ARE CURRENT FINANCIAL ACCOUNTING STANDARDS PROTECTING INVESTORS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

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HOUSE OF REPRESENTATIVES

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THURSDAY, FEBRUARY 14, 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 9 a.m., in room 2212, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Bryant, Buyer, Terry, Bass, Towns, DeGette, Harman, Markey, Rush, and Eshoo.

Staff present: Ramsen Betfarhad, majority counsel; David Cavicke, majority counsel; Brian McCullough, majority professional Staff; Brendan Williams, legislative clerk; Consuela Washington, minority counsel; David Nelson, minority investigator.

Mr. STEARNS. Good morning, everybody. I think what we will do, while members might be trickling in, I think I will start with my opening statement and even start with some of the witnesses and we can, as members come in, although it is not the normal procedure, we can break after the witnesses, to have some of the members' opening statements, but I would like to continue on, since we were supposed to start at 9 o'clock.

Introspection abounds in many sectors of business following the collapse of Enron. Boards of Directors are rethinking their duties of loyalty and duties of care, auditing firms are reviewing their client relationships with an eye toward independence, and Wall Street is contemplating more diligent company review rather than relying on market momentum.

Congress, too, is asking whether current accounting and disclosure standards are adequate to protect investors. If not, what Congress, the Securities and Exchange Commission, and the Financial Accounting Standards Board should do to make necessary changes.

Last week, Chairman Tauzin kicked off our review by holding a full committee hearing examining accounting standards, corporate disclosure, corporate governance, and the state of the auditing industry.

We will follow up on that hearing today with an in-depth look at the adequacy of current accounting standards. The central tenet underlying financial reporting is fair and transparent disclosure. All market participants benefit from approved accounting standards and meaningful disclosure. Counterparts can better understand the conditions of those with whom they transact, investors can make informed investment decisions, and companies themselves benefit from a cost-of-capital that accurately reflects risk profiles.

Our look at financial reporting today will focus on two main issues, off balance sheet accounting for special purposes entities and accounting for derivatives and financial contracts.

My colleagues, to qualify for off balance sheet treatment, current accounting rules require 3 percent of total capitalization of an SPE be an equity investment of an unrelated third party. The Enron implosion highlighted deficiency in the off balance sheet test even though for various reasons Enron's SPEs failed to meet the requisite 3 percent threshold.

The 3 percent test is arbitrary and does not adequately capture the economics of the transactions it records. It allows liabilities to be moved off balance sheet, without a true transfer of risk from the sponsoring company to the SPE.

FASB has been working on off balance sheet issues for some 10 years now. I look forward to an update on the progress of that project and hope for discussion on how we can expedite a resolution.

The second issue we will examine is the mark-to-market issue for derivatives in financial contracts. Mark-to-market accounting has increased transparency for liquid instruments in short-term contracts. It has, however, presented difficulties for valuing assets in long-term contracts. Valuation is arbitrary where there is no ready market for an asset. To assign a value to these assets, companies develop mathematical evaluation models. However, there is significant leeway in the assumptions underlying valuations, and since companies consider the models proprietary, assumptions underlying valuations are neither disclosed nor audited. Values assigned in this so-called mark-to-model accounting can be misleading to investors. So, I look forward to hearing what our witnesses have to say about mark-to-market accounting and the disclosure necessary to make the reported information transparent and meaningful to investors.

Congress, the SEC and FASB must be diligent in assessing the state of our financial reporting in the United States today. While today is a good start, I assure you this is just an ongoing process. With this, I urge the SEC to begin to fulfill its responsibilities of ensuring adequate disclosure in financial statements. If the SEC had reviewed Enron's filings over the past 3 years, it may have discovered the lack of disclosure and the problems the inadequate disclosure concealed.

Also, I am troubled by the SEC's recent assertion that one can violate SEC law even while fully complying with GAAP. It is clear that companies and their auditors have an obligation to comply with both the letter and the intent of GAAP. However, the SEC's comments go too far. The SEC seems to be ducking its responsibility to fix problems with GAAP and corporate disclosure by using its enforcement authority to impose burdensome standards on public companies and their auditors. As in a planned economy of old, that which is not explicitly permitted is prohibited. This is not a proper standard for a flourishing market economy.

I also urge FASB to be more expeditious in its review of financial standards. While I commend the fair process by which FASB has produced standards, I suggest FASB work with this committee to come up with a way to ensure due process while fixing deficiencies in a timely fashion.

As for this committee, it is clear we must start with the issues that have been highlighted by the Enron implosion, but our work cannot stop there. Improving financial reporting is a full-time job. As the markets evolve, we must keep pace with them to assure a robust and transparent reporting system.

So, I look forward to hearing from our distinguished panel today, and working with them to improve accounting standards and, obviously, financial reporting.

With that, for an opening statement, the gentlelady from California.

Ms. ESHOO. Good morning, Mr. Chairman.

Mr. STEARNS. Good morning.

Ms. ESHOO. It seems as if the morning came very quickly. Well, I want to thank you for having this hearing. It is an important one, and welcome to the gentlemen at the table. We have a few chairs between us, but I think it is because the hearing room, our main hearing room downstairs, is being redone. So, we are kind of scuttling all over the place to find a place to have these hearings but, nonetheless, it is important that we are here this morning on this issue of financial accounting standards.

We have had many hearings on the issue of financial accounting standards over the years. Now, because of the Enron implosion, as the chairman said, we need to examine very, very carefully what went wrong, and the steps that we need to take in order to make things right.

We know that there has been expanded participation by investors in our financial markets, and that is really based on their having informed—being able to make informed decisions, and informed decisions are really more important than ever. But when information provided by companies is false, investors, of course, are deprived of the opportunity to make these informed decisions. False information, bad information, can destroy the wealth, what employees are accumulating, and that leads to—obviously, has led to severe losses.

Investor confidence is really the “coin of the realm.” If, in fact, investors have confidence—and our markets depend on that—then they will make good decisions. If that is not the case, then that is undermined, and timely information is very important as well.

We are also all dependent upon the decisions of accountants being accurate, that they are timely, that they are comprehensible, and that they are complete. The collapse of Enron, of course, has shaken investor confidence. It has shaken all of us.

I think, on September 12, Americans said, “How could this have happened to us?” With the failure, with the collapse of Enron, we are now all saying, “How could this have happened?” How could this have happened in the corporate world?

So, we have to be really vigilant in terms of examining the extensive financial knowledge and how it was applied, how it was misapplied, and the complex accounting schemes that were developed, and I think this is very important to the American people.

I don't think, at the end of our examination and at the end of our legislating, that everyone in the country is going to understand complex accounting standards, but we can, indeed, I think, bring more transparency, and we need to weed out what went wrong with what is right in America. What I am concerned about is that we are going to be throwing the baby out with the bathwater in this. And our job as legislators is to be very prudent, to be tough, to be fair, and at the end of this, really come out with standards that are going to be fit for the nobility of the American people because that is what we are here for.

So, this hearing, Mr. Chairman, provides us with the first opportunity to assess what investor protections should be bolstered, and also where better enforcement, much better enforcement, will serve future employees and future generations because that is what we are here for.

So, again, I thank the witnesses for being here. I thank the chairman for calling this hearing. And I will stay on it and stay with you to make the system better. Thank you, Mr. Chairman.

Mr. STEARNS. I thank you for also coming on this early time. The gentleman from Nebraska, Mr. Terry.

Mr. TERRY. Thank you, Mr. Chairman, for calling this hearing. When I received notice of this hearing, I thought the 9 o'clock start was completely appropriate. Now, since it is 6 hours after our last vote, it doesn't seem so much that way. But this is an important matter and we need to get as much information, so I appreciate you calling this hearing.

Last week, Mr. Chairman, as you may recall, we had the opportunity to listen to many distinguished accounting professors from some of the most esteemed business colleges from this country, and they were asked one question, and that was if they thought an MBA graduate from their institution would be able to understand Enron's financial statements, and they answered no.

The Wall Street Journal recently published a story characterizing the byzantine financial procedures as the "black box" of accounting. The article went on to state that "in some instances, these black-box methods are so difficult to comprehend that even audit committees and CFOs have difficulty deciphering them." At least in the Omaha World Herald, one of the most renowned papers in the Nation, or at least the one I read mostly, there was an article about Warren Buffett saying a similar thing, that many of the financial statements that he reads are so complex that he concludes that "sometimes they are trying to tell him nothing," and maybe that is the point.

In light of these very complicated methods of accounting, I was interested to read in Mr. Jenkins' testimony, the listing of some of FASB's recent initiatives, which include issuance of standards that improved the transparency of business combinations; issuance of a standard that improved the transparency of purchased good will and tangible assets; issuance of a standard that improved the transparency of asset retirement obligations; issuance of standards that improve the transparency of impairment or disposal of long-lived assets; and the issuance of a report that encourages companies to continue improving their business reporting and to experiment with the types of information disclosed in the manner by which it is disclosed. That is why we are here today, is to discuss those types of solutions to the problems that face our economy and businesses today.

Ms. Eshoo, you echoed a concern of mine that was echoed by at least one witness to our full hearing last week, and that is, we have to restore the confidence back into the capital market system, the investors have to have confidence that what they read is accurate and true.

So, I appreciate you holding this hearing, Mr. Chairman.

Mr. STEARNS. I thank the gentleman. The gentlelady from Colorado, Ms. DeGette.

Ms. DEGETTE. Thank you, Mr. Chairman. Most of my constituents think that accounting is easy, you just add up the numbers and then you check the bottom. I know one corporate accounting office, for example, that has teeshirts that say "Go figure," and that is what they do. But the complexities of regulatory requirements and interpretations of corporate practice make accounting these days difficult in the best of times.

One practitioner I talked to said that "accounting is a combination of basic math, medieval alchemy, and religious insight." Accounting is an imperfect practice requiring the judgment of individual accountants and auditors. Of course, difficulties multiply when the auditor faces an inherent conflict of interest and when the bottom line of the consulting practice is more lucrative than the full disclosure and transparency for investors.

We learned about the failure of adequate accounting at Enron last week from the Power's report, and 2 weeks ago in the Oversight and Investigations Committee on which I sit. Our hearings on Arthur Andersen's accounting practices in Enron were illuminating because what we found is there was nothing inherently wrong in Andersen's accounting rules that would stop document shredding, for example, and, of course, if you shred the documents, it becomes that much harder for investors to find out what is going on.

Now, Congress has the duty to determine how the system failed and what, if any, actions Congress can take to restore public trust through more transparency safeguards, more public accountability, and better public oversight.

We have heard a number of proposals for reforms, including more shareholder involvement with auditors, more regulations to prevent conflicts of interest, more rigorous and independent peer review, and full disclosure of partnership interactions among others.

I hope that we will, Mr. Chairman, examine many of these potential reforms in detail because there is no magic bullet in this instance. We cannot fix with one swoop all the problems that we have encountered from the Enron collapse.

Today, I would like to focus on ways to ensure adequate disclosure of financial risks on company statements, which is really the heart of the problem here, I think. One of Enron's failings was its ability to engage in highly volatile transactions while not disclosing the risk involved. Enron, and probably their auditors, will argue that disclosure was made in the footnotes of these financial statements. However, these financial statements were dense, opaque, and difficult to understand.

In today's marketplace, with increasing ease of investment and increasingly less sophisticated investors, it is necessary to devise accounting standards that will provide average investors with their stock in 401(k) programs, as well as Wall Street analysts, with a truthful snapshot of a particular company's risk. This story is still unfolding.

As Congress continues to investigate the collapse of Enron, we will likely encounter additional accounting and auditing issues. This is a unique time for Congress to review accounting standards and assure that we have protection and transparency for the investor.

I am glad you are having this hearing, Mr. Chairman, even at 9 o'clock, and I look forward to hearing all the witnesses today, and yield back my time.

Mr. STEARNS. Thank the gentlelady. The gentleman from New Hampshire, Mr. Bass, is recognized.

Mr. BASS. Thank you very much, Mr. Chairman. I guess there is a theme this morning, however, I had a meeting at 8, so this is my second event of the day.

I guess the old saying "show me the money" is certainly more applicable now than ever before, with respect to accounting and business practices of investors, and I have learned a lot about accounting even as a small business person myself over the last few months, and I have come to understand the old saying "cash is fact, everything else is opinion" certainly applies more than I ever thought it might.

Others have said today that re-establishing confidence in the capital market through good new accounting standards and enforcement tools are certainly going to be one of the biggest opportunities and challenges for this subcommittee and the whole committee, and I will be looking to our panelists today to amplify on what areas of our accounting reviews need to be re-examined and what potentially new enforcement standards may be required from Congress.

So, with that, Mr. Chairman, I will yield back to you, and I think we are ready to listen to the panel.

Mr. STEARNS. Thank the gentleman. We have the distinguished ranking member, Mr. Towns, from New York, and I welcome his opening statement this morning. Good morning.

Mr. TOWNS. Thank you very much, Mr. Chairman. Fourteen years ago, then Chairman of this Commerce Committee was a gentleman by the name of John Dingell, held a number of oversight hearings on some of the very same accounting standards that confront us today. In response to these hearings, the Financial Accounting Standards Board was established. Unfortunately, it seems that this well-intentioned measure has failed the American people and the American investor. Of course, I am referring to the example of the Enron Corporation, the once seventh largest corporations in America. Two of the main reasons that this corporation filed for bankruptcy was a combination of bad accounting practices and conflict of interest between consultant services and auditing services.

The collapse and related scrutiny of its accounting practices has increased investors' awareness of a number of accounting standards that previously had been ignored by investors. The American investor is all too aware that many of these standards are being abused by many in corporate America and industries. These standards include the following: Nonconsolidation of the so-called "special purpose entity," the disclosure of related party transactions, issues of equity securities for something other than cash mark-to-market accounting, accounting for contracts involving energy trading and risk management activities, and restatements of previously issued financial statements.

Members of the accounting industry must improve these standards and prove to the American public that their industry and membership can, and should, be trusted once again.

I look forward, Mr. Chairman, to the hearing of the witnesses today, and I yield back.

