Testimony of Edmund L. Jenkins
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Financial Accounting Standards Board
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Full Text of Testimony

Summary

- The Financial Accounting Standards Board ("FASB") is an independent private-sector entity whose mission is to establish and improve standards of financial accounting and reporting for investors and other consumers of financial reports.

- The FASB has no enforcement authority. Standards developed by the FASB are enforced by auditors and, for public companies, the United States Securities and Exchange Commission.

- The FASB is funded by and subject to the oversight of a not-for-profit foundation—the Financial Accounting Foundation.

- The FASB follows an open and thorough due process to ensure the credibility and quality of the standards that it produces.

- Existing accounting standards require all entities, including the sponsor of a special-purpose entity, to disclose related party transactions and debt guarantees and other arrangements that expose the entity to risks that are not otherwise reported in the entity's balance sheet.

- Mark-to-market accounting is important to providing relevant and transparent information to consumers about energy trading contracts and many derivative instruments because the alternative often would be not to account for the contracts at all while they are outstanding.

- Enron Corp. ("Enron") has publicly acknowledged, and the report of investigation by the special investigative committee of its Board of Directors confirms, that its financial reports failed to comply with existing accounting requirements.

- The FASB is committed to proceeding expeditiously, consistent with its mission and due process, to address any financial accounting and reporting issues that may arise as a result of Enron's bankruptcy.

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 an overview of the FASB, its structure, and due process. My testimony also includes an overview of the existing accounting requirements for special-purpose entities ("SPEs"), related party transactions, and mark-to-market accounting, and Enron Corp.'s ("Enron") restatement of its financial statements to comply with the existing accounting requirements. Finally, my testimony includes the actions the FASB has undertaken to improve our process for setting standards, to address issues relating to the complexity of our standards, and to address other financial accounting and reporting issues that are necessary to further improve the transparency of financial reports. I want to thank you for the opportunity to again appear before your Subcommittee. I understand and appreciate your important oversight role.

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 and receive no federal funding.

Our mission is 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 economy 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 FASB has no power to enforce its standards. Responsibility for ensuring that financial statements comply with financial accounting and reporting standards rests with the auditors of those statements and, for public companies, ultimately with the SEC. It is also important to understand that the FASB has no authority or responsibility with respect to auditing, independence or scope of services matters. Rather, our responsibility relates solely to establishing financial accounting and reporting standards.

The focus of the FASB is on consumers—users of financial information, such as investors, creditors, and others. We attempt to ensure that corporate 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]

Some of the FASB's significant activities during 2001 included the following:

- Issuance of a standard that improved the transparency of business combinations.[2]
- Issuance of a standard that improved the transparency of purchased goodwill and intangible assets.[3]
- Issuance of a standard that improved the transparency of asset retirement obligations.[4]
- Issuance of a standard that improved the transparency of impairment or disposal of long-lived assets.[5]
- Issuance of a video to assist the public in understanding the importance of financial reporting to the US capital markets and to individual investment decisions.[6]
- Issuance of a report that encourages companies to continue improving their business reporting and to experiment with the types of information disclosed and the manner by which it is disclosed.[7]

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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. 141, *Business Combinations* (June 2001).
[3] See FASB Statement No. 142, *Goodwill and Intangible Assets* (June 2001).
[4] See FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (June 2001).
[5] See FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (August 2001).
[6] See FASB *Presents Financially Correct with Ben Stein* (2001).
[7] See Business Reporting Research Project, Steering Committee Report, *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures* (2001).

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 Foundation is separate from all other organizations. Its 16-member Board of Trustees is made up of 11 nominees from sponsoring organizations whose members have special knowledge of, and interest in, financial reporting.[8] There also are 5 Trustees-at-large who are not nominated by those organizations but are chosen by the sitting Trustees.

The FAF Trustees are 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.[9]

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

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?")

[8] See Attachment 1 for a list of the sponsoring organizations.
[9] See Attachment 1 for a list of the current FAF Trustees.

