Testimony of

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Full Text of Testimony

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]

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

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]

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[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).

- 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.

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

Those responsibilities include:

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?

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

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]

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

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.

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

[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.

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,

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

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?

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

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 indicated 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

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

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

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

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

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

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.

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

[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).

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

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

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,

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

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.

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]

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[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

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

> 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.

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[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.

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 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.

Thus, 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

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

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.

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[31] Ibid., page E1.