Mr. STEARNS. Thank the gentleman. The gentlelady from California is recognized for an opening statement.

Ms. HARMAN. Thank you, Mr. Chairman. Happy Valentine's Day, everyone. Let us hope that on this day and on following days, we both have improved national security and economic security. This hearing is really about how to improve our economic security and now to assess whether accounting practices that have been employed by Enron and other firms are what they need to be or, whether in the interest of economic security for America, we need to make some changes.

In particular, today I hope our witnesses will focus on whether deficiencies of current accounting standards, or their implementation or lack thereof, allow the shortcomings and failures that led to the bankruptcy of Enron and perhaps a few other recent entities.

The Enron bankruptcy has all the elements for scandal—avarice, deceit, hubris, obfuscation, malfeasance, self-dealing, influence peddling, manipulation, indifference and, unfortunately, even suicide. But it has at its core—and this is the saddest, I think, observation—dereliction of duty: dereliction of the duty board members have to shareholders; dereliction of the duty corporate management has to investors, employees and customers; dereliction of the duty auditors have to market analysts, the public and regulators; and even dereliction of duty that lawyers—and I happen to be a lawyer—have both to our clients and our system of justice. To be sure we have in place a system of checks-and-balances to protect investors in the public, but whatever the checks-and-balances in place at the time came for naught as those expected to exercise their responsibilities violated them or, worse, ignored them.

We may learn that there were many motivations for the behavior we have observed at Enron, Andersen, and elsewhere but, more importantly, what does that say for any additional checks-and-balances Congress or regulators may impose in the future? We may never be completely successful in changing behavior or the corporate environment that nurtured it, but we can, and we must, try.

We must, as legislators, as parents, and as citizens, respect the obligations we assume as members of society. We must also work to ensure that collateral damage is limited, and that those responsible are brought to a full accounting, and that public confidence in our markets, in our government institutions and our regulatory agencies, and in American business is restored as quickly as possible.

Thank you again, Mr. Chairman, for convening today's hearings. I look forward to participating as this committee seriously, professionally, and completely fulfills its obligations.

Mr. STEARNS. I thank the gentlelady. Mr. Buyer is recognized for an opening statement.

Mr. BUYER. I will pass.

Mr. STEARNS. The gentleman will pass. The gentleman from Tennessee, Mr. Bryant.

Mr. BRYANT. Thank you, Mr. Chairman. I want to thank you also for holding this hearing today, and the panelists for coming to testify before us today.

One of the most amazing aspects of Enron's collapse was that virtually no one saw it coming. And, of course, the question now is, or did they. It certainly seems that Enron had built a complex house of cards, seemingly over-valued for massive amounts of hidden debt and manipulative bookkeeping. That is why this hearing is so important today.

We have the opportunity to roll up our sleeves and take a look at the complexities of accounting standards. It is now evident that Enron violated existing accounting standards set by the national Accounting Standards Board, however, the rule on mark-to-market accounting is hard to enforce because the formula has so many factors. Enron was able to move its debts off the books by using special purpose entities. I understand that the rules regarding SPEs have been under review for sometime now, and I look for to hearing from the panelists today on this issue.

The fear of many of my constituents invested in the stock market is that you no longer can trust corporate financial statements. It is a legitimate worry that more companies may have Enron-type accounting bombshells to drop. I think certainly we can see that with the reaction of the stock market almost on a daily basis.

Large corporations with complex business models are susceptible to investor fears because their exact financial position is difficult to measure. Investors have been fraught amid questions about the market's biggest players' profits being the result of creative accounting. Our fragile economy does not need mass hysteria in the market resulting from innuendo and hearsay about a corporation's accounting standards. We must restore investor confidence in the accounting profession.

I am interested in hearing from the accountants on the panel regarding regulatory reforms of the accounting profession. Shareholders deserve better disclosure of accounting information and financial reports prepared in plain English.

I look forward to today's hearing, and again thank the chairman for holding this important hearing.

Mr. STEARNS. I thank the gentleman. I think we are complete with the opening statements.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. GEORGE RADANOVICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, today's hearing is a vital step in protecting our nation's capital markets. The integrity and stability of our capital markets are heavily dependent on the accuracy and proficiency of our financial accounting system. If corrupt business executives continue to find ways to bypass financial accounting rules, investor confidence will deteriorate.

The special purpose entities (SPEs) that were designed to enrich top Enron executives and defraud stockholders have raised public concern about whether the current accounting standards are insufficient. Investors of Enron were not provided the correct information needed to properly review the complex financial instruments and structures that were set up by Enron executives. We need to find out if the accounting standards are capable of extracting the transparency required by investors or whether corrupt companies are breaking the rules.

The Enron Special Investigation Committee uncovered dozens of transactions with special purpose entities effectively controlled by the company to hide bad investments. In California, Enron used one of their SPEs to form Azurix, a water trading company that dissolved this year, but not before a handful of executives made millions. In aggregate these transactions were used to report over $1 billion of false income through mark-to-market accounting and hide the decline in Enron's asset value. Such transactions should reflect true market conditions, and not false predictions made up of twenty-year forecast.

In the end, I hope we can answer these troubling questions raised by Enron regarding the efficacy and relevance of the existing financial accounting standards. Thank you, Mr. Chairman, for holding this hearing today. I look forward to the witnesses' testimony.

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

Today we are continuing to explore the policy implications of the Enron collapse—specifically whether accounting standards are adequate to present meaningful and transparent views of the financial health of our publicly traded companies.

We have learned that Enron filed false and misleading accounting statements that were not in accordance with GAAP. We have seen that some of Enron's management engaged in self-dealing that amounted to theft of shareholder assets and that the Directors and auditors who were suppose to supervise the corporation failed to prevent this theft.

We have also learned that Enron had a tangled web of off-balance sheet partnerships serving to hide billions of dollars in debt and other liabilities from public accounting statements and the market.

Today we will consider whether rules that facilitate off-balance sheet accounting need revision. Under current accounting practice, if an outside person owns as little as 3% of the equity of a company, that company's assets and liabilities can be taken off the books of the sponsoring company.

A test of real economic control makes more sense than the 3% rule. The Financial Accounting Standards Board has a long running project on off-balance sheet accounting. We will be looking for a status report on that project, and want to encourage FASB to expedite its consideration. I understand, yesterday, as an interim measure, FASB has proposed raising the 3% level to 10%.

We also want to consider issues like market-to-market accounting, and the use of pro forma statements rather than GAAP.

I have a message for the SEC officials here for you to deliver to Chairman Pitt. We have learned the SEC conducted no meaningful review of Enron's financial statements and required SEC disclosure from 1997 to 2001. The SEC should be taking steps under existing law to prevent additional Enrons. Such steps would include reviewing filed financial disclosure. Yesterday, an SEC official was quoted in the press as saying a company could comply completely with GAAP and still commit securities fraud. Such grandstanding is unhelpful. The SEC has not provided adequate guidance on what constitutes materiality for purposes of disclosure. Although this stance preserves all bureaucratic options in the event of a collapse like Enron, it does little to guide the overwhelming majority of honest companies who want to provide complete disclosure to the markets.

Chairman Pitt has also called for the creation of an oversight mechanism for auditors. This proposal appears to be a continuance of the status quo in which oversight is conducted by the accounting trade association. This hasty proposal appears to have little substance and provides us with little comfort that meaningful change is coming. We in Congress will have to take a look at this question.

I commend Chairman Stearns and Ranking Member Towns for holding this hearing. I commend my friend John Dingell for the continuing bipartisan cooperation we have had in the Enron investigation. We have important issues to consider today. I yield back the balance of my time.

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

Mr. Chairman, I commend you for scheduling today's hearing into whether our current accounting standards are protecting investors.

Enron's demise has focused public attention on accountants and auditors and the rules that they apply. A growing body of evidence suggests that Enron represents an egregious case of bad if not corrupt corporate management, misleading accounting and financial disclosure, shoddy auditing, and outright fraud. But the weaknesses illuminated by this debacle have long been familiar from previous scandals involving appalling audit failures. These include Cendant, Sunbeam, Waste Management, Microstrategy, and, most recently, Global Crossing. It is urgent that we respond soon with the right reforms.

I have been and remain a strong supporter of the Financial Accounting Standards Board (FASB) and the important work that it does. FASB has always produced high-quality standards, often against great odds. One criticism that we will hear today is that FASB's standard-setting process is too cumbersome and FASB is too slow in addressing a number of controversial and cutting-edge issues. FASB has been too slow, but not without help. I recall a rash of appropriations riders, as well as nasty letters, from key Members of Congress on some of these same issues in the past, telling FASB to go back and study for a year or more, re-propose the standard for public comment, or hold more hearings. You can't have it both ways.

Another criticism is that FASB's standards are too complex. So too are the financial transactions and structures to which they apply. A lot of the complexity is the result of comment letters to FASB asking for specific interpretations and clarifications. It seems that we may be damning FASB for the act of being responsive to its constituents. If FASB did simpler rules, I suspect we would be hearing complaints that FASB wasn't giving appropriate guidance.

I believe that we should aim for improvements that make sense. We should be mindful of the trade-offs and the unintended consequences. We should not compromise the public interest.

That brings me to the proposal to scrap "rule-based" standards and instead go to "principle-based" accounting standards. Mr. Herdman's testimony warns us that: "A move to principle-based standards will require greater discipline by the corporate community, the accounting profession, private-sector standard-setting bodies, and SEC staff . . . [A]ll constituencies must make concerted efforts to report transactions consistent with the objectives of the standards." I have no such faith in human nature. I don't believe for an instant that the good folks at Enron and Arthur Andersen would have felt more constrained by general principles than they were by explicit rules. Enron happened because these bad actors stood the rulebook on its head in order to achieve illegal objectives. Crooked management and abetting accountants will have more room to maneuver under general principles with no rules.

Nonetheless, Mr. Chairman, I have an open mind about these things, and I look forward to being educated by our witnesses. I welcome them and look forward to hearing what they have to say. I am especially interested in hearing more about how FASB intends to improve accounting for special purpose entities and the determination of fair values.

Mr. STEARNS. We will move to our first panel.

I want to welcome Mr. Robert Herdman, Chief Accountant for the U.S. Securities and Exchange Commission; Mr. Edmund Jenkins, the Chairman of the Financial Accounting Standards Board, and Mr. James C. Castellano, Chairman of the American Institute of Certified Public Accountants. We welcome all three of you on this early morning, and we look forward to your opening statement, and we will start with you, Mr. Herdman.

STATEMENTS OF ROBERT K. HERDMAN, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION; EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD; AND JAMES G. CASTELLANO, CHAIRMAN OF THE BOARD, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. HERDMAN. Chairman Stearns, Ranking Member Towns, and members of the subcommittee, I am pleased to appear before you on behalf of the Securities and Exchange Commission to testify on the importance of responsive and transparent financial reporting to investors and our capital markets. My written testimony addresses these issues in more detail, and I ask that it be included in the record.

Our financial reporting system has long been considered the best in the world and is one of the underpinnings of our capital markets, which are the deepest and most liquid in the world. However, certain aspects of the system can and should be improved so changes to accounting standards can be implemented more quickly, be more responsive to market changes, and provide more transparent information to investors.

Concerns about our financial reporting system precede the bankruptcy of Enron Corporation and my testimony reflects that. The Commission is investigating events associated with Enron's collapse; and, consistent with the Commission's rules and practice, I am unable to discuss the specifics of that ongoing investigation. The Commission requests that the subcommittee respect the confidential nature of the Commission's investigation and our reluctance to address specific issues related to Enron's compliance with Federal securities laws in this public forum.

The SEC relies on an independent, private sector standards-setting process that is thorough, open and deliberate. While the Commission has the statutory authority to set accounting principles, for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards. The quality of our accounting standards and our capital markets can be attributed in large part to the private sector standards-setting process, as overseen by the SEC.

The primary private sector standards-setter is the Financial Accounting Standards Board. The FASB's standards are designated as the primary level of generally accepted accounting principles, which is the framework for accounting.

The interpretative body of the FASB is the Emerging Issues Task Force. The secondary standard-setter is the Accounting Standards Executive Committee of the AICPA. The principal purpose of AcSEC is to develop standards for specialized industries under the oversight of the FASB.

Even before Enron's collapse, we called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity. Specifically, we asked the FASB to address criticisms that: The current standard-setting process is too cumbersome and slow, much of the recent FASB guidance is rule-based and focuses on a check-the-box mentality that inhibits transparency, and much of the recent FASB guidance is too complex.

Recently, some people have suggested that the FASB should be Federalized instead of remaining in the private sector. There is no assurance that simply placing the structure within the Federal Government would result in better accounting standards. For example, many question whether the FASB's proposal to expense stock compensation, before the Congress intervened, would have been better for investors.

I believe that with the Commission's leadership, the FASB can be effective, and confidence in the process can be restored. Private-sector standard-setting can work in our current business environment, even as financial transactions become more complex. Our financial reporting system can continue to be the best in the world.

When done properly, standard-setting in the private-sector has greater flexibility to complete rules more quickly than accounting standards set by the government. Furthermore, the FASB, the EITF and AcSEC are comprised almost entirely of people with accounting expertise, and the FASB has greater ability to attract and retain qualified personnel.

To understand the criticisms, it is important to understand how the current system of standard setting evolved. In the late 1970's and early 1980's, the FASB undertook a series of projects to drastically change how financial information is reported to investors and other financial users. As you might expect, such sweeping change has been very controversial and sapped the resources of the FASB.

As a result, issues such as revenue recognition, which is a factor in approximately one-half of all restatements and SEC enforcement cases, and consolidation of SPEs have not been adequately addressed by the Board. The EITF and the SEC staff have attempted to address some of the issues, but without an underlying principle the result has been disappointing.

Another criticism that has arisen over time is the trend to complex, rule-based accounting standards, particularly for financial instruments such as derivatives. This can be attributed to a number of factors including (1) changes in how companies do business; (2) granting exceptions to new controversial standards; (3) internal conflicts in the accounting literature as the conceptual underpinnings change; and (4) demands for a single answer to every question.

