report and Recommendations, August 31, 2000 ("Panel on Audit Effectiveness Report").

profit organization which is supported by contributions from accounting firms, corporations and other entities interested in accounting issues."[5] The primary role of FASB's parent, FAF, is to raise funds for FASB. Unfortunately, this uncertain funding structure constantly places FASB and FAF in the role of a hat-in-hand supplicant soliciting the industry for charity. Imagine what a large "entity interested in accounting issues" (for example, Enron in 1999) would want for its contribution. Unless the FASB can instead tax its industry in roughly the same way that the National Association of Securities Dealers ("NASD") can tax the securities industry, it will remain less than optimally independent or objective.[6]

Suppose financial independence is achieved. What comes next? If the need is for a "principle-based" system of accounting, instead of a "rule-based" system (as SEC Chairman Harvey Pitt has perceptively suggested), what principles should guide it? How should they be drafted? Here, I think it is useful to look a little more closely at the Enron experience. In so doing, I will necessarily be guided by the Report, dated February 1, 2002, prepared by the Special Investigating Committee of the Board of Directors of Enron Corp., which was chaired by Dean William C. Powers, Jr. of the University of Texas School of Law (the "Powers Report"), which constitutes the most authoritative source of information available to this point.

II. ENRON'S USE OF SPES.

The Powers Report identifies a number of accounting and auditing practices that were utilized by Enron management, possibly with the complicity of its auditors, to manipulate its reported numbers. One technique, however, stands out above the others: Enron's use of numerous special-purpose entities ("SPEs"). SPEs were used by Enron to accomplish a variety of objectives: First, because SPEs were not consolidated onto Enron's balance sheet, they served as a vehicle for hiding Enron's losses and enormous debts from its investors. Second, Enron regularly sold merchant investments to these unconsolidated SPEs and presented these transactions to the world as arm's length transactions. Third, Enron issued stock to certain of its SPEs in return for their notes and treated these stock issuances as if the stock had been sold in arm's length transactions. Although all of these uses raise serious issues, time and space considerations lead me to focus just on the first of these: the consolidation issue.

Enron's use of SPEs was spectacular; it used hundreds of them, often to shelter foreign-source income from U.S. taxes, but more frequently and suspiciously, to conduct business with itself. Although I am not an accountant, I believe that there has been a consensus among accounting commentators that GAAP permitted Enron not to consolidate these SPEs with its own financial statements only so long as two conditions were satisfied: (1) independent third parties held a "controlling" interest in the SPE, and (2) these same parties owned a "substantial" interest in the SPE. Over time and without formal action by the FASB, itself, the term "substantial" had come to be understood as requiring an independent equity contribution equal to at least 3% of the SPE's assets (the "3% Rule").[7] Once formed by Enron, the SPEs would then borrow debt from banks, which debt would typically be guaranteed by Enron. Although such guarantees are not unusual where SPEs are utilized, far less common (and indeed unique) was the fact that the principal asset of many Enron SPEs was Enron restricted stock. Thus, if Enron's stock price declined, the SPEs assets would be insufficient to cover the bank debt, and Enron would have to assume it.

The earlier described financial restatements in late 2001 that triggered Enron's downfall came when Arthur Andersen, as Enron's auditor, discovered that the 3% Rule had not been complied with because Enron had guaranteed bank loans made to Michael J. Kopper, ("Kopper") originally a middle level officer of Enron, to finance his stake in Chewco, an important Enron SPE.[8] Because less than the minimum required 3% equity remained after subtraction of Kopper's tainted stake, Chewco had to be reclassified as an Enron subsidiary, and this disqualification had a domino-like effect, because Chewco was the source of the outside equity in JEDI, another SPE. Hence, Chewco's fall took JEDI with it, as neither could satisfy 3% test based

[5] Panel on Audit Effectiveness Report at 198 (emphasis added).

[6] In so concluding, I do not mean to attack FASB as lacking in objectivity. On a number of issues, including the expensing of stock options, it fought the good fight. But it has been bruised and battered in these battles, and absent assured financing, I cannot predict that it will be able to maintain complete objectivity.

[7] The 3% Rule is really the product of an interpretation by the Emerging Issues Task Force of FASB.

[8] According to the Powers Report, Barclay's Bank effectively loaned Kopper all but $125,000 of his equity investment in Chewco. Kopper's domestic partner also owned a small fraction of the equity.

on Chewco's ownerships of JEDI. Although this discovery possibly came late, Arthur Andersen was aware all along that Koppers was, or had been, an Enron employee. Moreover, two other important Enron SPEs—LJM1 and LJM2—were essentially run by Andrew Fastow ("Fastow") Enron's chief financial officer, who served as the general partner of these SPEs. That he could have been considered independent of Enron seems even more debatable, because the 3% Rule requires that independent third parties have both a "controlling" and "substantial" interest in the SPE. Thus, even if the 3% equity test were met, the claim that the independent parties "controlled" these partnerships seems particularly tenuous when Fastow served as the general partner of both LJM1 and LJM2. Apparently, Arthur Andersen rationalized that the two LJM partnerships agreements sufficiently limited Fastow's authority, because they permitted his removal by a 75% vote (later reduced to a 67% vote) of the limited partners (see Powers Report at 76), that the limited partners (at least in Andersen's eyes) could be seen as possessing control. Although Andersen's conclusions can be doubted, it is perhaps more important (and certainly symptomatic) that the Powers Report, after reviewing these transactions and Andersen's determination, concluded: "We have reviewed these issues in detail, and have concluded that there are no clear answers under relevant accounting standards." (Id.). Thus, even if this equivocal answer protects Andersen, simultaneously it states the problem for Congress: at present, there are no clear answers to these critical questions. In their absence, gamesmanship can continue.

So what should be done to restore transparency in light of the popularity of SPEs? Two prominent accounting scholars—Professors George Benston and Al Hartgraves of Emory University—have argued that an answer is already inherent in existing GAAP principles. They conclude that FASB Statement No. 5 requires that guarantees of indebtness, and other loss contingencies with similar characteristics, must be disclosed even if the possibility of loss is remote.[9] The requisite disclosure should include the nature and amount of the guarantee. Hence, they conclude that "even if Andersen were correct in following the letter, if not the spirit of GAAP, in allowing Enron to not consolidate those SPEs in which independent parties held equity equal to act at least 3% of assets, Enron's contingent liabilities resulting from its loan guarantees should have been disclosed and described."[10] If they are correct, the guaranteed debt of SPEs must always be shown in a footnote to the financial statements of the putative parent. Today, I seriously doubt that most auditors are requiring such disclosure—or that most issuers are making it.