2. Selecting the FASB Board members, and

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 corporations, one from the analyst community, and one from the academic community. A public vote of five Board members is required to issue a proposal or standard.

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 ($14 million in 2000) of the FASB's financing results from the public sale and licensing of the FASB's publications. The remaining one-third ($6 million in 2000) 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 Trustee's fundraising efforts, and the FAF Trustees are prohibited from participating in the Board's technical decisions on establishing and improving accounting standards.

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 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. In response to constituent requests, including requests from our Financial Accounting Standards Advisory Council,[10] the FASB has recently initiated several administrative projects and activities to improve upon the Board's due process procedures, including the timeliness of the Board's standard setting.

[10] See Attachment 2 for information about the Financial Accounting Standards Advisory Council.

Those projects and activities include the following:

- 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.

- Working with the Emerging Issues Task Force (EITF),[11] 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.

- 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.

- Implementing an improved approach to determining what major new topics should be added to the FASB's technical agenda. That approach involves issuing a proposal for

[11] See Attachment 1 for information about the EITF.

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), its 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. It also explicitly reviews the Board's agenda decision criteria.[12] 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.

What Is an SPE, and What Are the Accounting Requirements for SPEs?

"Special-purpose entity" or "SPE" are terms frequently used to refer to an entity that is created solely to carry out an activity or series of transactions directly related to a specific purpose. An SPE may take on any legal form including a corporation, a partnership, a limited liability company, or a trust.

SPEs are commonly used as financing vehicles to which an entity (the sponsor) sells assets (such as a pool of mortgage loans) in exchange for cash or other assets. The funding for the SPE's purchase comes primarily from the SPE issuing debt or equity (or

[12] See Attachment 1 for information about the Board's agenda criteria.

both) to third-party lenders or investors. An SPE also may be established to acquire, construct, or manufacture assets that are used by another entity (its sponsor) under leases, management contracts, or other arrangements.[13] When properly structured, an SPE often reduces the credit risk or other risks for lenders or investors and, thus, lowers financing costs. SPEs also may create certain tax advantages for the participating parties.

SPEs raise a number of complex financial accounting and reporting issues. One issue is which party, if any, should be responsible for reporting or consolidating the assets and liabilities of the SPE into its financial statements.

The existing accounting requirements generally provide that the sponsor of the SPE (for example, Enron) is required to report all of the assets and liabilities of the SPE in its financial statements *unless* all of the following criteria are met:

1. A third-party owner (or owners) independent of the sponsor has a sufficient equity investment in the SPE;

2. The independent third-party owner (or owners) investment is substantive (generally meaning at least 3 percent of the SPE's total debt and equity or total assets);

3. The independent third-party owner (or owners) has a controlling financial interest in the SPE (generally meaning that the owner holds more than 50 percent of the voting interest of the SPE—thus, if the SPE's total equity is only 3 percent of total assets, *all* of its equity must be held by one or more independent third parties); and

[13] See Attachment 3 for a simple example of one such SPE structure that illustrates some of the potential business purposes that accompany the decision to form and transact with an SPE.

4. The independent third-party owner (or owners) possesses the substantive risks and rewards of its investment in the SPE (generally meaning the owner's investment and potential return are "at risk" and not guaranteed by another party). [14]

Although a sponsor of an SPE that meets all of the above conditions is not required to consolidate the assets and liabilities of the SPE in its financial statements, the sponsor is required either to recognize in its financial statements or to disclose in the footnotes to its financial statements the obligations, including conditional or contingent obligations or guarantees, that may arise from its transactions and relationships with the SPE. Whether the obligations must be recognized in the financial statements or disclosed in the footnotes generally depends on their nature and the extent to which payments are probable. The following is a brief summary of some of the more significant accounting requirements that might apply to the sponsor's (reporting entity's) financial statements:

- A reporting entity that sells financial assets is required to report information about what was sold. It is also required to report liabilities, including guarantees and recourse obligations, incurred in the sale, on the face of its financial statements at their fair value on the date of sale.[15]

[14] See EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions"; EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities"; and EITF Topic No. D-14, "Transactions involving Special-Purpose Entities."