As I mentioned in my introduction, over the last few years many of the standards have become rule-based as opposed to principle-based, and we believe that that trend needs to be reversed and that more principle-based standards need to be enacted. The rule-based approach makes it difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standards, and rule-based standards invite financial engineering, which is one of the reasons why yesterday I sent a letter to the AICPA's Auditing Standards Board asking it to prohibit opinions on accounting interpretations that accompany investment bankers' products that are designed to achieve a particular financial statement result by taking a path around the detailed rules.

And so while FASB addresses issues of timeliness, transparency and complexity, it must remain nimble to deal with changes in the market. It must accelerate its efforts to achieve short-term convergence with the International Accounting Standards Board and coordinate with the SEC's financial reporting and disclosure reform initiatives so our capital markets can continue to be the deepest and most liquid in the world.

In summary, let me reiterate that we have the deepest and most liquid capital markets in the world now largely because of the high quality of our financial reporting system. While it is imperative that the issues of standard-setting timeliness, transparency, and simplification of accounting standards be addressed, we should not abandon the system that has allowed us to achieve what we have to date. Instead let us take the opportunity to make fundamental changes to standard setting and SEC oversight. Thank you.

[The prepared statement of Robert K. Herdman follows:]

PREPARED STATEMENT OF ROBERT K. HERDMAN, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Stearns, Ranking Member Towns, and members of the Subcommittee: I am pleased to appear before you on behalf of the Securities and Exchange Commission ("SEC" or "Commission") to testify on the importance of responsive and transparent financial reporting to investors and our capital markets. The specific question this panel was asked to address is "Are current financial accounting standards protecting investors?"

Our financial reporting system has long been considered the best in the world and is one of the underpinnings of our capital markets, which are the deepest and most liquid in the world. However, certain aspects of the system can and should be improved so changes to accounting standards can be implemented more quickly, be more responsive to market changes, and provide more transparent information to investors. Our current system's weaknesses are more visible as a result of Enron's failure.[1] However, these weaknesses did not arise overnight, rather they evolved over many years. Investors expect our system to be the finest in the world. We intend to see that it remains the finest. Today I will discuss what should be done.

Concerns about our financial reporting system precede the bankruptcy of Enron Corporation and my testimony reflects that. The Commission is investigating events associated with Enron's collapse; and, consistent with the Commission's rules and practice, I am unable to discuss the specifics of that ongoing investigation. The Commission requests that the Subcommittee respect the confidential nature of the Commission's investigation and our reluctance to address specific issues related to Enron's compliance with federal securities laws in this public forum.

OVERVIEW OF US STANDARD-SETTING PROCESS

The SEC relies on an independent, private sector standards-setting process that is thorough, open, and deliberate. While the Commission has the statutory authority to set accounting principles,[2] for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards.[3] The quality of our accounting standards and our capital markets can be attributed in large part to the private sector standards-setting process, as overseen by the SEC.

The primary private sector standards-setter is the Financial Accounting Standards Board (the "FASB"), which was established in 1972. An oversight body appoints the members of the FASB. This oversight body, the Financial Accounting Foundation, is comprised of investors, business people, and accountants. The FASB's standards are designated as the primary level of generally accepted accounting principles ("GAAP"), which is the framework for accounting. The FASB's standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

The secondary standard setter is the Accounting Standards Executive Committee (AcSEC), which provides guidance in the form of Statements of Position (SOPs), sub-

[1] In a Form 8-K dated November 8, 2001, Enron Corporation stated that it would restate its financial statements for the years ended December 31, 1997 through 2000 and quarters ended March 31 and June 30 2001 because it did not follow GAAP. On December 2, 2001 Enron filed for bankruptcy.

[2] See, e.g., section 19(a) of the Securities Act of 1933, 15USC 77s(a), and section 13(b)(1) of the Securities Exchange Act of 1934, 15 USC 78m(b)(1).

[3] Accounting Series Release (ASR) No. 4 (April 1938) and ASR No. 150 (December 1972).

ject to the affirmative concurrence by the FASB at every step in the process. The principal purpose of AcSEC, which is a committee of the American Institute of Certified Public Accountants (AICPA), is to develop standards for specialized industries.

The interpretative body of the FASB is the Emerging Issues Task Force (EITF). It meets every other month to provide interpretative guidance, or develop new guidance, on narrow, new or emerging issues that arise under existing GAAP and when GAAP does not exist.

CRITICISMS OF U.S. ACCOUNTING STANDARDS AND STANDARD SETTING

Even before Enron's collapse, we called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity. Specifically, we asked the FASB to address criticisms that:

- The current standard-setting process is too cumbersome and slow.
- Much of the recent FASB guidance is rule based and focuses on a check-the-box mentality that inhibits transparency.
- Much of the recent FASB guidance is too complex.

Recently, some people have suggested that the FASB should be federalized instead of remaining in the private sector. Those who suggest this apparently have lost confidence in the FASB's process. There is no assurance that simply placing the structure within the federal government would result in better accounting standards. For example, many question whether the FASB's proposal to expense stock compensation, before the Congress intervened, would have been better for investors.

Federalization of the FASB not only would require increases to the federal budget, but also might disenfranchise those who are best qualified to address the highly complex business and accounting issues that must be resolved. I believe that with the Commission's leadership and cooperation by the FASB, the FASB can be effective, and confidence in the process can be restored. Private-sector standard setting can work in our current business environment, even as financial transactions become more complex. In spite of recent events, we still have the best financial reporting system in the world, and the Commission is intent on making it even better.

When done properly, standard setting in the private sector is the best alternative for our capital markets as it provides a number of advantages over federalized standard setting. Private sector standard setting has greater flexibility to complete rules more quickly than accounting standards set by the government. The FASB is comprised almost entirely of accounting experts and has a greater ability to attract and retain qualified personnel. Similarly, AcSEC and the EITF are composed of members with accounting expertise.

EVOLUTION OF STANDARD SETTING

It is important to understand how the current system of standard setting evolved. As we contemplate reform, we need to consider how we got here. In the late 1970s and early 1980s, the FASB undertook a series of projects to drastically change how financial information is reported to investors and other financial users. These projects, which include consolidation of financial statements and accounting for financial instruments, represent major conceptual changes in financial reporting. As you might expect, such sweeping change has been very controversial and sapped the resources of the FASB.

As a result, issues such as revenue recognition (which is a factor in approximately one-half of all restatements and financial reporting enforcement cases) and consolidation of SPEs have not been adequately addressed by the FASB. The EITF and the SEC staff have attempted to address some of the issues, but without an underlying principle the result has been disappointing.

In other cases, the FASB has delegated broad issues such as accounting for partnerships; property, plant and equipment; and the accounting for environmental liabilities to AcSEC. AcSEC is comprised of part-time volunteers from the preparer, auditor, and user communities and is subject to affirmative review by the FASB each step of the way. As a result, AcSEC is ill equipped to deal with broad issues in a timely manner. While AcSEC's guidance has been of high quality, it often takes years to issue because of its infrastructure constraints.

Another criticism that has arisen over time is the trend to complex, rule-based accounting standards. This trend can be attributed to a number of factors including (1) changes in how companies do business; (2) granting exceptions to new controversial standards; (3) internal conflicts in the accounting literature as the conceptual underpinnings change; and (4) demands for a single answer to every question. FASB Statement No. 133 on accounting for derivatives and hedging and Statement No. 140 on transfers of financial assets and extinguishments of financial liabilities are two prominent standards that have been subject to such criticism.

IMPROVING TIMELINESS

Now I would like to review with the Subcommittee actions that should be taken to continue to ensure that our financial reporting system remains the premier system in the world. Let's begin with the FASB. The FASB must change the scope of many of its technical projects and the manner in which it carries out its activities.

The FASB uses a building-block approach when developing standards. That is, the Board addresses a handful of issues at any given meeting instead of all of the issues that comprise a single proposal. This approach tends to expand the time it takes to resolve reporting issues. In contrast, the SEC staff generally will present an entire proposal to the Commission for consideration. The FASB needs to reconsider its approach.

The Board's major projects tend to be very broad. For example, the FASB currently has on its agenda a liabilities and equity project that raises six or seven important issues. I believe this project has too broad a scope. It attempts to weave too many issues into a conceptual framework everyone can agree on. Most people agree that more guidance is needed on equity derivatives and redeemable preferred stock. Why not separate out these issues and provide timely guidance on them? The remaining issues, where many believe no additional guidance is necessary, can be addressed at later dates. Narrowing the scope to its critical elements allows the process to move forward in a timely manner.

Some are calling for a limitation on the time a project can be on the FASB's agenda. I share their concerns about timeliness. It is clear that the FASB must work more quickly and be more responsive to market needs. For example, how it deals with the issue of when to consolidate SPEs is important. This project must be finished so it can be both effective for, and implemented by, the end of this year. If the FASB is not able to make progress on such important issues as they arise, the SEC should take action. We must improve our oversight of the standard-setting agenda.

PRINCIPLE-BASED ACCOUNTING STANDARDS

As I mentioned in my introduction, over the last few years many of the FASB standards have been rule based, as opposed to principle based. Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting. Examples of rule-based accounting guidance include the accounting for derivatives, employee stock options, and leasing. And, of course, questions keep coming. Rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.

An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction. FASB Statement Nos. 141, *Business Combinations,* and 142, *Goodwill and Other Intangible Assets,* which were issued in 2001, appear to be steps in the right direction. These standards will serve as a test of the level of specificity needed to strike a balance between rules and principles. Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues.

Furthermore, a byproduct of rule-based accounting standards has been an increase in the number of "SAS 50" letters issued to investment banks providing opinions as to whether hypothetical transactions follow accounting standards. SAS 50 letters may be used as the basis to structure complex transactions that technically comply with accounting standards, but do not accurately reflect the objectives of the standards. I believe it is in the public interest that the Auditing Standards Board ban those types of letters, and yesterday I sent a letter to the Auditing Standards Board urging that it do so.

A move to principle-based standards will require greater discipline by the corporate community, the accounting profession, private-sector standard-setting bodies, and the SEC staff. A move away from a check-the-box approach to financial reporting means that all constituencies must make concerted efforts to report transactions consistent with the objectives of the standards. While this may mean that not all transactions are recorded in exactly the same manner, it is my belief that similar transactions in this system of principle-based standards will not be reported in materially different ways, preserving comparability.

While the FASB addresses issues of timeliness, transparency and complexity it must remain nimble to deal with changes in the market. Looking ahead, it must accelerate its efforts to achieve short-term convergence with the International Accounting Standards Board and coordinate with the SEC's financial reporting and disclosure reform initiatives so our capital markets can continue to be the deepest and most liquid in the world.

RESOURCE MANAGEMENT

Now I would like to discuss how better resource management should improve timeliness of standard setting. This is where the leadership of the SEC is important. As I stated at the outset, the FASB is subject to the oversight of the SEC.

Allow me to describe how I believe that oversight should work. In light of its enforcement and review activities, the SEC is in a unique position to provide input into the FASB's agenda. We have a responsibility to do that, and the FASB has a responsibility to address the issues we refer to them in the time frame that we request, even if it is 180 days. I believe that we can and should stay out of their way once we ask them to take on a project. However, we should meet with the FASB frequently to monitor the status of their projects. If projects are languishing, we must determine why.

Generally, there are two reasons that topics remain on FASB's agenda for extended periods. First, there may not be a problem with existing guidance, as many believe is the case with the basic consolidations model. Using resources to revisit this model slows the process and detracts from the Board's ability to address the more important issues such as SPEs.

Second, a topic may remain on the agenda for an extended period because it is too broad. This is a principal reason why the Board has had to spend much time on its liability and equity project. Instead of focusing solely on the pressing issues of accounting for redeemable preferred stock and equity derivatives, the FASB has decided to use the project to make conceptual changes to minority interest and require separate accounting for elements of certain debt instruments, delaying project completion.

The changes I have discussed in my testimony should allow the FASB time to address important issues as they arise, and eliminate the need to refer broad issues to AcSEC and the EITF, so they can focus on developing industry and interpretative guidance, respectively, as they were designed to do.

CONCLUSIONS

In summary, let me reiterate that we have the deepest and most liquid capital markets in the world largely because of the high quality of our financial reporting system. While it is imperative that the issues of standard-setting timeliness, transparency, and simplification of accounting standards be addressed, we should not abandon the system that has allowed us to achieve what we have to date. Instead let us take the opportunity to make fundamental changes to standard setting and SEC oversight.

Mr. STEARNS. I thank the gentleman.

Mr. Jenkins.

STATEMENT OF EDMUND L. JENKINS

Mr. JENKINS. Good morning, Chairman Stearns, Ranking Member Towns, and the members of the subcommittee. I appreciate the opportunity to speak to you this morning again.

I appear here on behalf of the Financial Accounting Standards Board. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. JENKINS. As you know, the FASB is an independent private-sector organization. We are not part of the Federal Government and we receive no Federal funding.

We are an independent group, and our independence comes from the fact that our seven-member Board serves full-time and we are required to sever all financial ties with our former employers. We are funded primarily through the sale of our publications and to a lesser extent through private donations solicited by the Trustees of a not-for-profit foundation, the Financial Accounting Foundation.

Board members and members of the FASB staff are prohibited from being associated with fundraising activities.

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 capital markets because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, and comparable financial information.

Because the actions of the FASB affect so many organizations and are so important to the efficient functioning of the capital markets, our decisionmaking process must be open and thorough. Many times Congress has asked us to assure them that that process is working, and we believe it is. An open and thorough process is essential for ensuring both the credibility and quality of the resulting standards. The standards in the U.S. are generally recognized as the highest quality standards in the world.

It is important to understand that the FASB has no authority for to enforce its standards. Responsibility for ensuring that financial statements comply with accounting requirements rests with the officers and directors of the reporting entity's financial statements, and for public companies, 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.

Now, the FASB does not know many of the facts relating to Enron's financial accounting and reporting. However, it is clear that Enron publicly acknowledged in its filings with the SEC that its financial statements did not comply with existing accounting requirements in at least two areas. Those failures resulted in financial statements that materially inflated assets and net income and materially understated liabilities in years beginning in 1997 through 2000. In addition, the February 1, 2002 Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron further suggests that Enron's financial statements included other violations of existing accounting requirements. One such reference in the report states: "Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental substance."