Thus, several important questions are now outstanding: (1) How much discretion does an auditor possess in defining "control" in the case of an SPE actively managed by a corporate official?; (2) Must the auditor at least requre disclosure of the corporate parent's guarantee (or other contingent obligation) with respect to SPE debts or liabilities?; (3) Should 3% really be the measure of a "substantial" equity investment; (4) Should pyramid structures among SPEs be possible so that a Chewco (assuming it had a 3% independent equity) could own 3% of JEDI (and potentially JEDI could own 3% of still another SPE—hypothetically R2D2)?

Press reports have suggested that FASB or its Emerging Issues Task Force ("EITF") may respond to Enron and the SPE issue by raising the current 3% level of 10%. This seems precisely the kind of "rule-based" approach that has no "principled" logic. Moreover, it also hints at some of the procedural problems surrounding FASB. Currently, the EITF, which was responsible for the original 3% Rule, identifies emerging accounting issues and publishes its "consensus" in authoritative releases.[11] As the Panel on Audit Effectiveness noted in its report:

> "The short time frame in which the EITF is expected to respond to the need for guidance does not permit pre-issuance public exposure to its pronouncements."[12]

Such a private approach to standard-setting may have been acceptable before Enron, but it should not be afterwards. More sunlight is the minimum prescription for FASB in light of the arguably over-extended earlier pronouncements of EITF in this area.

III. WHAT SHOULD CONGRESS DO?

There are only a modest list of goals that Congress can reasonably hope to accomplish with respect to FASB. These include:

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[9] See George J. Benston and Al. L. Hartgraves, "Enron: What Happened and What We Can Learn From It" (forthcoming in Journal of Accounting and Public Policy).

[10] Id. at p. 30.

[11] See Panel on Audit Effectiveness at p. 198.

[12] Id. at 198.

1. *Independent Financing.* The costs of FASB should be spread over all companies that file financial statements with the SEC. This cost-spreading could be accomplished either by empowering FASB to tax its costs on all publicly held companies or, more simply, by taxing accounting firms that audit publicly held companies on a proportionate basis (i.e., a firm that filed 21% of all audits would pick up 21% of FASB's costs). Audit firms could then pass these costs along in their audit fees (which a very concentrated market structure actually makes more feasible).

2. *Public Disclosure and SEC Consultation.* The claim that the need for quick action justifies the EITF to operate in secrecy is overbroad. If accepted, most federal agencies could make similar claims. Public notice and formal SEC consultation seem sound prudential procedures that cost little and would give the SEC greater insight and possibly leverage in the policy formulation process at FASB. In particular, FASB's (and the EITF's) agenda should be negotiated with the SEC.

3. *Principled Accounting.* The "Financial Accounting Standards Board Act" (the "Act") contemplates a more principled based system of accounting. But how do you get there from here? The standards specified in Section 5(a) of the Act are useful, but they omit the critical concept that drives the U.K.'s more "principled" system. U.K. GAAP requires auditors to report a "true and fair view" of an enterprise's financial condition.[13] Similar language could be incorporated into Section 5(a) as a guiding instruction. Arguably, there is already a notion of "fair presentation" in U.S. law, which similarly requires the auditor to "fairly present" the company's financial position (in addition to complying with U.S. GAAP), but this can be debated (and the idea will be resisted by the industry, absent a legislative statement).[14]

Finally, the notion of "transparency" is never explicitly expressed in Section 5(a). This word may mean different things to different people, but its omission is notable. As the Panel on Audit Effectiveness phrased it in its recent report,

> "Transparency simply means openness. It is a concept that calls for full and fair disclosure of information to the constituencies who need that information."[15]

It would not hurt, and it might help, if this concept were more clearly articulated in Section 5(a) of the Act.

Mr. STEARNS. I thank the gentleman.

Professor Lev.

STATEMENT OF BARUCH LEV

Mr. LEV. Thank you for the invitation.

I provided a very brief testimony, which can be added to the record.

I read the proposed Act. I see there are several useful elements, like the emphasis on primary standard, the focus on intangibles, better accountability of the FASB. But on the whole, I cannot support the Act.

The major reason is that I do not see in the Act anything that changes the structure of the FASB, its operating procedures, like due process, majority rule, or the governing body. And without such changes, I do not see it is likely that there will be any major change in accounting standard setting in the United States after the bill is passed.

So the first question that I would like briefly to address is: should the FASB change in a major way? And I think so. Let me elaborate.

Institutions are usually judged by inputs and outputs, what goes in and what comes out. On the input side, I am highly impressed by the FASB, highly competent people, motivated, definitely mean

[13] See Benston and Hartgraves, supra note 7, at 33.

[14] The SEC's staff has recently suggested that decisions, such as U.S. v. Simon, 425 F.2d 796 (2d Cir. 1969), do require such a fair presentation. See Norris, "An Old Case Is Returning to Haunt Auditors," New York Times, March 1, 2002 at C-1. But unless Congress speaks, this debate will continue indefinitely.

[15] See Panel on Audit Effectiveness Report at p. 158.

well, work very hard. They have issued so far close to 200 statements, erasing single handily whole forests in the United States.

On the output, I am somewhat less impressed. If you look at the reporting arena, it is huge, unexplored, unchartered areas, crucial issues that were not dealt with. Let me mention just a few.

The first one is close to the heart of Mr. Jenkins, who is here and for whom I have the highest respect. He led about 10 years ago a very important committee that came to be known as the Jenkins Committee, whose major recommendation with respect to financial reporting was that in the complex business life—and this was 10 years ago, 12 years ago—financial measures, measures that just reflect dollars, like sales and purchases, are insufficient, and the system has to augmented with a whole set of nonfinancial measures, like employee turnover and customer dissatisfaction, a number of defective products, and so on, and so on.

Managers wholeheartedly adopted it. Practically every corporation now uses for internal purposes what is known as balance score card, score card that has both financial and many nonfinancial measures. But there was basically nothing in financial reporting done in this area. That is the first one.

The second area, which is close to my heart, intangibles, assets like patents and brands and information systems and human resources, which are now, by far, the largest in size and the major contributors of value to our corporations. Basically, nothing has been done so far, although there is a glimmer of hope.

In January, the FASB, last January, the FASB added some very mild disclosure agenda items on intangibles, so the jury is probably still out on that.

The third area, which there is basically nothing done in financial reporting about it, is risk assessment, risk indicators. Accounting is completely silent with respect to the riskiness of the enterprise.