[15] See FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (September 2000).

- A reporting entity that enters into certain derivatives or energy trading contracts is required to recognize those contracts in its financial statements at fair value, including the fair value of any obligation that arises from those contracts.[16]

- A reporting entity is required to disclose in the footnotes to its financial statements the fair value of its financial instruments, including the fair value of any commitments, letters of credit, financial guarantees, or debt.[17]

- A reporting entity is required to disclose certain unrecorded long-term obligations in its financial statements.[18]

- A reporting entity is required to disclose indirect guarantees of indebtedness of others in its financial statements.[19]

- A reporting entity is required to recognize certain loss contingencies in its financial statements, including guarantees of indebtedness of others, and to disclose the nature and amount of loss contingencies in its financial statements even though the possibility of loss may be remote.[20]

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[16] See FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998); and EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities."

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

[18] See FASB Statement No. 47, *Disclosure of Long-Term Obligations* (March 1981).

[19] See FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others* (March 1981).

[20] See FASB Statement No. 5, *Accounting for Contingencies* (March 1975).

In recent testimony before Congress, SEC Chief Accountant Robert K. Herdman commented on the existing accounting requirements for SPEs.[21] He stated, "On balance I think that the special purpose entity accounting is working as well as could be expected right now, but it does cry out for the FASB to finish their project here and conclude whether . . . a different set of rules should be enacted."[22] The FASB project that Chief Accountant Herdman was referring to in his testimony is one of a group of the Board's related projects on consolidations and related matters.

In 1982, the Board added a group of projects on consolidations and related matters to its agenda. The projects were intended to cover all aspects of accounting for affiliations between entities along with several other matters that raise similar or potentially related issues about financial statements. Specific areas to be addressed by the projects included:

- Consolidations policy and procedures
- The equity method of accounting
- Disaggregated disclosures or segment reporting

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[21] See Transcript of hearing before the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee and Oversight and Investigations Subcommittee of the Committee on Financial Services, United States House of Representatives, page 28 (December 12, 2001).

[22] Transcript of hearing, page 28. The SEC recently issued a Commission statement setting forth certain of its views regarding disclosure that should be considered by public companies while preparing annual reports for the year ended December 31, 2001. Those views included a reminder of existing disclosure requirements relating to liquidity and capital resources, including off-balance-sheet arrangements, certain trading activities that include non-exchange-traded contracts accounted for at fair value, and effects of transactions with related and certain other parties. See Release Nos. 33-8056; 34-45321; FR-61 (January 22, 2002).

- Investments in unconsolidated entities and joint ventures

- New basis or "push down" accounting in the financial statements of subsidiaries.

Since adding the group of projects to its agenda, the Board has issued two major standards. The Board has also issued, through other projects, extensive guidance in the form of Statements and Interpretations that address the accounting for SPEs or other off-balance-sheet financing arrangements.[23] The EITF also has issued guidance in the form of consensuses that address those areas.[24]

The first major standard, issued in 1987, requires consolidation of the assets and liabilities of all majority-owned and controlled subsidiaries in the financial statements of the parent entity.[25] That standard eliminates what was arguably the major vehicle for off-balance-sheet financing at the time in terms of the amounts involved. Before that standard, many entities established a financing subsidiary that borrowed capital and utilized that capital to finance customer purchases of the products of its parent and other affiliates or finance other parts of the operations of the consolidated group. Such subsidiary assets and liabilities often were not consolidated, even if the parent entity owned all of the subsidiary's equity.

[23] See Attachment 4 for a detailed listing of guidance provided by FASB Statements and Interpretations related to related party transactions, special purpose entities, and off-balance sheet financial arrangements.
[24] See Attachment 5 for a detailed listing of significant EITF issues related to special purpose entities and off-balance-sheet financial arrangements.
[25] See FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (October 1987).