I want to assure you, Mr. Chairman and members of this Committee, that consistent with the FASB's mission and due process, the Board is prepared and committed to work with the subcommittee, with the SEC, and all other constituents to proceed expeditiously to resolve any and all financial accounting and reporting issues that may arise as a result of the Enron bankruptcy.

Attachment 4 to the full text of my testimony provides a detailed listing of the FASB's extensive existing guidance relating to accounting and disclosures of related party transactions, special purpose entities, and off-balance-sheet financial arrangements and guarantees.

The Board has active projects underway in over a half-dozen areas that will propose significant improvements to existing requirements, including a project to improve the accounting for consolidations, and a project to improve the guidance for determining the fair values of financial instruments. With respect to the project on consolidations, which we have struggled with for far too long, the Board plans to issue a proposal on an expedited basis in the second quarter of this year that will resolve some of the more common issues encountered by some entities in present practice, including issues relating to consolidation of SPEs.

Yesterday at our public Board meeting, the Board concluded to go forward with a proposal developed by our staff that will address these issues. We are going to bring the full proposal to our Board in a meeting in 2 weeks on the 27th, and debate that proposal with the intent of issuing it for public comment as quickly as we can thereafter.

I discuss mark-to-market accounting in my testimony. I need to point out to you that we cannot alone sustain the transparency necessary to maintain the vibrancy of our capital markets. Other parties must also carry out their responsibilities in the public interest. They include reporting entities, auditors and regulators. We can no longer tolerate reporting entities that seek loopholes to existing standards and don't apply them with the intent with which they were written. We no longer can tolerate reporting entities and auditors that look to see "where does it say that I can't do that."

Just one more comment in summary, Mr. Chairman, please. 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, as you, Mr. Chairman, stated in your opening comments, that transparent financial accounting and reporting do matter and that the lack of transparency imposes significant costs on all who participate in our capital markets. Thank you very much.

[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 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]

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

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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).

[8] See Attachment 1 for a list of the sponsoring organizations.

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?")
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.

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 coordi-

[9] See Attachment 1 for a list of the current FAF Trustees.
[10] See Attachment 2 for information about the Financial Accounting Standards Advisory Council.
[11] See Attachment 1 for information about the EITF.

nate 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 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 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
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]

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

[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.

[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."

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]
- 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]

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
- 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

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

[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).

[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).

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.

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 fordealing with consolidation policy issues that have been identified by constituents in the following four areas:

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 prin-

[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).

[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.

cipal 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 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 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 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

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[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]).

[31] Statement 57, paragraph 2.

[32] Statement 57, paragraphs 16 and 17.

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:

> 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]

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 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 receiv-

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

able 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. 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 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.

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

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[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."

[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).

[44] Powers Report, page 4.

[45] Powers Report, page 4.

[46] Powers Report, page 17.

- 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.

Mr. STEARNS. I thank the gentleman.

Mr. Castellano.

STATEMENT OF JAMES G. CASTELLANO

Mr. CASTELLANO. Thank you, Chairman Stearns, Ranking Member Towns and other distinguished members of the subcommittee,

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

for inviting me to testify before you today. I am Jim Castellano, elected Chairman of the Board of The American Institute of Certified Public Accountants, the AICPA. I live in St. Louis, Missouri. I am the managing partner of a local CPA firm in St. Louis—Ruben, Brown, Gorenstein and Company. I welcome this opportunity to appear before you today on behalf of the AICPA's 340,000 members in public practice, in industry and academia, and government. I, too, have submitted written testimony that I ask be included in the record of today's hearing.

Events of the past few months are deeply disturbing to the accounting profession. What happened at Enron is a tragedy on many levels, and this is a difficult time for us and all those involved with the financial reporting process.

We are proud of our profession. We take seriously our public responsibility, and we are committed to doing our part to restore confidence in the financial reporting system.

No one has all the facts about the Enron failure, and jumping to conclusions prematurely disserves everyone, including investors. But the accounting profession wants to make one thing perfectly clear, and that is that our profession has zero tolerance for those who break the rules.

The accounting profession is actively engaged on a number of fronts. Some are new initiatives, and many more are an acceleration of initiatives that have been underway.

Since the Enron collapse, we have come forward to embrace some reform proposals that we previously opposed, such as some scope of service restrictions for auditors of public companies, and we are supporting the SEC's initiative to move from self-regulation to public regulation, from public oversight to public participation, a move that is unprecedented in the 100-year history of our profession.

The United States General Accounting Office, in its 1996 study of the profession, concluded that the actions taken by the profession in response to the major issues raised from the many studies from 1972 through 1995 show that the profession has been responsive in making changes to improve financial reporting and auditing of public companies, but we cannot rest on the past.

There are a number of additional reforms that need to be enacted. These include revising current accounting rules for special purpose entities such as those used by Enron to deter accounting abuses; requiring additional disclosures in company filings with the SEC including management's discussion and analysis, MD&A; requiring reporting on a company's internal control system to evaluate its effectiveness in making that report available to investors; requiring auditors to take additional steps to search for fraud; requiring nonfinancial information to supplement the historical financial statement; increasing the frequency of financial reporting, and making it illegal for anyone in the company to lie to an auditor or withhold material information.

We also stand ready to provide additional assurances over management's discussion and analysis. In June 2001, we introduced a new audit level service to examine management's discussion and analysis, so we hope that more audit committees and board members will avail themselves of this added assurance.

The focus of auditing must change as well. Auditors will be reporting on information systems. They will be focusing heavily on preventive controls and providing assurance that information systems are operating effectively and sufficiently to produce reliable information.

This transition is going to require that the accounting profession attracts the most talented professionals to serve the public interest. But there will still be pitfalls even in this scenario. There is the threat of management overriding the systems and preparing fraudulent and untruthful disclosures. That is why our profession, even before these recent Enron events, has been working on improving auditing standards and guidance to auditors to help them better detect fraud.

An exposure draft of a new board standard intended to elicit public comments will be issued by this month's end, with the final standard issued later this year. In addition to these changes, we are also reviewing the adequacy of all auditing standards regarding all issues emanating from Enron.

Now to the reporting model. No reporting model will protect investors from greed and bad judgment. However, an improved reporting model will provide every investor with better quality information and increase the likelihood of better investment decisions. We need more information, timely disclosures and plain English.

Reporting models should also address off-balance-sheet activity, liquidity issues, other risks and uncertainties, forward-looking information, nonfinancial performance indicators, unreported intangibles, and other information.

To modernize the model, we must focus on three things. First, a broader bandwidth of information; second, different distribution channels, namely, the Internet; and, third, increased reporting frequency, ultimately, we can see in the future leading to on-line, real-time reporting. The profession has been working actively on additional reforms, and they are outlined in my written testimony. We, too, look forward to working with Congress, the SEC, and the FASB to develop meaningful reforms in these areas, and we are open to other areas of inquiry. This is a debate that is long overdue and one that we welcome.

In conclusion, Congress and others should carefully consider these reforms. They are essential to restoring investor confidence in the financial reporting system, and I can assure you that the CPA profession wants, as I know you do, to assure that this future comes about to the benefit of shareholders, consumers and, indeed, all American citizens.

Again, I thank you for the opportunity to address this important issue with you today.

[The prepared statement of James G. Castellano follows:]

PREPARED STATEMENT OF JAMES G. CASTELLANO, CHAIR, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Thank you, Chairman Stearns, Ranking Minority Member Towns and other distinguished members of the committee for permitting me to testify today on the adequacy of current accounting standards. I am Jim Castellano, Chairman of the Board of the American Institute of Certified Public Accountants. Corporate accountability is of great importance to the continued strength of the American economy and confidence in our capital markets. In order for our capital markets to function effectively and for our economy to allocate resources efficiently, it is essential that business enterprises report accurately and fairly to investors and that investors perceive that they do so. Our economy needs both the fact and appearance of credible financial reporting.

The business collapse of Enron last year has shaken the faith of America, and of the world, in our financial markets. The personal tragedy to Enron's employees, retirees, and investors goes far beyond the dollars and jobs they have lost. And this tragedy occurred despite the fact that we have the freest, most open, transparent, and dynamic financial market in the world. The accounting profession has also been deeply disturbed by what has occurred. We are proud of our history of serving the public interest by providing assurance to the investors that the financial statements of public companies fairly present, in all material respects, the financial position of these companies'.

The Enron business failure has added additional pressures on our economy and raised questions concerning confidence in our capital markets. Legitimate questions are being asked about corporate ethics and governance, including the role of a company's board of directors and its audit and finance committees, internal controls, compliance with accounting and audit standards and other SEC reporting requirements, financial reporting transparency, the adequacy of the current financial reporting model, the auditor disciplinary and quality review process, how analysts use available financial information in making buy/sell recommendations to investors, and other issues.

While no one has all the facts and relevant information about the failure, it appears to be the result of many contributing factors, all of which need to be addressed to restore investor confidence in the system. Our profession has zero tolerance for those who do not adhere to the rules. The AICPA and its members are committed to the goal of assuring that investors and creditors have the highest quality of financial information. We will take the necessary steps to restore public confidence in the accounting profession and capital market system, and will work with Congress to develop meaningful public policy reform.

My goal today will be to touch on some of the reforms we have supported and will continue to support for the accounting and auditing system, and to suggest additional reforms which we as CPAs believe will strengthen the financial reporting system.

Capital should be deployed where it can be most productive. At the root of productive capital investment is the availability of timely, reliable and meaningful information. The success of our capital markets depends upon informative, reliable financial reporting—often referred to as "transparency." Three critical conditions must exist for investor information reporting to be meaningful. There must be:

1. Adequate reporting standards that provide full transparency of all meaningful and relevant information to investors;
2. Compliance with those reporting standards, including appropriate auditing;
3. Timely access to, and sufficient user understanding of, the information available.

ADEQUACY OF CURRENT ACCOUNTING STANDARDS AND REPORTING SYSTEM

The current accounting model has historically performed well. But to work for today's economy, it must be modernized. Economic change has moved much more swiftly than accounting for such changes has adapted. Intellectual capital has become the greatest engine for corporate growth. Yet, accounting is still based on hard assets—physical plant and related items for producing goods. Many companies, like those in advertising, produce revenues based almost exclusively from knowledge work. Knowledge work has become the key to all companies' effectiveness. Even companies producing tangible goods have become highly dependent on intangible sources of revenues and competitive advantage.

Changes in business prospects have made quarterly reports outdated. Timely information has always been prized, but the pace of change in corporate dynamics and earnings capabilities has made it much more important. Corporate diversification, alliances of all sorts, the rate and depth of economic change, and transnational relationships have enormously changed the risks facing modern corporations. The relative absence of up-to-date information with which to assess corporate earning capacity coupled with the pace of change, helps explain the volatility of today's share prices. Meanwhile, the use of the Internet for economic communications has been exploding. Real-time disclosure of selected financial information—that is, information that can be useful to investors without creating competitive disadvantage to companies—on the Internet is clearly foreseeable. Investors need more frequent corporate financial and non-financial disclosures (i.e. on-line, real-time) to make informed investment decisions.

The accounting profession was first among those convinced the accounting model needed to be modernized. From 1991-1994, a special committee of the American Institute of Certified Public Accountants (AICPA) studied the state of business reporting.[1] The committee's greatest achievement was its research on the needs of investors and creditors. The research showed that investors have many unmet information needs. This evidence was new because investors and creditors do not actively make their information needs known to the accounting community.

The findings on information needs should have been a loud wake-up call to those who depend on the disclosure system or have responsibility for it. Investors and creditors are, figuratively speaking, the customers of financial reporting. More precisely, because corporations seek capital from investors and creditors, investors and creditors are customers of the corporation's sale of securities. Monetary exchanges do not take place without information, and the better the information about a prospective purchase, the better the purchaser's chance to make a satisfactory pricing assessment. Putting the same point in terms of investors' purchases of securities, the better the information they have the lower the risk of poor investment or credit decisions.

The report concluded that investors' needs were not being fully met. It described needs that go far beyond what is required by the current financial reporting model. In fact, to capture the idea of reporting non-financial information, the report adopted the broader term "business reporting." The report contained an illustrated, comprehensive model of business reporting designed by the Special Committee, as well.

Business reporting is wider than financial statements. It should include non-financial information and presentations outside the financial statements. The Special Committee's business reporting model was not limited to financial statements, although it at all times includes them, in recognition of their importance to investors and creditors. The "accounting model" has in the past referred only to financial statements, but in the future it will refer as well to business reporting to investors and creditors.

It is very disappointing that the report was produced seven years ago and so little has been done in response. If investors' needs were not being met seven years ago, they are likely being met even less today. Calls for reform have come from many different sources, including nonaccountants. They include former SEC Commissioner Steven M. H. Wallman, economist Robert E. Litan, and Yale School of Management dean and former Under Secretary of Commerce for International Trade Jeffrey E. Garten. Wallman has written on his own and with Margaret Blair as part of a Brookings Institution project on intangibles. Litan joined Peter Wallison in a project for the AEI-Brookings Joint Center for Regulatory Studies.

Garten recommended that companies be given incentives to provide more information on intangible assets and performance metrics, in a report by a group commissioned by the SEC. Economists recognize the importance of intellectual capital as a source of economic growth, which means a source of revenue. For example, Brad DeLong wrote, "Economic development has become less and less about accumulating more and more physical capital and more and more about the creation and deployment of intellectual capital."[2] A 1996 United States General Accounting Office report said: "[T]he current reporting model does not provide information about important business assets. As a result, historical cost-based financial statements are not fully meeting users' needs."[3]

In the broadest sense, if we are going to modernize the accounting model, we must focus on these things:

- First, a broader "bandwidth" of information, such as was endorsed by the AICPA's Special Committee;
- Second, different distribution channels, namely, the Internet;
- And third, increased reporting frequency, ultimately, on-line, real-time reporting.

The root problem is the mismatch between widespread agreement that users' information needs are not being met and the lack of consensus on how best to meet those needs. Efforts to modernize business reporting must be accelerated, but where should they start?