It would be incredibly important to know what would happen to the company if interest rates change, if oil prices change, if foreign currency change, if countries to which the companies selling or buying from are going to be depressed. There is a whole area of risk management, risk assessment, particularly in finance; it did not even touch financial reporting.

And the fourth, and last one that I will mention, is a huge area. It is one that you are very familiar with due to Enron and others, and that is, of course, liabilities, off the balance sheet, all kinds of promises and guarantees and other things that are not captured by the accounting net.

As Professor Coffee mentioned, none of these issues are new. Many of those were deliberated when I was a student, which is a few years ago. Yet, there is no satisfactory solution, no reporting on this issue, systematically reporting. And in many of those cases, there is not even a progress done.

So I would really hesitate, at this stage, to Federalize the FASB as is. Thirty years ago, at the height of discontent with accounting standard setting, which, of course, does not come even close to the crisis that we have now, the AICPA, the American Institute of Certified Public Accountants, set up two committees, which came to be known after the respective Chairman, the Trueblood Committee, which was in charge of determining objectives of financial reports like the rules that the bill is talking about; and then the Francis Wheat Committee, which was in charge of standard setting or examining standard setting in the United States, doing an incredibly important job.

The current FASB is the child of the Wheat Committee. This was established exactly 30 years, in 1972. And on this anniversary of 30 years, I propose to set an accounting standard setting commission.

Mr. Greenwood was here and he spoke about the bill that he initiated, the Market Integrity Commission. I think we should do an accounting, or you, an accounting standard setting commission to examine basically four areas, three descriptive and one proscriptive.

The first one is to examine very carefully the 30 year record of the FASB. I may have been overcritical, but we definitely have to know what is the record.

The second is the role that accounting setting standard-setting played in the current crisis and the current debacles. People differ markedly. If you speak with accountants, for example, practicing accountants, they will tell you that it is the responsibility of GAAP. And many of them testified to this effect, that they are basically chained. They are straightjacketed by an irrelevant GAAP.

If you speak with others, it is not the responsibility of GAAP. We should know what is the role or what was the role of GAAP in the current crisis.

The third area that we should examine is alternative mechanism for standard settings around the world. Professor Dharan mentioned it, that people used to say the United States has the best accounting framework, GAAP, in the world. I would never have believed in that because I have never seen a shred of evidence to support this argument, but now very few people, I think, believe in that.

The fourth area that the commission should look into, which of course is based on the first three, is to propose to come up with improvement in the way accounting standards are set in the United States.

I truly believe that once in 30 years examining accounting standards setting is not too frequent. On the basis of this examination, we may find ways to change the procedures, the working, the structure, the governing bodies of FASB, and maybe there will be a need to Federalize the FASB, but I suggest to base it on a very close examination.

Thank you.

[The prepared statement of Baruch Lev follows:]

PREPARED STATEMENT OF BARUCH LEV, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

I have examined carefully the proposed "Financial Accounting Standards Board Act." With all due respect, I wish to state at the outset that I cannot support this Act.

1. REASONS FOR LACK OF SUPPORT

Succinctly put, I do not see how this Act will improve upon the current state of accounting standard-setting in the U.S. The Act does not contain any material changes to the current organizational structure of the Financial Accounting Standards Board (FASB), nor does it change the FASB's operating procedures (e.g., due process, or required supermajority for new statements), or its governing bodies. Sections 3 (Standards Authoritative) and 4 (Duty of FASB) of the Act essentially describe the status quo. Most of Section 5 (Requirements for Establishment of Accounting Standards) are currently included in the FASB's Conceptual Statements.

The requirement for a Primary Standard (Section 5c) is novel and much needed, yet it is too vague. How, for example, will the primary standard differ from current generally accepted accounting standards? Section 5d directs the FASB to develop standards for various important issues, such as off balance sheet items, mark-to-market accounting, and revenue/liabilities recognition. However, these topics have been deliberated by the FASB for decades. What in the proposed Act will yield an improved outcome? I, therefore, cannot support the Act.

2. MY PROPOSAL:

In 1971, responding to widespread dissatisfaction with accounting standard-setting, the American Institute of Certified Public Accountants (AICPA) set up two important committees: One, to determine the primary objectives of financial statements (the "Trueblood Committee"), and the other to study the establishment of accounting principles (the "Wheat Committee"). The latter—the Wheat Committee—led to the establishment of the FASB in 1972.

Now, 30 years later, the dissatisfaction with corporate financial reports and their audits is much more widespread and the adverse impact on capital markets and the economy immeasurably more severe than 30 years ago. I, therefore propose to establish an Accounting Standard Setting Commission to study: 1. The 30-year record of the FASB in establishing accounting and financial reporting standards in the U.S. 2. The role of accounting standards in the recent cases of corporate bankruptcies, audit failures, and financial reporting fraud. 3. Alternative ways around the world of setting accounting standards.

With the aim of: 4. Proposing improvements in the manner by which accounting and financial reporting standards are set in the U.S.

I strongly believe that it is crucial to condition any legislation concerning accounting standards on a clear understanding of the FASB's record, the role current standards played in corporate, audit, and financial reporting failures, and the effectiveness of alternative standard-setting mechanisms. Once in 30 years is not too frequent to seriously study these crucial issues to investors, corporations, and the nations' welfare.

Mr. STEARNS. I thank the gentleman.

Mr. Regan.

STATEMENT OF NED REGAN

Mr. REGAN. Mr. Stearns, Mr. Towns, and Members of the Commission, thank you for inviting me.

I will make a couple of very fast points, very quick points. One is that for 15 years, I was the New York State Controller and had auditing and accounting responsibilities for the City, New York City, State and local governments and entities. The individual that preceded me was Arthur Levitt, Senior. And the one that followed me is Carl McCone.

It is an elected position, and I have raised a lot of funds in the course of each of those campaigns and am quite familiar with those issues that now and then get referred to in a different context.

I have also been a trustee of the Financial Accounting Foundation, which oversees FASB. That has been mentioned. And it raises the money for FASB. I can address any questions you might have about that.

I was a member of the Volker Advisory Panel, which is now, of course, out of business, the one that was to scrub up Arthur Andersen, but we went out of business.

And finally, I am now the President of Baruch College. Mr. Greenwood referred to it, and it is the Bernard Baruch College, referred to Bernard Baruch, and it is from this background that I speak.

We are a public college. We are publicly supported in State and city. We are the largest business school in the country and the second largest accountancy school in the country.