The second major standard, issued in 1997, requires improved reporting of information about an entity's various operating segments.[26]

In addition, the Board issued two Exposure Drafts addressing consolidation policy—the first in 1995 and the second in 1999.[27] Establishing criteria or policy for determining which entities should be included in a set of consolidated financial statements involves many difficult considerations extending beyond SPEs, and both of those proposals were extremely controversial. For example, the most controversial issue in the project on consolidations policy has been whether to require consolidation of entities that a parent entity effectively controls by means other than majority ownership, such as a large minority holding if ownership of the majority is widely dispersed. That issue extends beyond what are usually thought of as SPEs, and both Board members and constituents have been sharply divided on it.

The Board continues to actively pursue further improvements in connection with its longstanding project on consolidations policy and procedures.[28] In November 2001, the Board decided to concentrate its efforts on developing guidance on an expedited basis for dealing with consolidation policy issues that have been identified by constituents in the following four areas:

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[26] See FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997).

[27] See FASB Exposure Draft, *Consolidated Financial Statements: Policy and Procedures* (October 16, 1995); and FASB Revised Exposure Draft, *Consolidated Financial Statements: Purpose and Policy* (February 23, 1999).

[28] See Attachments 6 and 7 for a summary of the Board's project on consolidations policy and procedures and a detailed timeline of the Board's activities in connection with the project, respectively.

1. So-called strawman situations (for example, situations in which control of an entity is indirect and perhaps disguised through holdings of an entity's agents, management, or other related parties)

2. Entities that lack sufficient independent economic substance

3. Convertible instruments and other contractual arrangements that involve latent control

4. The distinction between participating rights and protective rights of various shareholders, partners, and other investors in an entity.

The Board believes that effective guidance for the above situations would resolve many of the issues encountered by some entities in present practice, including issues relating to consolidation of SPEs. The Board's immediate plans are to issue proposed guidance dealing with the first two of those situations in the second quarter of this year and the following two situations soon thereafter.

What Are Related Parties, and What Are the Accounting Requirements for Related Party Transactions?

For accounting purposes, related parties are defined quite broadly to include:

- Affiliates of the enterprise

- Entities in which the enterprise has investments that it accounts for using the equity method

- Management of the enterprise (including members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions, and other persons who perform similar policy-making functions)

- Other parties with which the enterprise may deal if one party controls or can significantly influence the management and operating policies of the other to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

- Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its separate interests.[29]

Transactions with related parties generally are *accounted for* in the same way as if they were transactions with unrelated parties. More specifically, related party transactions generally are required to be accounted for in accordance with their terms; it usually would not be feasible to account for a transaction based on what the terms might have been had the transaction been between unrelated parties.[30] Reporting entities, however, are required to disclose detailed information in their financial statements about their

[29] FASB Statement No. 57, *Related Party Disclosures,* paragraph 24(f) (March 1982).
[30] One exception involves the accounting for leases. In cases where "it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related . . . the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form" (FASB Statement No. 13, *Accounting for Leases,* paragraph 29 [November 1976]).

related party transactions. Those requirements include, but are not limited to, disclosure of:

1. The nature of the relationship(s) involved

2. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements

3. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

4. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.[31]

In describing the basis for the Board's conclusions regarding those requirements the Board stated:

> The Board believes that an enterprise's financial statements may not be complete without additional explanations of and information about related party transactions and thus may not be reliable. Completeness

[31] Statement 57, paragraph 2.

implies that ". . . nothing material is left out of the information that may be necessary to insure that it validly represents the underlying events and conditions."

The Board also believes that relevant information is omitted if disclosures about significant related party transactions required by this Statement are not made. "Completeness of information also affects its relevance. Relevance of information is adversely affected if a relevant piece of information is omitted, even if the omission does not falsify what is shown." [Footnote references omitted.][32]

What Is Mark-to-Market ("MTM") Accounting, and What Are the Requirements for MTM Accounting?