Reform should address unreported intangibles, off balance sheet activity, non-financial performance indicators, forward-looking information, enterprise opportunity

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[1] AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus,* 1994.

[2] A Framework for Understanding Our New Economy, part of a joint project with Stephen Cohen and John Zysman, http://econ161.berkeley.edu/OpEd/virtual/technet—outline.html.

[3] GAO, *The Accounting Profession: Major Issues: Progress and Concerns,* GAO/AIMD-96-98, September 1996,p.16.

and risk, and more timely reporting. These could become time-consuming projects. However, we support the following list of near term reforms.

NEAR TERM REFORMS:

The FASB should issue standards-level guidance on the location, form, and content of non-financial information that would supplement the historical financial statements. In particular, the FASB should address non-financial performance indicators, unrecorded intangible assets, and forward-looking information. The FASB should determine whether such supplementary reporting should be required, based on experience with voluntary reporting or any other relevant factors it chooses to bring to bear.

As part of the its standards-level guidance, the FASB should make explicit that for purposes of its mandate, disclosures that supplement the financial statements can be desirable to meet users' needs, even if the disclosures go beyond what some believe is necessary to understand the financial statements. The broader criterion of information useful for making investment and credit decisions should apply. In addition, in the same guidance, the Board should make more explicit the tension between the desirability of comparability and of relevance in business reporting, making clear that users' needs can at times be satisfied best by relevant information that is not comparable across a population of companies.[4]

The FASB, working with the SEC, should begin a project to consider revising the frequency of reporting based upon the needs of users utilizing the capabilities of modern accounting software and telecommunications.

The accounting profession stands ready to sponsor projects to help the FASB and the SEC complete the projects recommended above in the shortest reasonable timeframe.

These recommendations to the FASB are compatible with its adoption of its project on intangibles.[5] The project would establish standards for disclosures about intangible assets not recognized as assets in the financial statements. The proposed project follows the publication of a study by the FASB staff which identified four possible intangibles projects.[6] We strongly support the FASB's adoption of the proposed agenda item. Although the project will entail some difficult subjects, it should be put on a fast track.

OTHER REFORMS

Support for reform should not be limited to standard setters, regulators, and those whose oversight can take on formal qualities. All interested parties—including but not limited to the accounting profession, the investment community, registrants, creditors, and the financial industry—should be actively and constructively engaged. They should be united by the common goal of improving the national welfare by empowering investors with better information and thereby spurring growth-creating capital allocation.

For example, we recommend reforms in the following areas:

OFF BALANCE SHEET DISCLOSURES:

We encourage FASB to reprioritize its project agenda and move quickly on its consolidation project to address off-balance sheet disclosure transparency issues. Existing accounting rules for special purpose entities should be reviewed for possible accounting abuses and new types of financing vehicles.

REPORTS ON EFFECTIVENESS OF INTERNAL CONTROLS:

In the near term, company management should be required to make an analysis and assertion as to the effectiveness of the company's internal control apparatus.

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[4] Statement of Financial Reporting Concepts No. 2, Qualitative Characteristics of Accounting Information (FASB 1980), states: "Improving comparability may destroy or weaken relevance or reliability if, to secure comparability between two measures, one of them has to be obtained by a method yielding less relevant or less reliable information" (par. 116).

[5] Available at the FASB's website: http://www.fasb.org.

[6] Wayne Upton, *Business and Financial Reporting, Challenges from the New Economy* (April 2001). Available at the FASB's website: www.fasb.org. Upton's potential projects were as follows: "Address" the format and content of non-financial metrics, in notes or elsewhere (5 issues are set out, including whether standard setters should develop a standard format); the format and content of disclosure about recognized and unrecognized intangible assets; recognition of intangible assets created as the result of a "project" effort (e.g., R&D); and recognition and measurement of embedded intangibles and service obligations (e.g., a bank's core-deposit intangible and an insurer's claim-handling obligation). The list is in Appendix A, pp.111-113, of the website version.

The auditor should be required to attest to and report separately on the effectiveness of the management assertion. Management and auditor's reports on internal controls could make a positive and cost effective contribution to the assurance system and will improve investor confidence in the integrity and reliability of financial statements issued by those who access the capital market. In the wake of the savings and loan collapse, congress placed similar requirements on depository institutions and their auditors.

DISCLOSURES BY COMPANY MANAGEMENT:

Stock Options: The FASB working with the SEC should require expanded disclosure of stock options received by the company management.

Insider Trading: Currently, company insiders do not have to disclose stock sales on the open market until the month after the transaction at the earliest. We believe it would make more sense to require disclosure of the intent to sell shares PRIOR to the transaction. In addition to the SEC, all other interested parties such as employees, shareholders, retirees, and pension fund managers should be notified.

Other Disclosures: We encourage the SEC to initiate additional rulemaking action to enhance disclosures in public company filings related to other management disclosure issues. The AICPA recently endorsed a petition to the SEC calling for more disclosure in a company's proxy statement about a company's liquidity, off-balance sheet entities, related party transactions and hedging contracts.

We are encouraged by the SEC's desire to make rapid progress on business-reporting reform and its desire to achieve timely and more informative filings that can help better inform investors without harm to the SEC's investor-protection mission. It should consider carefully the relevant recommendations of the ABA Committee on Federal Regulation of Securities[7] and revisit the proposals made in 1996 by the SEC's own Advisory Committee on the Capital Formation and Regulatory Processes. The Congress should support these efforts.

MANAGEMENT DISCUSSION AND ANALYSIS OF OPERATIONS:

As auditors, we also stand ready to provide additional assurances over management's discussion and analysis ("MD&A"). Our responsibility, under a traditional audit, is to read the MD&A and consider whether such information is materially inconsistent with the financial information presented in the audited financial statements. We are not required to render a report on our findings; rather we are only required to inform management of our findings if we believe the information is materially inconsistent. Because as a profession we believed that audit committees and boards of directors may want additional assurances relative to MD&A, we introduced, in June 2001, a new audit level service to examine the MD&A. This service, which is separate from our traditional audit, examines MD&A for the purpose of expressing an opinion as to whether:

a) The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.
b) The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements.
c) The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.

While the demand for this additional voluntary examination has been slow to develop, we hope that more audit committees and board members will avail themselves of this added assurance.

AUDITOR RESPONSIBLITY:

We also need new audit strategies and technologies. In an ideal world, companies would be producing the new disclosures with the desired frequency over the Internet; auditors would be providing contemporaneous assurance that the information was reliable; investors would benefit from better decision making information; productive corporations would benefit from a lower cost of capital; and the economy would be growing with more stability and promise, even than now.

To accomplish this result, not only must the reporting model change but also the focus of auditing must change. Steps toward this new direction have already begun. Auditors in this new world would be reporting on information systems. They would be focusing heavily on preventive controls and providing assurance that information

[7] A letter with relevant proposals, in the context of reforming the regulatory regime under the 1993 Securities Act, was sent to the SEC Division of Corporation Finance on August 22, 2001. See www.abanet.org/buslaw/fedsec/comments.html.

systems were operating effectively and sufficiently to produce reliable information. The transition is also going to demand personnel of the highest caliber. But there will still be pitfalls even in this scenario. While new disclosures could be produced, and the auditors could provide assurance over the systems producing the disclosures, there is still the threat of management overriding the systems and preparing fraudulent and untruthful disclosures. That is why our profession, even before these recent Enron events, has been working on improving auditing standards and guidance to help auditors better detect fraud. Two of the more noted proposed changes, among others, are explicit procedures addressing the risk of management override of controls and required procedures to evaluate the business rationale for significant unusual transactions. A draft of this new standard, intended to elicit public comments, will be issued by month's end with the expectation of issuing a final standard by the end of the year.

In addition to these changes, we are also looking at the following reforms:

We are reviewing the adequacy of professional auditing standards regarding all issues emanating from Enron, including audit procedures from related party transactions, special purpose entities, hedging contracts, internal controls established by the finance or audit committees, and working paper and record retention, and others. We will work with the SEC, FASB and Members of Congress on these recommendations.

We believe it should be illegal to lie to your auditor in the same way for example, that it is a illegal to lie to a prosecutor. We would support legislation or regulations that would accomplish that.

Public Participation:

The AICPA, is committed to working diligently with Congress and the SEC to develop a new regulatory model that improves and goes beyond the current self-regulatory processes. While the current self-regulatory model provides for significant public oversight over the existing peer review process, there is no public oversight over discipline. This new model would affect all firms doing SEC audits. We will diligently work to improve the profession's peer review and disciplinary process as it relates to auditors of SEC registrants. We strongly support moving from public oversight to public participation and increasing the transparency, effectiveness, and timeliness of the process. We will work with the Congress and the SEC to strengthen regulation of the profession as they implement a system that incorporates active public participation to enhance discipline and quality monitoring.

Non-Audit Services

We will not oppose prohibitions on auditors of public companies from providing financial systems design and implementation and internal audit outsourcing. We believe such prohibitions will help to restore the public's confidence in the financial reporting system.

Preparing For the Future Now:

But there is another way of viewing this scenario. The disclosures could be produced, and auditors could find themselves inadequately prepared to provide assurance to investors about the information's reliability. The transition to new reporting and auditing models is going to demand not only new audit approaches but personnel of the highest caliber. With this in mind, the profession has been working actively in the following areas:

Continuous Auditing. Continuous auditing or continuous assurance involves reporting on short time frames and can pertain to either reporting on the effectiveness of a system producing data or more frequent reporting on the data itself. An AICPA task force has concluded that the enabling technologies, if not the tools, required to provide continuous assurance services, are, for the most part, currently available. Their actual implementation will evolve with progressive adoption of the concept and the emergence of appropriate specialized software tools. Work is needed, however, to better understand the market potential for continuous assurance. A clearer insight is needed into both users' needs as well as decision-makers' perceptions of the value of this service. A marketing study of user needs would help assess the types of key performance indicators, system reliability issues, and financial and non-financial information that would benefit users. Depending on corporate platforms and established monitoring processes used for other purposes the costs of providing continuous auditing or assurance will vary. Therefore, further research is also needed to better understand how the potential purchasers of these services, such as management, boards and institutional investors, perceive the value of continuous assurance relative to the current model of periodic assurance.

XBRL. XBRL (or Extensible Business Reporting Language) is a freely available internet-based language for business reporting. It is a framework that provides the business community a standards based method to prepare, publish, reliably extract and automatically exchange business reports of companies and the information they contain. Whatever new reporting standards are considered appropriate, it is likely to be richer in disclosure than what we have today and will need XBRL to facilitate.

SysTrust. SysTrust is an assurance level service that independently verifies the reliability of a particular system (including a financial reporting system) against a framework of standards that address security, availability and integrity. Providing a freely available benchmark for what makes a system reliable, SysTrust is designed to provide assurance to boards of directors, corporate management, and investors that the systems that support a business or a particular activity are reliable.

Performance Measures and Value Measurement. The Value Measurement and Reporting Collaborative (VMRC) is the culmination of years of discussion about the need to change the reporting model. Numerous reports, white papers and books have cited the need for better information to be disclosed by publicly traded companies, not merely more information. Over the past year, the AICPA has been approached by a number of organizations that claim to have the solution to the need for better disclosure. While some companies are already taking steps to report information that investors want, currently these efforts are isolated and may not be comparable between companies. Rather than work with one organization, the AICPA and the Canadian Institute of Chartered Accountants are establishing the VMRC as a means to allow the various stakeholders to work together to determine the best methodology for reporting. Current suggestions include, but are not limited to, reporting of non-financial measures, intangible assets or a combined discounted cash flow and risk analyses. Specifically, the collaborative will:

- Understand the needs of the user community/stakeholder groups;
- Determine what is currently taking place in the field;
- Undertake an in-depth review of 7 or 8 alternative approaches to value measurement and reporting;

Further, this new framework, which will work in conjunction with the current model, will move the current reporting forward not in an incremental step, but in the revolutionary change that is needed today.

Student Recruitment. The AICPA has embarked on a new student marketing and recruitment plan, designed to attract more students—and the best students—to the accounting profession. This five-year, $25 million initiative is targeted toward late high school and college students, and is interactive in its approach, using web-based business simulations and games, college TV networks and other technology-based techniques to reach this important generation of young people. The campaign will help students understand the important role that CPAs play in all facets of the business world, and the important responsibilities CPAs have in helping businesses and individuals succeed.

In conclusion, I maintain that Congress and others should carefully consider these reforms as they are essential to restore investor confidence in the financial reporting system. I can assure you that the CPA profession wants, as I know you do, to assure that this future comes about for the benefit of shareholders, consumers, and indeed, all American citizens.

Thank you for this opportunity to express our views.

Mr. STEARNS. I thank the witnesses of the first panel. I will start with questions. The accounting profession has been looked at as something that is arcane and difficult to understand, but I think Mr. Bass, from New Hampshire, sort of summarized the whole process, that “cash is fact and everything else is opinion,” and we have a major corporation, of course, that imploded with a collapse and a bankruptcy, and we read in the paper there are other corporations that are now questioning their accountants, they are questioning their procedures, and even down to Krispy Kreme now. I saw in yesterday’s Washington Post there was some question about how they are putting assets to hide the amount of debt they have. So, whether it is Tyco or Global Crossing or Enron, you have a host of these companies out there.

The purpose of our hearing today is to try and tell the American people and our colleagues to come up with answers so that investors feel confident in the market, there is transparency.

So, the first basic question is, we talk about GAAP, which is generally accepted accounting principles, so let me just ask yes or no, going from left to right, Mr. Herdman, did Enron practice GAAP?

Mr. HERDMAN. Chairman Stearns, they have announced that in a couple of instances they needed to restate their financial statements. Beyond that, because of the pendency of our investigation, I can't comment.

Mr. STEARNS. Okay.

Mr. JENKINS. As I testified, Enron and the board committee have both acknowledged that they did not follow GAAP.

Mr. STEARNS. Okay. We have Enron that said they did not follow the generally accepted accounting principles, is that true, Mr. Castellano? Do you agree with that?