The kids that come there are from modest backgrounds. It is the standard city college of New York story. And it is what has been going on in New York City for over a 100 years. Poor kids getting a break they need, and into the economy of New York, the economy and culture of New York they go.

We probably graduate 1,000 a year. There are 2,500 a year that get there BBA or MBA, but well over 1,000 a year are headed for their CPAs.

I have heard Mr. Markey use a different definition of CPA, which I suppose one could agree with, but that definition is scary if you are thinking about 1,000 kids a year that have no options, except to become a CPA.

And so the question that bothers me, especially with how I feel, and I feel just like all of you feel; I share every comment, every statement that was made and agree with it. It is scary times. But it is scary for another reason. I do not want our kids to join a tainted profession. And so we not just have investors, but we have somebody else to think about.

I will give you just one example of when I was member of the Financial Accounting Foundation, and it has not been mentioned yet. FASB proposed about 5 years ago to put derivative instruments or a ruling that would put derivative instruments from the back pages of corporate financial reports, if they even appeared there, onto the balance sheet, with a stated value, somewhat like the stock option situation.

The business community, especially the money centered banks, rose up and came here to Congress, and there was a lot of lobbying and a lot of bills were authored, and fortunately never passed. An enormous amount of pressure was put on FASB to back off from going forward with that rule.

And one of the bills would have had FASB report every one of its standards for a second approval to the SEC, which of course would have put FASB right into a political context, which, of course, was the purpose of the Bill. And the purpose was to have us back off, like FASB backed off on stock options.

Fortunately, I came with Ed Jenkins and others, people whose names you know and who you have met, and we spent a couple of days here in Washington and primarily dealing with Senator Alphonse D'Amato, who has been the chairman of the Banking Committee, and he saw the bill right away within 5 or 10 minutes as a consumer protection bill. And of course, it was, investor protection bill.

Under his leadership, the bill was beat back. It disappeared. FASB went ahead with their ruling, and by the way, it is 704 pages long. I mean, we look for clarity in the rules. And 704 pages on a derivative standard is enormously complex.

But does anybody think a derivative is anything other than complex? I do not know how you simply a rule that says put derivatives on the balance sheet.

Well, on the balance sheets they went 3 years ago, and you have not heard of them since. And you would have thought that at the time of the scandals that we have had, where corporations aided by their outside CPA firms, the auditing firms, would have made use of any kind of an instrument—we have heard some described—any kind of an instrument they possibly could have to hide, manipulate, and engineer their earnings.

But notice derivatives just have not appeared there. There is no more Greenwoods gifts and greeting cards, no more Proctor & Gamble, no more Orange Counties. I think that is a very direct result of a FASB, very complex, very hard to discern, but an enormous protection for consumers and for investors in this country and it worked.

Now that experience made me, and I come from government. I call myself now an ex-politician. I was an elected official for over 25 years, locally and then in the state. My other profession—and I admire what public officials, elected public officials, do, including all the Members of Congress and all of you.

But I get a little nervous with that, based on that derivative experience, about moving FASB and its independence a little closer to regulation and oversight, GAO sort of reports and maybe increase the probability of that, as Congressman Markey said, that there could be lobbying by Congress as to the particular standards.

That is painful for me to say and perhaps painful for you to hear, but that was my experience, the one experience that I did have.

So I am nervous about that part of the bill. I endorse, what Ed Jenkins had to say and much of what Baruch Lev and others have had to say, about the thrust of the bill, about the fact that somebody now in Congress is looking at accounting standards. I think that is wonderful.

The final conclusion or remark I have has to do with something that has been very only casually referred to, and that is the International Accounting Standards Board. There is a move among the industrialized countries to establish international accounting standards, principle based, not necessarily rule based.

Some of the issues, maybe many, perhaps all of the issues that have been raised, both by yourselves and members of this panel, as being as something that we desire, are conceivably being dealt with, certainly principles versus rules based accounting, by the International Accounting Standards Board. And there is inevitably, and it will occur just as sure as we are all in this room, a strong movement and inevitably the accomplishment of international accounting standards.

So I would urge that whatever work you do here, and again, I applaud it like my colleagues at this table, you look at the international accounting standards movement and maybe discuss that with the people involved-Paul Volker you have already acknowledged in your opening statement, Mr. Chairman—as way to cure some of the issues, maybe all of them that have been raised.

And I fear that if we try to move ahead of them, or ahead of this movement, we will not spook the international accounting standards process, but I think we could raise some problems that we really do not want to raise, especially if they can accomplish, with your guidance and help and oversight in hearings like today, if they can accomplish exactly the purpose you want them to have for the American investors.

Thank you.

Mr. STEARNS. I thank the witnesses, and obviously, I gave you extra time.

I was telling the staff this feels like we are in a lecture series hall, a very fine lecture on a very important issue, and particularly in light of what happened today in the newspaper with WorldCom.

The purpose we are trying to do is see if the bill that we have proposed, that you call the draft discussion or another term I think you used, discussion draft, is good. Now, Professor Lev said he does not think it is. I had a feeling Dr. Dharan does. And I think Professor Coffee seems to feel that there is some validity to it. And Mr. Regan is cautious. Mr. Jenkins is sort of agnostic about it. So he is being very typical. I mean I think he is wise because of his position.

But we have gotten three ideas as just a result of your conversations, which we think we can take adding a funding mechanism; add Mr. Coffee's suggestion on fair representation; and perhaps add a Commission that Professor Lev talked about in the four things that you mentioned within the standard setting commission, to bring that in.

So we might not all agree on our draft discussion, but you have given us some ideas. Now Professor Coffee has said to us that out of all the bills that has been drafted in this subcommittee, this subcommittee of the House Commerce Committee, is the most forward step toward trying to solve the problem.

And so we are eager to try and do something of substance. We are caught in a jurisdiction problem in this subcommittee because we do not have enforcement. So we are sort of on a fine see-saw here, which we have to work through.

But you have been very enormously helpful, and so we are very glad to have your testimony.

Let me just ask some quick questions here.

Mr. Regan, you are on the Foundation dealing with FASB.

Mr. REGAN. Right.

Mr. STEARNS. Did that work? And do you think that we should do something in the area of giving them more independence? And how would you suggest we do that?

Mr. REGAN. I think the Foundation worked in this sense, mainly because under former SEC Chairman Levitt, he had moved very strongly, and this is like 7 years or 8 years ago, to make sure that there was a majority on the FAF of independent trustees. And I was one such,and that is how I got on there.

I am not from the CPA firm.

Mr. STEARNS. No, I understand that.