"Mark-to-market" or "MTM" accounting describes an accounting method whereby certain contracts (largely financial contracts but also some nonfinancial contracts) and the changes in the value of those contracts are reported at their fair value on the face of an entity's financial statements. MTM accounting has long been used by broker-dealers and traders of financial contracts, for both internal and external reporting purposes, to provide transparent and relevant information to management and investors about the economic results—favorable and unfavorable—of the entity's trading activities. Those entities utilize MTM accounting not only because it provides the most relevant information, but

[32] Statement 57, paragraphs 16 and 17.

also because other cost-based accounting methods present difficulties that can result in opaque and potentially misleading information about those activities.

Beginning nearly a decade ago, in an effort to further improve the transparency of financial reports in the face of similar difficulties, accounting standards gradually expanded MTM accounting beyond broker-dealers and traders of financial contracts to entities that buy or sell certain financial instruments and other contracts. Thus, MTM accounting became required for certain debt and equity securities in 1994,[33] energy trading contracts in 1999,[34] and certain derivative instruments in 2000.[35]

MTM accounting is especially important in providing relevant and transparent information about energy trading contracts and many derivative instruments because the alternative often would be not to account for the contracts at all during the period they are outstanding. Because energy trading contracts and many derivative instruments often are entered into at no net upfront cost (because they create rights and obligations that are initially equal but opposite), those contracts escape accounting recognition in a cost-based accounting model until the contracts are transferred or closed.

One element of MTM accounting is computing a contract's fair value and changes in fair value. The accounting requirements for determining those amounts include the following:

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[33] See FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993).
[34] See EITF Issue 98-10.
[35] See Statement 133.

Fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is . . . that market price.[36]

Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, options pricing models, or matrix pricing models).[37]

[36] Statement 107, paragraph 5.

[37] Statement 107, paragraph 11. The Board has an active agenda project to determine whether the requirements in Statement 107 should be improved. The Board plans to issue a proposal to replace Statement 107 in the first quarter of 2003. In addition, the EITF is in the process of codifying additional interpretative guidance about the accounting for energy trading contracts, including guidance for measuring the fair value of those contracts and providing disclosures about the presentation of the gains and losses on those contracts. See EITF Issue No. 02-3, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities."

Chief Accountant Herdman in his recent testimony before Congress stated:

> I don't believe that there's any evidence to indicate that Mark-to-Market accounting has led to misleading information to investors. The broker/dealers in this country have used Mark-to-Market accounting . . . to account for their activities for many, many, many years. And they have sophisticated financial instruments that aren't quoted on exchanges that need to be accounted for at market value. And so estimates need to be made of value in order to accomplish the mark-to-market process.[38]

He also added, "We haven't seen any indication that Mark-to-Market accounting has caused problems . . . for any . . . companies within the energy industry."[39]

Finally, in commenting on the existing MTM accounting requirements, Chief Accountant Herdman stated, "I think the principles of Mark-to-Market accounting are quite clear in the accounting literature that exists today, and the circumstances under which it should be done."[40]

Did Enron's Financial Statements Comply with Existing Accounting Requirements?

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

[38] Transcript of hearing, page 22.
[39] Transcript of hearing, page 22.
[40] Transcript of hearing, page 22.

accounting requirements in at least two areas. First, Enron indicated that with respect to four SPEs that it created during the year 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.[41]

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 (see above discussion, "What Is an SPE, and What Are the Accounting Requirements for SPEs?"). 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.

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

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 recent 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.[42]

More recently, a committee of three outside members of Enron's board of directors filed a public report ("Powers Report") that stated that its investigation "identified significant problems beyond those Enron has already disclosed."[43]

Those further problems included entering into transactions that Enron

> could not, or would not, do with unrelated commercial entities. Many of the more significant transactions

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

[43] 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., page 3 (February 1, 2002).