Mr. CASTELLANO. Chairman Stearns, they have reported that in their filings to the SEC, that is correct.

Mr. STEARNS. Okay. So, Mr. Herdman, I don't think that that is a secret, it is public knowledge, you should acknowledge it, too, that they didn't do it. I mean, on-line investigation is good, but they have said it publicly, so I think we are at that point.

So, the next question is, they didn't follow it, but there are a lot of other corporations that say they are doing it, and yet investors can't find the transparency and confidence. Do we need, based upon the modern technological innovation that we are seeing in today's market, do we need to change the generally accepted accounting principles? Just start left to right, yes or no?

Mr. HERDMAN. We need to continue to improve them.

Mr. STEARNS. Do they need to be revised and modernized, or can we just continue the way we are going with the GAAP accounting principles?

Mr. HERDMAN. We need to have accounting principles that are responsive to developments in the marketplace and have accounting principles today to be responsive to the questions about consolidation of SPEs. We need better accounting principles with respect to the very important issue of revenue recognition. I believe, Mr. Chairman, what I am describing is a system of continuing to improve rather than just throwing out the entire system.

Mr. STEARNS. Do you think we need major change, or just on the edges?

Mr. HERDMAN. We need a variety of change. Not only do we need to continue to change the underlying principles themselves, we need to find ways—and we at the SEC are working very hard on projects to accomplish—ways to make financial statements more understandable to ordinary investors. Financial statements today are very complex because businesses are very complex, transactions are very complex. But we need to find a way through plain English disclosure, through some type of condensation of disclosure, while not taking away anything that exists today, to find methods whereby ordinary investors can indeed read financial statements.

Mr. STEARNS. So, you are saying we probably need some major reform.

Mr. HERDMAN. Yes, we do.

Mr. STEARNS. Mr. Jenkins?

Mr. JENKINS. As I testified, we have six initiatives underway right now that I think are needed to improve financial reporting and will. I would put them in the area of continuous change and improvement. Certainly, the accounting for special purpose entities has been an issue that has been on our agenda, as I said, for far too long, and we need to address that and, as I also said, we are addressing it expeditiously, and we expect to have a completed standard in that area by the end of the year.

Mr. STEARNS. Okay. Mr. Jenkins, you are saying this morning we do need to make major changes, and you have these along the way.

Mr. JENKINS. But I put them in the area of continuous improvement. I don't want to throw the baby out with the bathwater. I think our basic model is sound.

Mr. STEARNS. Okay. Mr. Castellano?

Mr. CASTELLANO. I would concur that the basic model is sound and that we do need continuous improvement, but I would take a step further, and that is that we need to look well into the future and envision a broader business reporting model that would include more disclosure about nonfinancial performance indicators, for example. I know the FASB has done research on this. I encourage them to continue to pursue the results of that research, and work toward additional disclosures that will help investors make decisions about whether companies are worth investing in for the future.

Mr. STEARNS. Mr. Castellano, here there are two areas that I am looking at—one, GAAP, but then oversight, trust to verify. And we are at the point—are we at the point like we were in 1934 when we established the Securities and Exchange Commission, where we need to do something truly new to give confidence to investors, and what should that be.

We have a corporation that has to comply with the SEC. We have the American Institute for Certified Public Accountants, yourself, and the arm of that, as I understand it, was the Public Oversight Commission, and all these three in some ways failed to find Enron. I think that is true.

And so a lot of us are trying to say, what is a better structure? Now, the SEC has come out with the idea they think the Public Oversight Commission should be abolished, isn't that true, Mr. Herdman?

Mr. HERDMAN. Yes, it is.

Mr. STEARNS. Explain to us what you want to replace that with. You did it in your opening statement, but is this going to be appointed by Members of Congress, appointed by you, or the American Institute of Certified Public Accountants? Tell us what this new structure is that you think will make sure we don't have anymore Enrons?

Mr. HERDMAN. Mr. Chairman, what we have decided on is a framework whereby the current system of self-regulation of the accounting profession would be replaced by a system that would no longer be under the auspices of the AICPA. It would be composed of a board of people who would be nominated by members representing the public rather than members representing the profession. It would replace the current system of peer review with a more vibrant and more frequent system of quality control review, and it would have real disciplinary power to proceed against accountants that have violated either ethical or competency requirements.

As to the details of how that will all be implemented, we are still in the process of fleshing that out. We have announced that we are going to seek input from all constituencies including Congress, before proceeding to a rulemaking. We are going to be doing that partially through some round tables that are in the process of being scheduled. After we get our input, we are going to determine the particulars of a rule proposal which would go out for public comment and final implementation.

Mr. STEARNS. Okay. My time is expired, and we do have a vote, but I think we have some more time so Mr. Towns is recognized for his questions.

Mr. TOWNS. Thank you, Mr. Chairman. This Committee actually promoted pay equity for the SEC. The President recently signed this bill into law. However, no additional funds were included for the SEC in the President's budget. If the SEC's funding is not enhanced, then why should we expect that a new accounting oversight board would have the resources to properly do its job? If we put a board in place without additional resources, what have we really accomplished? Mr. Herdman.

Mr. HERDMAN. Congressman Towns, you raise two very important points. We at the Commission very much look forward to—we applaud Congress' passing the pay parity legislation. We applaud the President signing it. And we certainly hope that it gets funded promptly.

The funding for the new regulatory board would not necessarily come from the SEC. In fact, the way we have discussed it is coming from the public sector broadly, not just the accounting profession definitely, but from the public sector more broadly.

Mr. TOWNS. Well, I am a little concerned because I don't want you to get involved in fundraising and not doing your job. I mean, that is my concern.

And let me just say also, Mr. Jenkins, that is the complaint we get about you and your agency, the fact that you are so involved in fundraising that sometimes your other responsibilities sort of all through the cracks.

Let Mr. Herdman respond first, and then I will come to you.

Mr. HERDMAN. And I think I erred in my comment, it is not the public sector, it is the private sector more broadly.

In terms of fundraising, you are entirely correct that a credible and consistent and reliable system of funding these oversight activities needs to be developed just as it has been developed with respect to the FASB, and it needs to be money that is there year in and year out to fund the important activities of these boards.

Mr. TOWNS. Now, let me say that the reason I am pushing this issue is because it was also stated that the annual report of all Fortune 500 companies, that you also review them. I am just trying to see where you are going to get the resources to do that, that is my concern.

Mr. HERDMAN. We have the resources to review the financial statements of the Fortune 500 companies. That project is beginning, and while that necessarily takes away from other activities, we believe that it is an appropriate deployment of our resources to review those financial statements.

Mr. TOWNS. I sure hope you can, but you have got to convince me on that because you have more people than IRS in order to do what you are saying. You would have to have as many.

Mr. HERDMAN. As Chairman Pitt indicated in his testimony last week, the Commission is undertaking a review of the sufficiency of its resources. When it makes a determination as to whether resources are sufficient, it will communicate that to Congress. If it makes a determination that we need more resources, we will certainly be up here asking you for the money to provide those additional resources.

Mr. TOWNS. Mr. Jenkins?

Mr. JENKINS. Yes, thank you, Congressman Towns. The FASB board members, the people who set the rules, we are prohibited by our enabling legislation, by our enabling contracts, we are prohibited from fundraising. The fundraising takes place by an independent, largely public interest Board of Trustees that is over the FASB itself. And that accounting foundation does three things—it selects the board members, it raises the money, and it makes sure that our due process is open and complete.

On the contrary, it is prohibited, again by our enabling documents, it is prohibited—the Trustees are—from getting involved in technical accounting standard matters.

So, we have divorced fundraising from standard-setting in our projects. So the Board members spend no time, nor do our staff spend any time, on fundraising.

Mr. TOWNS. Thank you very much. I yield back, Mr. Chairman.

Mr. STEARNS. The gentleman yields back. I think we will take a break here while we have a vote, and we will be back shortly. A few members will be back immediately, so we will be able to continue.

The subcommittee will stand in recess.

[Brief recess.]

Mr. STEARNS. The Committee will come to order. I think in the absence of a Republican member, Ms. DeGette, why don't you start.

Ms. DEGETTE. Thank you, Mr. Chairman. Mr. Castellano, in your testimony, you said that your organization was now willing to consider scope of services restrictions. What exactly did you mean by that?

Mr. CASTELLANO. Congresswoman, what we have said is that the accounting profession, the American Institute of CPAs, will not oppose restrictions on auditors of public companies performing internal audit outsourcing services or financial systems implementation and design services for their publicly held clients.

Ms. DEGETTE. And previously you had opposed such restrictions. Why was that?

Mr. CASTELLANO. This change in——

Ms. DEGETTE. Why did you oppose it previously?

Mr. CASTELLANO. Because we don't believe even now in not opposing those restrictions today. We don't believe that there is an inherent conflict in auditors performing nonaudit services for their clients, that there are safeguards that must be followed within our code of ethics today, and if those safeguards are followed, the auditor's judgment would not be impaired.

Ms. DEGETTE. Well, in your opinion, Mr. Castellano, were those safeguards followed in Arthur Andersen's representation of Enron?

Mr. CASTELLANO. I don't know the details of Arthur Andersen's relationship with Enron.

Ms. DEGETTE. So, if you still think that there are safeguards, why have you shifted your position that you are now not opposing such restrictions? Is it a political decision?

Mr. CASTELLANO. No, not political. Thank you for the question.

Ms. DEGETTE. You are welcome.

Mr. CASTELLANO. We recognize that public perception is a critical element in restoring public confidence to the capital market system and in our profession, and that because of the debate that has gone on about this issue of those two services going back to the prior SEC administration's rulemaking initiative in this matter, that has raised the public's interest, the public's sensitivity to those. We recognize that. We know that we need to move on beyond this.

Ms. DEGETTE. So what you are saying is you don't think there is a problem, but you are shifting your position because of public perception that there is a problem, correct?

Mr. CASTELLANO. Because it appears now that the public believes there is a conflict in the appearance of independence of those two services.

Ms. DEGETTE. But you don't think there is, right?

Mr. CASTELLANO. We don't think, with appropriate safeguards as required by our code of ethics today——

Ms. DEGETTE. You think that the safeguards are in place now, right?

Mr. CASTELLANO. I do believe that the safeguards are in place now and they must be followed under our code of ethics.

Ms. DEGETTE. Thanks. Mr. Jenkins, I wanted to ask you a question about FASB because a couple of weeks ago, the Oversight and Investigations Subcommittee had a hearing on Arthur Andersen's destruction of documents, and what we found when we looked at Arthur Andersen's client engagement information with Enron, which is a long document, what we found is that while Arthur Andersen said Mr. Duncan willy nilly destroyed documents, in fact, Arthur Andersen's own client engagement said that the auditor is required to destroy at the end of every engagement, all documents, all work documents except for the final work product, and that only in the instance where someone is served with a subpoena, either civil or criminal summons, is document destruction to cease. Is that consistent with FASB policy?

Mr. JENKINS. The FASB has no responsibility or authority over that particular issue. That issue does not impact financial reporting. That is an auditing issue. Auditing is under the purview of the AICPA through the Auditing Standards Board, as enforced by the SEC. We don't have anything to do in that area.

Ms. DEGETTE. That is what I thought, so let me ask Mr. Castellano, is that kind of policy allowed under your organization's standards?

Mr. CASTELLANO. I think to a certain extent, it is a legal issue, but we do have standards, auditing standards, covering documentation that, in general, require that the auditor maintain sufficient and adequate documentation to support the procedures that were performed and the level of review that was conducted on the procedure.

Ms. DEGETTE. Okay. Let me read you this policy and see if you think it is standard in the—let me ask you, how long have you been involved in the industry?

Mr. CASTELLANO. I have been a CPA for about 28 years.

Ms. DEGETTE. About 28 years. What Arthur Andersen's policy says is, "Drafts and preliminary versions of memos and reports, superseded workpapers, backup diskettes, and other types of information not in the central client engagement file should be destroyed when they are no longer useful to the engagement, and no later than when the engagement is completed." Is that standard practice in the industry?

Mr. CASTELLANO. That practice is not governed by our auditing standards.

Ms. DEGETTE. Okay. Who governs that?

Mr. CASTELLANO. I think that is really a legal issue as to what documentation must be retained.

Ms. DEGETTE. Is there some organization that would govern what papers are destroyed by auditors, if you don't do it and Mr. Jenkins' organization doesn't do it? Mr. Herdman, does your organization cover that?

Mr. HERDMAN. No.

Ms. DEGETTE. Who regulates that?

Mr. CASTELLANO. As I said, there is an audit standard that requires documentation of the matters that I mentioned. Those matters do not include, I don't believe, the items that you mentioned.

Ms. DEGETTE. I gotcha. Who is in charge of regulating what documents auditors keep or destroy? Does anybody regulate that?

Mr. CASTELLANO. I don't believe so.

Ms. DEGETTE. Thank you.

Mr. STEARNS. I thank the gentlelady. The gentleman from Nebraska is recognized for questions.

Mr. TERRY. Thank you, Mr. Chairman. I have two questions. My first, Mr. Jenkins, if you could help me. I need to tie down the cause-and-effect to make sure that the policy that we embrace here can actually help fix the problem and instill the confidence back into the capital markets and investors, so help me.

On page 23 of your testimony, you note—here is the way I am going to frame your question—that in 1997, Enron indicated—in 1997 it had overstated its income, net income, by $96 million, and then every year that was compounded to some extent, but yet it wasn't until 2001, mid to late 2001, that anyone became aware of these problems.

So, as a layman, help me understand which of your suggestions for changes that transparency in a variety of areas will help shine the light as quickly as possible. Through the changes that you suggest, would somebody have caught in 1997 that Enron had overstated its net income by $96 million? Why did it take 5 years?

Mr. JENKINS. We don't know why Enron didn't follow generally accepted accounting principles in 1997 and other years, apparently. We don't know what caused them to do that.

What do know from the public record is that they didn't follow now existing generally accepted accounting principles. So, we wouldn't need to make any changes apparently in our existing requirements in order to have had that result in 1997 had Enron followed our rules. What we are trying to do is to further improve those rules for the future.