Mr. REGAN. But it was dominated by the industry and now is not. So the FAF and the history of that in the last 4 or 5 years has been very good.

Speaking for protecting the independence of FASB, as an FAF trustee that myself, Emanuel Johnson, and David Reuter, former SEC Chairman and others came to Congress on the derivatives issue.

So I think we are covered there in a major way. And I know there was some statement about that there is no underlying authority for independent standard setting. I respectfully disagree with that. I think it is an independent as it needs to be and as it should be.

Second, it was fund raising and you did not—I raised funds, I helped raise money for FASB. And of course, we called on industry, and of course, that is a conflict. That is a potential conflict. There are conflicts all over the place. It is how you handle them that counts, and I think we handle them well.

There were plenty of things when we would go into raise money. We would get a little lecture sometimes, a polite lecture about this standard or that standard, derivatives being an example, but we managed to raise money.

These people understand that the independence of FASB is important, that we are going to make our own or FASB is going to make their own judgment in their way, shielded by the FAF.

Mr. STEARNS. Professor Coffee, you had talked a little bit about the gamesmanship that Enron used in dealing with the self-dealing transaction, the special purpose entities. You touched on the 3 percent rule.

I certainly agree with you. I guess you feel it is ridiculously low. What would you suggest FASB do? Make it 20 percent, 10 percent?

Mr. COFFEE. Well, I point in my written statement to the written comments of George Vincent, a professor of accounting who says that in addition to tinkering with the requisite level in determining what is a substantial investment, you also need to provide that when the parent organization guarantees the debt of the special purpose entity, even though this may be a contingent guarantee, that that should be shown on the financial statements of the parent.

George Vincent criticizes Arthur Andersen and the whole Enron reporting on the grounds that FASB Statement Number 5 required the inclusion in a footnote of those loss contingencies.

I am not an accountant and I am not going to resolve this dispute, but I think it points again to the somewhat ineffable character here under which people interpret these rules in different ways.

And in going forward, I think the public wants to see that the liabilities that are guaranteed by the parent company of a special purpose entity, because generally speaking the bank debt of such SPE will be guaranteed by the parent, and it should show up on the financial statements of the parent.

Mr. STEARNS. So basically, you would not change the 3 percent, you would just guarantee——

Mr. COFFEE. Oh, no. I would definitely think it would be appropriate to raise that, but I think the problem here——

Mr. STEARNS. It is a transparency.

Mr. COFFEE. [continuing] it is not just a rule issue. It is this principle issue. The liabilities that are guaranteed by the parent should show on the parent's financial statement.

Mr. STEARNS. So all these contingent liabilities have got to be transparent?

Mr. COFFEE. That is right.

Mr. STEARNS. Yes, Professor Lev.

Mr. LEV. May I add a word here? Because that is a great example of how you can dispose of rules and rely on principles. I would completely dispose of any rule, 3 percent, 30 percent, 90 percent. I would rely on a principle, which is a proportional——

Mr. STEARNS. Okay. Yeah. Okay. We are going to have——

Mr. LEV. I would rely on a principle, which proportionately consolidates the SPE with the parents. So if it is 20 percent, then I, of course, will consolidate 80 percent, what the parent has in this case. And then there will be a trace of the SPE in the parent financial reports.

So you can dispose of this rule and rely on a principle of proportional consolidation.

Mr. STEARNS. Okay. My time is expired. We are going to have a second round here. So if you will be patient. We are lucky that we do not have any votes so that we are not interrupting what I think is a very fascinating discussion.

The ranking member, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Someone referred to this as being the best accounting system in the world. I sort of missed who said that. I mean with all the problems that we have, how could you even think about that today?

Mr. DHARAN. Representative Towns, what I said was that others say this. It is almost mandatory now. I mean, you hear virtually everybody who wants to say anything about the accounting and financial reporting system say that we have the best system in the world.

Professor Lev disagrees with it and I, personally, do not think we have the right to claim. It is not really agree or disagree. It is just that we need to prove through deeds, as opposed to just making claims.

And I personally, do not think, given all the scandals we have had and we have witnessed in the last 6 months, we have the ability to claim that we have best financial reporting system in the world.

We should be in a position to do that, if we clean up our act, but right now we do not have that luxury to claim.

Mr. TOWNS. So you really feel that maybe it is the resources? We do not have the necessary resources to be able to take a very serious look at what is going on and to be able to bring about a kind of enforcement.

I mean, what is the problem here?

Mr. DHARAN. Well, I think, as I mentioned in my testimony also, the problem is multi-folded and we really do need multiple solutions. We have to definitely enforce the existing rules much more clearly so that the investing public will know that if somebody breaks the law, they will pay for it.

I think the worst thing we can ever do to any kind of law system is when you have rules that are not viewed by the investing public as being enforced.

We also need to take into account the needed resources of the SEC and the FASB to address these evolving issues. As things change in the world, we need to make new rules. There is no question that rules need to be added over time. But are we doing them in a way in which we are becoming too specific, as both Professor Coffee and Lev mentioned, or are we doing it in a way that will take care of a whole variety of evolving problems?

I think that is where the current situation needs to be addressed. In other words, if I see a problem somebody says, somebody found something on the floor, and we make a new rule, finders, keepers. Is that the way that you want to approach it or do you want to have a general principle that says do not take what does not belong to you?

And so, in a sense, we need to consider future evolving of nature of these problems as opposed to just the current status of the problems. This is exactly what the principles-based accounting is supposed to accomplish.

Mr. TOWNS. Okay. Let me say, too, join my colleague, Mr. Jenkins, in saying that it has been a pleasure working with you over the years. And of course, I would like to get your comments on this particular issue.

Mr. JENKINS. Well, I agree with Dr. Dharan that it is a multifaceted issue. When we talk about what some refer to that we have the best financial reporting system in the world, we are talking about not only the accounting standards. We are talking about the approach we take to auditing, the way information is presented by management.

It is the entire scheme of things. We need to have auditors that are independent. We need to have financial executives that follow the intent of the principles that we provide.

Our standards are principle based. We just do not stop there. We have had this discussion before, I think. I would be happy to talk about principle based versus detailed later.

But it includes auditing independence, scope of service, and accounting standards. And there is a difference between the two, between accounting standards and auditing standards, and we have to keep that clear in our minds as we look for a multifaceted solution to this issue.

I believe that at the present time, the accounting standards that we have, the standards that the FASB is responsible for, are still the best, most comprehensive, provide the most transparency of any set of accounting standards in the world.