> 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.[44]

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."[45]

The Powers Report also states that Enron's disclosures about its transactions with the partnerships were "obtuse, did not convey the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the parternships."[46]

Conclusion

The FASB is responsible for establishing and improving financial accounting and reporting standards that ensure that financial reports provide transparent information to investors and other consumers.

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[44] Powers Report, page 4.
[45] Powers Report, page 4.
[46] Powers Report, page 17.

I want to assure you, Mr. Chairman, Ranking Member Towns, and all the Members of the Subcommittee, and all investors and other consumers that participate in the US capital markets, that consistent with the FASB's mission and due process, the Board is prepared and committed to proceed expeditiously to resolve any and all financial accounting and reporting issues that may arise as a result of Enron's bankruptcy.

The Board already has active projects under way in over a half-dozen areas that will propose significant improvements to existing requirements in the areas of:

- Accounting for consolidations, including consolidations of SPEs
- Determining the fair values of financial instruments
- Disclosing fair values and changes in fair values of financial instruments, and
- Distinguishing liability instruments from equity instruments and accounting for complex instruments with both debt and equity components.

The Board also is cognizant that some, including SEC Chairman Harvey L. Pitt, have raised concerns about the speed of our standard-setting activities. As described above, we have begun pursuing a number of projects and activities to improve our efficiency and effectiveness without jeopardizing the openness and thoroughness of our due process that are essential to maintaining high-quality accounting standards.

The FASB and the accounting standards we issue, however, cannot alone sustain the transparency necessary to maintain the vibrancy of our capital markets. Other market participants also must carry out their responsibilities in the public interest. Those participants include officers and directors of reporting entities, auditors, and regulators.

Officers and directors of reporting entities that seek to access the capital markets to finance their needs are responsible for preparing their financial statements and presenting those statements to investors and other consumers. They must apply the accounting standards in a way that is faithful not only to the language of the requirements, but to the requirements' clear intent. Seeking loopholes to find ways around the language or intent of the standards obfuscates reporting and harms investors and other consumers by creating information that is not transparent and that is not a true reflection of the economics of the underlying transactions.

Auditors are required to examine a reporting entity's application of accounting standards to determine that the requirements have been fairly applied. They too must ensure that not only the language, but the stated intent, of the standards are followed, and not accept facile arguments by a reporting entity's management that the financial statements are acceptable just because the language of the standards does not explicitly prohibit an inventive reporting technique or methodology that is intended to hide information from unsuspecting consumers. Auditors' primary responsibility is to the investing public who do not have the benefits of the same level of access as auditors do to the underlying facts about an entity's operations and transactions.

Finally, regulators, principally the SEC, also have an important role to play. The SEC's responsibility is investor protection. Through its oversight and enforcement activities it must also seek to ensure that reporting entities provide information consistent with the language and intent of the relevant standards. The SEC must also ensure that auditors, in accordance with accepted auditing standards, have properly and thoroughly examined and certified the reporting entity's information.

If anything positive results from the Enron bankruptcy, it may be that this highly publicized investor and employee tragedy serves as an indelible reminder to all of us, including reporting entities, auditors, and regulators, that transparent financial accounting and reporting do matter and that the lack of transparency imposes significant costs on all who participate in the US capital markets. Conversely, providing transparent financial information the markets need to operate efficiently benefits not only those who use the information but also the entities who provide it. The Royal Swedish Academy of Sciences recognized the importance of adequate transparent information to markets in awarding the 2001 Nobel Prize for Economics to three Americans for their pioneering contributions to the theory of how markets work when buyers and sellers have differing amounts of information.[47]

The work describes why market participants may overdiscount for the effects of uncertainty if they do not trust the information available to them. The result is that items traded in that market, whether it is the market for stock in entities or the market for used cars, are not efficiently priced. In essence, providing transparent, credible information lowers the risk premium charged by market participants.

Thank you, Mr. Chairman. I very much appreciate this opportunity and would be pleased to respond to any questions.

[47] The Royal Swedish Academy of Sciences, "The Prize in Economic Sciences 2001," press release (October 10, 2001).