Mr. TERRY. But that doesn't answer the question. What policy—what can we adopt if there is a company like Enron or Global Crossing who wants to manipulate the system? How do we catch that? If this started in 1997, what policy can you suggest to us that in that same year that this type of shenanigans is undertaken, that it can be discovered?

Mr. JENKINS. Well, again, I am not trying to avoid your question at all, on the contrary. But until we know why they didn't follow the rules, it is a little hard to address how we might correct it.

Mr. TERRY. Well, let us just say they did want to and we will make that assumption and go forward. They were intentionally being deceptive perhaps.

Mr. JENKINS. Then it seems to me that it gets over to a question of the responsibilities of top management, the responsibilities of the audit committee, the responsibilities of the auditors, and that that is accepting at face value that Enron said they didn't follow, as they stated in 2001, they didn't follow existing standards, I think that is where that trail has to lead.

Mr. TERRY. All right. Then, Mr. Castellano, then maybe your suggestion that we somehow criminalize lying to your auditor as a solution, explain how that will work, and then I want to come back to Mr. Herdman and ask if that is appropriate, to criminalize providing false information to your auditor. In fact, isn't it already—aren't there already laws in place? In essence, what you are trying to do is deceive your shareholder and using your auditor as the conduit in which to deceive.

So, Mr. Castellano, if you would expand on why we should criminalize and if you think it will be effective, and then, Mr. Herdman, if you could follow up and answer the same questions.

Mr. CASTELLANO. Well, let me first say that as I said in my oral testimony that I don't believe any changes in the reporting model are going to protect investors from greed and bad judgment. I mean, that starts with the entity itself. They have to have the right tone at the top, and the right system of corporate governance from the Board of Directors, the Audit Committee, the senior investors in the company. That is where it starts.

Auditors need protection along the lines that I described, so that those who may be so inclined to withhold material information from an auditor, is that a violation of securities law? I don't know, I am not an attorney. Lying to an auditor, is that a violation of securities law? I don't know. Perhaps we need clarification. We are raising the issue because we think this net of scrutiny here, that it is appropriately being cast, needs to be cast far and wide, and all need to do a very thorough self-review.

Mr. HERDMAN. Under Section 13 of the 1934 Act, lying to the auditor is already forbidden. And I believe I have the citation—correct me—under Section 20(c) of that Act, we believe that through the operation of that section it would be a criminal violation of the law.

Mr. TERRY. Thank you, Mr. Chairman.

Mr. STEARNS. Thank the gentleman. The gentleman from Illinois, Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman. I want to thank the chairman, and I also want to thank the witnesses for being present this morning.

Mr. Herdman, the SEC has the primary responsibility for enforcing FASB's accounting standards. That is correct, is that right?

Mr. HERDMAN. The SEC has the primary responsibility for oversight of the entire disclosure system.

Mr. RUSH. Well, I want to return to Mr. Towns' line of questioning. Until the capital markets relief act is fully funded, the SEC would find it hard to retain and attract high quality staff as well as meet its current staggering workloads. Now, how does the SEC intend to return investor confidence if it is unable to provide pay parity for the very people responsible for protecting those investors? How can SEC fulfill its responsibility to the American public if you have a disparity and you lack pay parity among your employees?

Mr. HERDMAN. Congressman, as I said earlier, we believe that the pay parity issue is very important to the Commission's ability to attract and retain the high caliber people necessary to fulfill our role. However, if we don't get it, I would have to say we will just have to continue to muddle through as we have in the past.

Mr. RUSH. What type of initiatives are you approaching in terms of trying to get the money to pay your people a decent wage over there?

Mr. HERDMAN. I am sure that our Chairman is doing everything that he can with respect to that.

Mr. RUSH. Let me ask you, can you describe what your agency did to ensure the Enron and others were or are following the accounting principles regarding SPEs and mark-to-market accounting?

Mr. HERDMAN. I believe this Committee is aware of the fact that we did review Enron's financial statements for its year ended December 31, 1997, and included in that review process we took a look at their quarterly reports that had been filed up through March 1999.

Mr. RUSH. So you haven't looked at them since 1997, is that what you are saying?

Mr. HERDMAN. We haven't looked at any annual financial statements since 1997.

Mr. RUSH. What is the reason for that?

Mr. HERDMAN. Well, I think the Commission staff, in its review of filings, uses what is referred to as a "selective" process for picking which filings will be reviewed, with the goal of reviewing each company's filings no less frequently than once every 3 years. As I understand it, when Enron's turn came up for review earlier in 2001, which was prior to my return to the Commission, Congressman, it was decided to wait to conduct that review in 2002 because of the fact that our new accounting rules went into place in early 2001 concerning derivative financial instruments. It was known that Enron engaged in a lot of derivative financial instruments, and it was felt—and it was a very principal decision—that it would be more productive to review Enron in 2002 when the financial statements for the first time then would reflect these new accounting requirements.

Mr. RUSH. So your decision was based primarily on the fact that there were new requirements that you were enforcing, and it wasn't based on any kind of funding issues, just primarily based on changes in terms of your procedures?

Mr. HERDMAN. That is my understanding, yes.

Mr. RUSH. Okay. So, in other words, you have reviewed corporate accounting work products as it relates to your regulations for other corporations since 1997, is that correct?

Mr. HERDMAN. Yes, we have.

Mr. RUSH. Have you found any accounting irregularities similar to the ones at Enron pervasive throughout the economy, or should this committee—is there a red flag that should be waved as relates to other corporations in terms of their accounting procedures at other corporations?

Mr. HERDMAN. We have, in our review process, found instances where we disagreed with a company's interpretation of the accounting rules or other requirements, and have required restatement or amendment to filings with respect to that. I am not familiar with any situations——

Mr. RUSH. Does the SEC view the accounting climate in terms of corporate America as being a situation of crises at this point?

Mr. HERDMAN. I wouldn't say, Congressman, we see it as a crisis. I don't know of any other Enron-type situations that are out there, but we certainly are not going to just hope that that is the case. We initiated just yesterday announcements about new rulemaking activities that we are entering into. That is just the start of our activities with respect to it. In the wake of Enron, everything is on the table. There is nothing that is off the table. We are fundamentally relooking at all of our requirements in order to make sure that investors are adequately protected.

Mr. RUSH. Mr. Herdman, my view of the SEC—and maybe it is correct or maybe it is not correct—but I certainly would like the SEC be a lean, mean, fighting machine as it relates to protecting the investors and the investors' interest in this country, and I certainly think that we all must do all that we can to ensure that the employees that we have to count on to protect our investing public, that those employees are paid adequately so that they will be able to do their job and so that we will be able to retain those employees.

With that, Mr. Chairman, I yield back the balance of my time.

Mr. STEARNS. The gentleman yields back.

Mr. TOWNS. Mr. Chairman, may I ask a question?

Mr. STEARNS. Sure.

Mr. TOWNS. Are you going to have another round?

Mr. STEARNS. I think we will have another short round. The gentleman from Illinois, Mr. Shimkus. Excuse me, Mr. Shimkus,I am sorry. Mr. Buyer.

Mr. BUYER. Thank you, Mr. Chairman. King Solomon said long ago that there is nothing new under the sun. And so I took a little look at history here. To be a good listener to all of you—and it is not just about you and how you react to this, it is different institutions will react to something. Immediately, you circle the wagons. You begin your introspection. You examine yourself. Sometimes you are hard on yourself, sometimes you are not. Sometimes you say—and I will use your quote—"our basic model is sound," which means you like yourself, but you are willing to do a self-examination. You throw out some recommendations. But, you know, you have been here before.

So, as I was looking and reading about the Treadway Commission, I look at this and say, well, what we are all having to deal with is confidence in the markets, the integrity of your systems, you are self-regulated in your profession as CPAs. You are well respected in my hometown, and I would hate to see anything erode that respect that the CPAs have in my hometown.

So, when I looked at the milestone in shenanigan prevention that the Treadway Commission did—see, all of you came together back in 1985 to do this, and you financed it. You did it. Government didn't do it. You said, "If we are going to be self-regulated out there, we are also going to lean forward," and there are oftentimes you get blown back on your heels, and that is what has happened here, I think. You have been blown back on your heels. And when I read the conclusions and recommendations of the Treadway Commission, it almost sounds like everything that is applicable to today.

And so when I went over here to the SEC, the SEC should have the authority to impose fines in an administrative proceeding, seek fines directly from court, authority to issue cease and desist orders when securities laws are violated—it goes on and on—criminal prosecution, fraudulent financial reporting cases—why do fines become the exception and not the rule? Why are you so hesitant? I don't understand.

If the academic community and all of you embraced the Treadway Commission's findings, you get out there, you try to teach the students, the academic curricula embraces it, and we are trying to do the teaching, some things still failed. If we try to set the proper tone for top management and directors, some things failed. With regard to independent public accounting and auditors having responsibility for the detection of fraudulent financial reports, some things failed.

So, I almost have to pause here, gentlemen, and I want to have a constructive dialog with you. If you lean forward to prevent shenanigans—and King Solomon is right, you know, we can set the rules in place, we can do everything we can, but that is why we still have a criminal code. But I don't want to lose sight of the ball here. The ball is making sure that that marketplace—that there is integrity and there is confidence out there, and that there is enforcement with teeth.

So, here is my ultimate question. Are we at a point where instead of every entity out there saying "circle the wagons," introspection, and then say, "well, here are some recommendations we have," and that Enron isn't the—don't cast the Enron shadow on everyone, and that is sort of the fear in the marketplace.

Are we at a time where perhaps all of you should come together once again on Round 2 of your National Commission, examining Treadway and—I mean, we have got to have a single entity, you know what I am saying? Congress is out here. We are doing all our hearings. Each of you are doing it. I don't want government-fund a national commission that does this. Do we need now a second sort of Treadway Commission that sort of brings all this together, and that is what I throw on the table. I welcome your comments.

Mr. HERDMAN. Congressman, I would say at this point that we believe that that is the role that the SEC should be fulfilling. We have started a number of initiatives. We have asked the stock exchanges to once again consider the governance provisions related to public companies, and they have set up a committee that will start to do that. We have encouraged the Financial Executives Institute to take a hard look at their code of conduct and to reinforce it in the wake of recent events. We are working with the FASB. We are working to re-establish the regulation of the auditing profession. We last week announced new protocols and agreements with the exchanges and with the brokerage firms with respect to the analyst community. We are working on a number of fronts, and believe that we are covering all the bases and that everyone right now is engaged, I believe, in very critical introspection with respect to what needs to be done in the wake of these events, and that is productive and that is appropriate.

Mr. JENKINS. The issue of the Treadway Commission which really does, as Mr. Herdman suggested, relate to corporate governance issues, is an important one. The tone at the top, which I think is the basic theme of Treadway, I think is essential and we, at the FASB, are going to try to issue financial reporting standards that are more principle-based rather than detailed rule-based in the hopes that we can do away with the attitude of some in the corporate arena, and some perhaps in the auditing arena, that apply the rules on the basis of "where does it say I can't do that" rather than on the basis of the clear intent of the rule and the clear representation of the underlying economic events.

If we move in that direction, which we are being encouraged strongly to do, and would like to do because I think it would also expedite our process, then having the proper tone at the top, to summarize in one phrase the Treadway report, will become even more essential.

Mr. CASTELLANO. The American Institute of CPAs is absolutely committed to meaningful reform. The Treadway Commission was sponsored by COSO, the Committee on Sponsoring Organizations, which is a group that includes the American Institute of CPAs, FEI, the American Accounting Association, Institute of Management Accountants, and the Institute of Internal Auditors. COSO still exists. COSO continues to work and to meet. In fact, I understand there is a meeting February 19th where they are addressing enterprise risk management.

So, I would expect that through our participation and support of COSO that we will continue to work toward meaningful reform along the lines that you suggest, Congressman.

Mr. BUYER. Thank you, Mr. Chairman.

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

Mr. MARKEY. Thank you, Mr. Chairman, very much. My brother Johnny was a 1969 Magna Cum Laude graduate of Boston College, majoring in finance. I said to my brother at the time, asking wisdom from a 21-year-old, "Why are you a finance major, Johnny, why weren't you an accounting major?" And he said, "Well, Eddie, the finance majors play the game and the accountants keep score. I want to play the game." Well, about 10 years later, the accountants said to themselves, "Why don't we play the game and keep score at the same time inside of corporations." And, of course, that is the underlying pathology here in the accounting industry, that they believe that they could play both roles at the same time. You can't do it. It is an inherent conflict of interest.

Now, we are having this hearing, Mr. Chairman, in the Armed Services Committee room, and I look at this painting at the back of the room, and I think it is symbolic of why we are here because I see that painting characterizing investors trying to fight their way out of a jungle of misleading documents and fraudulent accounting statements, left to fight their own way out without any help from the accounting industry or the Securities and Exchange Commission in protecting their 401(k) plans, protecting their investments for their families because they weren't given the proper information, they were just dropped into a jungle that was rough and tough but misled in terms of how many protections were being given to them.

So the question now is, what are we going to do to protect these people? Mr. Castellano, I understand that Chairman Pitt was an attorney for the AICPA, for the accountants, and the Big Five accounting firms prior to being appointed as the Chairman of the Securities and Exchange Commission, now the public's Number One protector against the accounting industry's abuses.

What were Mr. Pitt's duties for the accounting industry when he was your attorney?

Mr. CASTELLANO. Congressman, I wasn't involved at the time Mr. Pitt was serving as attorney for the American Institute of CPAs, so I can't specifically answer your question, but I will be happy to get back to you with a response on that.

Mr. MARKEY. So you have no idea what he did for AICPA, is that what you are telling us today?

Mr. CASTELLANO. I don't know the details of what he did. I know that he had worked at the time of the formation of the Independent Standards Board, I believe, in some of the work in the creation of the Independent Standards Board, but I don't know the specifics of what his services were.

Mr. MARKEY. Well, how much did AICPA pay the new Chairman of the Securities and Exchange Commission at the point at which he was working for the accountants?

Mr. CASTELLANO. I have no idea, Congressman, but we can get that for you.