The issue, again, seems to be, for the most part, that they have not been applied either by companies or their management, a company's management or their auditors, apparently,in the way that they were intended.

Some of that may well be driven by the fact of the details that we have in our standards, and we would support moving toward a more principle-based set of standards.

But a lot of it seems to be this corporate governance, this tone at the top, where top management seems to have in too many cases concluded and demonstrated to their lower management that they can do pretty much anything that they please to excess. And that has set a tone that perhaps has made it very easy for those responsible internally in a company for the financial statements to say, "Well, if I need another penny this quarter, it is no worse than what I see my CEO doing."

Mr. TOWNS. You know, that is the part that bothers me because it is almost at the point now where probably people are saying everybody is cheating. If they did not cheat, you would not be able to compete.

I mean, that is the sad commentary.

Mr. JENKINS. It is. And that is why I would—I was not aware, Chairman Greenwood, of your proposal on your Integrity Commission, but that seems to me, without knowing anymore about it than what you said, that seems to me to be attacking this issue at the right place.

Mr. GREENWOOD [presiding]. Thank you. The time gentlemen has expired. I appreciate that.

The Chair recognizes himself for 5 minutes for inquiry.

To me, to get to the core of this thing, is the answer to the following question that I would like you to answer. When we look at an $800,000,000 restatement by Enron, when we look at today's front page and see a $3.8 billion restatement by WorldCom, and in between those events, all kinds of other restatements going on, are we seeing this ability of the accountants in cahoots with the managers of these companies to hide losses and inflate revenues? In short, to manage earnings, are they doing this because they are: (a) breaking and ignoring FASB rules; (b) finding places where FASB has not gotten around to making rules yet, and gaming the system that way, or are they figuring out how to use FASB's rules in ways in which they can cleverly and still deviously go to the management and say, "Listen. Here is the FASB rule. You can use it this way and here is how you can put the pea under the cup"? Which is it?

Mr. Jenkins.

Mr. JENKINS. Well, I think it is sort of all three. What we do know from Enron is that they restated their financial statements for that $1.8 million you talk about.

Mr. GREENWOOD. Eight hundred million.

Mr. JENKINS. Well, 800,000,000, whatever it was.

In order to get into compliance with existing standards.

We know from the Powers Report it is replete with references to the fact that Enron either failed to comply with existing GAAP, failed to properly structure their transactions in order to be in compliance with GAAP.

And finally, we have the testimony in the Andersen trial where it is clear that the advice that Andersen's professional standards group in the national office gave to the auditors in the field and to Enron's management simply apparently was not followed.

Each of those three pieces of evidence would suggest that there is nothing wrong with accounting standards. So I think, however, I am not suggesting that we do not need to improve accounting standards. In fact, next week, we will propose for public comment a new standard on accounting for special purpose entities and it will not have a bright line of 3 percent or 10 percent or whatever. It will be a principle based standard.

And we also have already proposed and have received comments on a proposed standard dealing with disclosures of guarantees and commitments that simply clarifies, at least from my perspective, what we think already was in the literature.

Mr. GREENWOOD. Okay. Let me go right down the panel. Mr. Dharan.

Mr. DHARAN. Thank you.

I think you mentioned three things. The first one, ignoring the rules, I do not think that is a common problem. If it is, it is a fraud and it is a case that needs to be addressed in——

Mr. GREENWOOD. Although that is what Mr. Jenkins just said.

Mr. DHARAN. I agree. But I do not think that is—I think he mentioned about not ignoring rules as much as not doing them the right way. That is the gray area, which is more of the third nature, third kind that you mentioned.

They are taking the existing rules and trying to see if they can just comply with them in the most bare minimum ways. And that, obviously, causes questions of interpretation, and when 2 different people come and look at it, they come up with 2 different answers.

And this is exactly why we really should not have those kind of rules that we can go around.

But, Chairman, let me address a slightly different issue on this, which I think you alluded to, but I want to clarify that. The difference between what is going on now and what has probably always been in place for 500 years in accounting is that now the accounting violations are of a more collusive nature, that is, involving more than just one person.

In the old days, you would read about newspaper articles about somebody violating accounting rules or not implementing them right, but that person, he or she would do it himself. They may classify a cost one way versus another, and that is being done in one room by one person or maybe a couple of people.

What we now observe in cases like Enron and Tyco and Global Crossing and certainly WorldCom today, these are things that require enormous collusion and cooperative behavior between several people of top management, the CFO, the treasurer, the CEO, and certainly in some way indirectly or directly, the Board of Directors.

Mr. GREENWOOD. With the Board of Directors either snoring in the back room or spending so much time at the shrimp bowl that they are not paying attention, right?

Mr. DHARAN. I agree. Either they are snoring or ignoring, but what is going on is that this is a case that involves enormous number of people and that is why I refer to them as financial engineering, rather than just accounting.

In order to do this, you also have lawyers and investment banks from the outside that need to cooperate in setting up new entities.

In the old days, we did not do that. And so, in a sense, we are witnessing a much more comprehensive approach to financial engineering that has been going on for the last 5 to 10 years.

Mr. GREENWOOD. Excellent. Thank you.

Professor Coffee.

Mr. COFFEE. Let me be brief. I agree with the answer that it is both, that there is some cheating, and that is why the senior management of Rite Aid, the former senior management of Rite Aid, was indicted last week for cheating in a large earned earnings restatement case.

But there are also cases in which the rules were either inadequate and too lax, or they were too vague and open-ended. I think there is now getting to be agreement that the 3 percent rule was too low. That is an example of a rule that was too lax.

The Powers Report talks about another problem with off balance sheet entities, and that is this question of who is really in control. Mr. Fastow was the general partner of two of these partnerships, LJM1 and LJM2. As a general partner, it seems like Enron is in control of the partnership, but the editors looked at the partnership agreement that said the limited partners had the right to remove him with a 75 percent vote, and they said that means he is not in control because he could be removed.

The Powers Report says, "We cannot figure out who is right. These rules do not tell us what the standard is for who is in control."

That is rule that is a little too indefinite.

Now, a third example. We have been talking about off balance sheet financing. Maybe the bigger problem in Enron too, although it has not gotten as much attention, is mark to market accounting, particularly the use of mark to market accounting where there is no background market that gives you fair market value.

That is an area, again, where I think accounting has a lot of work to be done. I will defer to others who can tell me, who know from this more, but I think there are lots of areas where the rules are open-ended, and they can be gamed. And if you are going to have an integrity commission, which I think is a very useful thing, you will find that the process of gamesmanship has become very formalized in recent years.

A major investment banking firm will come up with a new structure, a new off balance sheet structure or new set of relationships between SPEs and the company, and they will get one particular accounting firm to bless it. Then they will market this structure to every one in the industry, with a letter saying, "We have an accountant that will bless this. We will give it to you. You can put it in tomorrow."

Now, that is the process by which gamesmanship gets marketed nationwide in a very structural way. I think that is the kind of the process you should take a look at, but it suggests to me that gamesmanship is there and it is not far beneath the surface.

Mr. GREENWOOD. Excellent. Thank you.

Professor Lev.

Mr. LEV. I really do not have anything.

Mr. GREENWOOD. You have no response.

Mr. Regan.

Mr. REGAN. I think, Mr. Jenkins is correct, and others, that it is a little bit of all three. I think that I agree with virtually everything that has been said on it.

I think that gaming the system is kind of part of life; it is human nature. The real question, after you get through that, Mr. Greenwood, is this. There are five points of bumps in the road of people that should have noticed this and should have said something about it and should have done something about.

There is the Board of Directors, and you referred to them just now.

There are the CPA firms. We have just dealt with them.

There are the financial analysts, and thousands of them in the country. They saw all of this happening and never told their investors that.

There is the regulatory agencies. They had to know all of this was going on. It was very much in the papers. They did not do enough about.

And finally, there was the press itself that was having a field day reporting the bubble and never lifted the rug to look underneath it.

So there is gaming the system, and I endorse all the suggestions, including, by the way, your market integrity commission and added, I think, Professor Lev's additions, are worthy of thinking about.

But its gaming is part of the process. Here are five checks and balances, five bumps in the roads, all failed.

Mr. GREENWOOD. Thank you.

Mr. SHIMKUS [presiding]. Musical chairs.

I, too, am glad to have you. As you know, there are a couple of hearings going on and one on the third floor on area codes. So I am sorry that I missed a lot of the opening statements. But I am glad to hear some of the analysis.

I have my MBA degree and one of the classes we had to take was Ethics in Business. And I think that is a cycle that we always have to continue to go back to, ethical, moral principles in how we related with individuals.

People will lie, people will steal, and people will cheat. We need the accounting profession to help us ensure that these statements are clear.

I was interested in the mark to market comments because I also used to be a county treasurer. It is interesting, as a county treasurer. You have an assessed evaluation to calculate property taxes.

Of course, the individual consumer/homeowner wants that really low when we are evaluating property taxes, but when they go to sell the house, they want it really, really high. And so I always look at them in the eye, when they would come to the point about the property tax bill, and I would say, "Now, look at the value that we have for your home. Would you expect to get that much if you sold it?"

Of course, they do not want to answer the question because it then takes the wind out of their sail.

I think that is very similar, in my casual way, of what probably is going on with business and industry, especially with the reorganization, and I know in our area of the country, refineries, closures, and concentration and refineries around the books for millions and millions of dollars. You put them up for sale; they get half what was listed on the books.

So it is not as clear-cut as we all would like it to be. And I do not have an answer for that.

But, Mr. Dharan, you talked about the—and this might be a touchy question—the individual cheating or stealing versus the collusion, which I think really has scared us and is probably of the major concern.

I do not know if this was addressed, but do you see the collusion? Has this occurred since we addressed the whole accounting versus consulting debate?

Is collusion more apt to occur in this whole new era of accounting and consulting?

Mr. DHARAN. I think the collusion problem, which I referred to as financial engineering problem, started because of the emphasis on stock price. That started in the 1980's, primarily thanks to stock options that were issued in large numbers during that era. And then of course the 1990's saw an enormous increase in stock price which led to the wealth creation that had to be sustained.

Until the 1980's, I don't think management at the top management level consciously sat down and did this amount of thinking about how much to report, how do we report, where do we get the numbers from, and so on.

Previously, you were trying to meet the sales targets, run the company right, save the cost. But now the focus is make sure that the market expectations are met, make sure that the——

Mr. SHIMKUS. The expectations, not necessarily the reality.

Mr. DHARAN. Not necessarily the reality.

And so the game became, as President Regan mentioned, the game became basically you set the market expectations and then you try to meet them. But the trying to meet is where accounting came in.

And previously, that was really done at the lower levels, trying to make divisional profits and divisional targets, but now we are talking about corporate profits and corporate targets. Clearly, that meant that at the corporate level, people had to get together and start colluding.

So rather than the CFO worrying about divisional managers fudging numbers, now we have to worry about the CFO fudging numbers. And this is a very different ball game, which requires a much, much different approach to standard setting and implementation.

Mr. SHIMKUS. Does anyone want to add or comment to that?

But I really find that fascinating because, in my days in school, you would hope that the return on investment of the productivity of a company would be enough that would affect the stock price, not this perceived—you know, the environment, the business environment has changed, and the new economy is a perfect example of that wave of soaring expectations and historic prices for very little assets, except for providing information.

Now that industry is sorting itself out. But it is just a new world. Where is the return on assets on an information based environment and economy where there is no real assets traded that you can evaluate?

So, let me ask this other.

Did anyone want to add to that?

How does Federal recognition help? It is probably addressed in a lot of opening statements. I know the legislation gives FASB standards Federal recognition. Why is that important?

Mr. JENKINS. Well, frankly, I am not sure that it is important. On the one hand, it would be a statement of support for the independence of the FASB and for the role that it plays and its responsibilities, and that is good.

On the other hand, it raises, as there was some discussion, the question of the interrelationship between the powers that the SEC has through the Securities Act, the 1930 Securities Act, and the FASB, and it seems like there would need to be some reconciliation, if that part was to go forward.

To me, the draft legislation, as it stands, which has the statement of giving Federal authority to the FASB, but also the statement later on that I think says that nothing in this act changes really the responsibilities or powers, authority of the SEC, needs to be clarified.

Mr. SHIMKUS. Anyone else want to add?

My time is out. And I relinquish the chair back. Oh, he just walked out.

Let me now recognize the ranking member for 5 minutes.

Mr. TOWNS. Thank you very much.

You know, the Senate bill, the Sarbanes bill, in Section 106 actually has funding. And I noticed, Professor Coffee, that you mentioned that we are not in the position to write technical rules and all of that, but make certain that they have the resources.

Have any of you had the opportunity to look at the Sarbanes bill?

Mr. COFFEE. I did testify before the Sarbanes committee and I do think there are a number of good suggestions in that bill.

Mr. JENKINS. I have looked at portions of that Bill so far as they impact the FASB, including the funding proposal, and I would find it an acceptable approach.

The key, Mr. Towns, is——

Mr. TOWNS. Hold on, just 1 second. I want to hear you. That will go off in a second.

Okay. Now.

Mr. JENKINS. Okay. Thank you.

The key, Mr. Towns, is that if we are going to have a nonvoluntary, stable source of funding that is going to come from legislation, if it is going to come from legislation, we have to be sure that it does not just change the appearance of lack of independence or threat to independence from the accounting profession and the business community over to appearance of a threat of independence coming from the political side.

And so it is important that that source of funding be clear that it is not subject to the appropriation progress of Congress, for example.

Sarbanes' legislation as proposed does try to do that. And the other issue is where the funding is going to come from? What is the source of funding?

The Sarbanes legislation, as I recall it, would have the funding come from registrants, public companies, based on some formula approach, and I would find that to be acceptable as well.

Mr. TOWNS. Yes, Professor.

Mr. LEV. Let me say a word about funding. I mean funding is, of course, always important, but I do not think it is crucial in the questions that we are discussing here. Suppose, as a mental exercise, that the FASB budget would have been tripled tomorrow. Do you think that the outcome would have been specifically different? I doubt it.

There are structural issues that have to be examined and have to be resolved. And let me just give you two, very briefly, of those.

The first one is the membership of the FASB. They are basically all accountants. Now, I am also an accountant so I'm not going to negatively reflect on them, but there are enormous improvements in information in other areas which are far distant from accounting, information systems, linguistics. In the sciences, the DNA is the most complex information system that exists in the universe in this case.

Now, the solutions will not come only from accountants, only from this claustrophobic approach if we look inside and we think that we know best this case. We have to look at outside. We have to add members to the FASB who are not accountants in this case and that is just one area.

The second area is that we never get rid of rules. To the best of my knowledge, and Ed will correct me, in the entire existence of the FASB only two statements were abolished, one on oil and gas by the SEC and one on inflation accounting because inflation was abated in this case.

The rules are issued without clear criteria of success, of measuring the success, and hence, in the future there is no ability to abolish regulation in this case. We just add and add enormous amounts of regulation. And I am sympathetic with all of the criticism that we have of corporate managers. I am sympathetic with them that it becomes impossible, the accounting burden that we have now.

There must be a process in the FASB of a continuous examination of rules every 3, 5 years, and getting rid of those that either do not work or are not needed anymore. These are just two examples of structural changes in the standard setting in the United States, and funding in my opinion is not really a big issue here.

Mr. TOWNS. Interesting.

Yes, Mr. Jenkins.

Mr. JENKINS. Well, I would like to disagree a little bit with my friend, Baruch.

First of all, while there is much more to a whole set of information than financial reports and financial statements, there is much to be done with respect to financial statements alone. And I believe that if——

Mr. TOWNS. I am sure, Mr. Chairman, that my time is up, but I would like to just get the answer to that question, Mr. Chairman.

Mr. JENKINS. And I believe that if our budget were tripled that we could put much more resources into improving our financial statements, in our standards. I believe that we would have time to do some of this sunset review that he suggests.

But the second point I disagree with is on that issue. We do amend and replace standards based on new information, new techniques. It is hard to think of a standard that we have issued that has not amended existing literature.

And so I think to that extent we are refreshing the literature as we go along.

Thank you.

Mr. GREENWOOD [presiding]. I thank my colleague.

Professor Coffee, you make an excellent point about fair representation, that fair representation currently required by GAAP could be interpreted to require accountants to insure that financial statements demonstrate an accurate picture of a company's health, even if the statements technically comply with GAAP.

Why has the accounting industry resisted such an interpretation?

Mr. COFFEE. I think it is the pressure of litigation. This is an open area in the law.

There was a time 30 years ago when it was clear that the standard of looking at financial statements was whether they gave full and fair disclosure. Under the pressure of litigation, the certification has been narrowed a little bit, and it talks about whether you are complying with GAAP and whether you are giving a fair presentation in compliance with GAAP.

All of that revising of the certificate was done in light of lawyers advising auditors about how to reduce their litigation profile.

During the late 1980's at least the accounting industry was under tremendous litigation pressure and for a period of time its viability was open to some question. Now, that has changed dramatically with the passage of the Private Securities Litigation Reform Act.

Mr. GREENWOOD. Which you had mentioned, we saw.

Professor Lev, you suggest the creation of a commission to study failures in accounting standards. Should the commission be appointed by the President? And who should serve on this commission?

Mr. LEV. Definitely by the President. There is no doubt it should be a very high level commission. And if I could just take an example of the previous commissions, the chairman can be a non-accountant. As far as I know, Francis Witt, and correct me, was an SEC Commissioner previously and non-accountant. It should have some accountants in it, but definitely people from other areas who can speak about changes, advances in information in this case.

Mr. GREENWOOD. This is my last question to Mr. Jenkins.

The revenue recognition has been under consideration for 26 of FASB's 32 years of existence, and I have made just that note in my opening statement.

I mean, is it not time that we reach a conclusion on this or some resolution of this issue?

Mr. JENKINS. We have now a formal project on revenue recognition on our agenda. We will be discussing it publicly the next time, on July 10 in our public board meeting. We are moving forward in this area.

I think like so many things this is an area where the progress has been made in small steps. There have been any number of pronouncements dealing with revenue recognition over the life of the FASB, some of them coming from the FASB, some of them coming from other related standard setters at the AICPA. So we have been making some progress.

But there is not a basic underlying standard in the United States on revenue recognition, and we need one, and we are going to have one.

Mr. GREENWOOD. That concludes my questions.

The ranking member.

Mr. TOWNS. Mr. Chairman, I guess I have more of a statement than anything else. Being that this is very complicated and I think we need to do something, I mean, there is no question about it. I would like to just ask, you know, the members of this panel to assist us in maybe making written recommendations to us as to what they think should go into legislation.

I guess Professor Lev would not want to participate in that, but the other members, I would like to get their opinion on it as we move forward.

I would feel a lot more comfortable with that. It is actually more into the technical drafting than anything else.

Mr. GREENWOOD. A good suggestion, a good suggestion.

I thank my colleague, and I thank all of you.

And honestly, Mr. Regan, we also believe that CPAs should have a very secure future, and that is why here in Congress we want to make sure that happens.

So, again, thank you for your testimony.

Mr. REGAN. Thank you.

Mr. GREENWOOD. And I appreciate your coming.

The hearing is adjourned.

[Whereupon, at 12:28 p.m., the subcommittee was adjourned.]