Mr. MARKEY. Did the AICPA, did the accountants recommend Mr. Pitt to the White House when the White House was considering who to appoint as the new head of the Securities and Exchange Commission?

Mr. CASTELLANO. I am not aware that the American Institute of CPAs recommended Mr. Pitt to the White House.

Mr. MARKEY. So you are saying that you did not endorse his candidacy?

Mr. CASTELLANO. I am not aware that the AICPA recommended the chairman——

Mr. MARKEY. Aha, so they did not recommend him.

Mr. CASTELLANO. Not to my knowledge.

Mr. MARKEY. But you don't know that they didn't, is that what you are saying?

Mr. CASTELLANO. To my knowledge, we did not, but I—to my knowledge, we did not. I believe I have answered.

Mr. MARKEY. So AICPA never wrote any letters to the White House, or call anyone at the White House, or meet with anyone at the White House to discuss Mr. Pitt's appointment?

Mr. CASTELLANO. My advisor tells me that we did not, and we were not consulted.

Mr. MARKEY. Okay. Now, how many times has the AICPA met with Mr. Pitt since he has been at the Securities and Exchange Commission?

Mr. CASTELLANO. There have been a number of meetings, I don't know how many. We have stated very clearly that we are very interested in supporting the Commission's recommendations to move from self-regulation to public regulation, from public oversight to public participation in the areas of discipline in what was formerly called "peer" review, but will probably have another name under the SEC's new structure. So there have been a number of meetings, I don't know how many, where we have been asked to work with and support the Commission in their proposal for moving from self-regulation to public regulation of our profession.

Mr. MARKEY. Can you provide for the record each meeting that you have had so far with the new Chairman of the Securities and Exchange Commission?

Mr. CASTELLANO. I believe we can, certainly.

Mr. MARKEY. Now, I understand that Mr. Paul Atkins and Ms. Cynthia Glassman are also alumni of two large accounting firms, and that they are both under consideration to become Commissioners at the Securities and Exchange Commission, is that correct?

Mr. CASTELLANO. As I understand, that is correct, yes, sir.

Mr. MARKEY. So, if those two accountants, combined with Mr. Pitt, are at the Securities and Exchange Commission, and there are only five members, that would mean three out of the five members of the Securities and Exchange Commission would then be alumni of the accounting industry at the point at which there is the greatest crisis in the history of the accounting industry, would that be correct?

Mr. CASTELLANO. Well, Mr. Pitt is not an alumni of the accounting profession, but he has performed services, as you said.

Mr. MARKEY. He was your lawyer.

Mr. CASTELLANO. He has done work for the accounting profession, but he has never been a practicing member of the profession.

Mr. MARKEY. But he was the lawyer for your profession, for the AICPA, was he not?

Mr. CASTELLANO. Yes. I just want to be clear that in my view, in my understanding, alumni means someone who is part of the profession itself. I am not familiar with the background of the other two Commissioners who have been recommended, although I do understand that they do come from accounting firms in some capacity.

Mr. MARKEY. Well, I guess what I am saying is, with your former lawyer and two former accountants comprising three of the five votes at the Securities and Exchange Commission, it puts the accounting industry in the catbird seat.

May I continue for 1 additional minute, Mr. Chairman?

Mr. STEARNS. Unanimous consent, so ordered.

Mr. MARKEY. Mr. Herdman, where did you work before you went to the SEC?

Mr. HERDMAN. I worked at Ernst and Young.

Mr. MARKEY. Mr. Herdman, I have heard concerns raised that one of the first acts taken by Chairman Pitt when he took office was to remove the top accountant in the Corporation Finance Division and announce to the Securities and Exchange Commission that they would now have a "kinder and gentler" Securities and Exchange Commission that wouldn't force companies to restate earnings.

I have also heard that the number of accounting slots at the Corporation Finance Division is being slashed in the SEC's budget request. How do you, as the Chief Accountant now at the SEC, respond to those concerns?

Mr. HERDMAN. I respond that you have been misinformed. The Chief Accountant of the Division of Corporation Finance resigned that position. As to the question of whether the number of accounting slots in the division has been cut, that is not consistent with what I believe to be the case.

Mr. MARKEY. You are saying there is not going to be a reduction in slots at the SEC Accounting Division?

Mr. HERDMAN. That is my understanding.

Mr. MARKEY. Will you submit that to the committee because that is completely at-odds with what we are being told.

I think, Mr. Chairman, if I may, that there is a problem at the Securities and Exchange Commission at this point in time. When it comes to giving confidence to the capital formation process in this country, that the reforms are going to be put in place which are going to give to every ordinary family, every investor, the real confidence that the numbers are real, that there is some reason to trust the stock market.

Now, I know Mr. Pitt is saying that he is going to recuse himself from any enforcement action against any particular company or individual, but he is not going to recuse himself from the rulemaking process in terms of putting on the books for the next generation, the rules that are going to give every family—and let us not kid ourselves, every single family that was in mutual funds over the last 10 years probably had Enron stock, or the stock of some of these other companies that had phony numbers.

And so I think we have really got a huge question that we have got to ask because we are not talking just about the reality, we are also talking about the perception because confidence is the key to investment in the stock market. And if we don't have a public that believes that the people who have this responsibility are independent enough from those who are seeking to not put the toughest rules on the books to protect the investor, then I am afraid that we might not see the investment in the stock market in the next generation that will create the jobs that will make our country as prosperous as it should be.

Mr. STEARNS. Thank the gentleman. The gentleman from New Hampshire, Mr. Bass.

Mr. BASS. Thank you, Mr. Chairman. I have some reservations about my friend from Massachusetts' very eloquent remarks. Having accountants on the SEC certainly might be cause for concern, but accounting is not a simple craft, and it might not hurt to have people who understand the industry, understanding that they have no ethical conflicts of interest, might not be a bad way to deal with the question of where we go. After all, President Eisenhower was the head of NATO and was an important military officer in American history, and yet he did more to cut and carve and make the U.S. military more efficient as President, even though some thought he might have a conflict of interest there.

A couple quick items. I think perhaps we should, in light of what my friend has said prior to me, have a look at the other picture on the wall over here. Perhaps there are some issues that we can draw allusion to here. We have those contrails up in the high atmosphere, the business community moving forward, and the accounting industry not quite knowing how to catch up with the businesses because the businesses have so much more money than they do, and they are uncertain in this day and age. There is a lot of interesting artwork in this room that really does have some bearing on the hearing that we are having this morning.

Mr. MARKEY. Can I say, I see that as Enron carpetbombing the investors of their company all throughout the year 2001 without any——

Mr. BASS. Touche. Mr. Herdman, I heard you say something at the end of I think it was Mr. Buyer's questioning, and you said, "There are no other Enron-type situations out there"—I am quoting you now. Is that true?

Mr. HERDMAN. I believe I said, Congressman, that I am not aware of any Enron-types of situations that are out there. I certainly am not going to say that there are no other Enron situations out there.

Mr. BASS. How do you define an Enron-type situation?

Mr. HERDMAN. Well, I would define it as a huge, huge company that within a matter of months, a very short period of time, goes from being a high-flier to being bankrupt.

Mr. BASS. And just one more time just to confirm it, you are the Chief Accountant for the SEC, you are not aware of any other Enron-type situation, as you defined it, out there?

Mr. HERDMAN. That is correct.

Mr. BASS. Thank you very much. What a difference a couple of years makes. I wonder what the subject of this hearing, the tone and tenor of this hearing might have been 2 years ago. As I recall, the debate was quite different, how to state the real value of dot.coms and so forth—we discussed this—but how it has changed in the last couple of years. Third, I am surprised at the disparity between the amount of resources that the regulators have versus those which are available to the people whom you regulate. I would guess, I will make this up, that the top Fortune 500 companies probably spend about average—I will be conservative—$10 million apiece on accounting each year. If you add that up, it comes to about $100 million—no—$100 billion, and you guys have a budget of what, about $250 or $270 million?

Mr. HERDMAN. I believe it is just below $500 million.

Mr. BASS. So there is a discrepancy here. My friend, Mr. Towns, and others on the committee need—I think we need to examine that issue.

The last issue or open-end question I want to ask is, we are not the only country that regulates accounting practices and financial information. Are there any other models in any other countries, industrialized countries around the world, that we might look at as a guide to figure out what works better and what doesn't work so well versus the system that we have here in this country. Can any of the three of you address that, do you have any knowledge?

Mr. HERDMAN. I think that it is safe to say that there is no other country in the world that has anything that approaches the SEC in terms of its oversight of the markets, oversight of the preparer, the registrants and the auditors. It just doesn't exist.

One thing that we are looking at is a fairly recent form of regulation adopted in the United Kingdom with respect to auditors, and we think that there are some valuable lessons to be learned from that.

Mr. BASS. What are they?

Mr. JENKINS. There are a lot of different kinds of regimes around the world. Up until quite recently, most of the regimes that were involved with accounting and financial reporting were directly a part of the government of those countries. But, interestingly, the trend is significantly moving toward private sector standard setting for the setting of accounting standards—maybe not for the regulation of auditors or scope of services or tax services. But for accounting standards setting, for example, Germany has moved to a private sector standard setter, Australia somewhat the same way, New Zealand, and other Anglo-Saxon countries. In particular, Japan has recently established a private sector accounting standards setter in an effort to overcome their very significant capital market issues.

Mr. BASS. Mr. Castellano, do you have anything to add?

Mr. CASTELLANO. Just to say that the American Institute of CPAs is a member of the International Federation of Accountants, IFAC. We participate actively in that international organization of accountancy organizations, and we are looking at all different models to see if we can learn something.

Mr. BASS. Mr. Chairman, my time is expired. I would like at some point in the future if Mr. Herdman could tell us what lessons we may have learned—the very last phrase of your answer to the question—I would be interested in knowing that.

Mr. STEARNS. Can you answer that question quickly?

Mr. HERDMAN. I think the predominant one concerns regulation of the auditing profession, and that the oversight body and the various committees that carry out the regulation should be dominated by members representing the public interest as opposed to those representing the profession.

Mr. BASS. Interesting. Thank you very much.

Mr. STEARNS. I thank the gentleman. The gentleman from Illinois, Mr. Shimkus, is recognized for questions.

Mr. SHIMKUS. Thank you, Mr. Chairman. I, too, as an Army officer, really enjoy being in this room, although we are much more constrained than if we had full access to our regular committee room.

Bill Gates loses $1 billion in the tech crash—we call it—"paper loss." Investors in Enron, who saw their portfolio balloon from $15 a share to $90 over a 2-year period, and we forget that a lot of that is what we cavalierly say is a "paper loss." And I am really interested in this period of time from January 2000 to January 2001 because we have a price increase from approximately $37 a share to a high of $90 a share, and then by the end of the year it is back to—well, at the end of the year it is at $80 a share, and then because of a lot of things it then falls off the chart.

Three things that I have been looking at—and I am not on the Oversight Subcommittee, so I am not delving into all the issues—but I want to know just three things, or just get some help in educating myself.

First of all, I don't know how you could work in America auditing major corporations and not be a member of a big accounting firm, there are five. If you are in the business of accounting large entities, you are a member or employed by one of the major accounting firms, that is just a reality.

But three things—and we will just go Mr. Herdman, Mr. Jenkins, Mr. Castellano—and maybe you can answer these, maybe not, the problem of special purpose entities, a solution; the problem of the employee stock option rollout issues, a possible solution; the problem with performance statements—and you may not think there is a problem with performance statements—a possible solution.

Mr. HERDMAN. I am not sure I understood your third point, Congressman.

Mr. SHIMKUS. Performance statements, you know, those statements which some people would say is "corporate spin" to explain their balance sheets and all the other hard data that is out there. I have my MBA, but I will never say I—some people will say it is credible, it helps. Some people say it is spin. And it hides and deceives.

Mr. HERDMAN. I believe what you are referring to are earnings press releases that present the results of operations on an alternative basis, an alternative of GAAP sometimes known as "pro forma."

Mr. SHIMKUS. Right.

Mr. HERDMAN. Fine. I will start with the SPEs. I think, as I said earlier, we definitely need to have more comprehensive rules about when SPEs should be consolidated with the sponsoring entity, and we need to have those done very, very quickly so that they are in place for year 2002 financial reporting.

Mr. JENKINS. If you want to take each of these issues one at a time, that is fine.

Mr. SHIMKUS. Yes, that would be great. Mr. Jenkins, why don't you follow on.

Mr. JENKINS. Well, as I told this committee briefly earlier this morning, we at the FASB have been working on providing improved guidance with respect to special purpose entities. Yesterday, at our public board meeting, we outlined and gained approval from the Board of an approach that we think will significantly improve that accounting, and our plan is to move rapidly to meet the goal that Mr. Herdman described of existing standards being in place by the end of this calendar year. And to that end, we are going to develop the full—we are going to develop a full document and have a public discussion of it on the 27th of this month.

Mr. SHIMKUS. So you both agree it is a problem, and there is movement to fix it. Mr. Castellano, on the special purpose entities?

Mr. CASTELLANO. Just to add to that, the AICPA in December, I believe, asked that this issue arising from Enron be addressed, and we are working with the FASB and absolutely support them as a private sector standard setter to address this issue, and we are delighted that it is being addressed. I am sure that they will address the issue of better disclosures, the risk and uncertainties involved in SPEs, and do so expeditiously.

Mr. SHIMKUS. Mr. Chairman, since my time is up, maybe they can—if you want me to finish the question, I can. If you want them to submit in writing, I will be willing to do that.

Mr. STEARNS. I think what we are going to do is have each member go around and ask one quick question, just take a second round here quickly, and see if we can get through it.

Mr. SHIMKUS. So, would you want them to submit the other two answers in writing, that is my question.

Mr. STEARNS. I think that would be a good idea.

Mr. SHIMKUS. If you would do that——

Mr. JENKINS. Could I ask just a point of clarification, please. On the second issue, on employee——

Mr. SHIMKUS. I was basically referring to the employee stock option standard—consolidation in accounting and the standards that apply to employee stock options.

Mr. JENKINS. Employee stock options, not 401(k) plans. Thank you.

Mr. STEARNS. I think we are going to have a couple of votes here. I think we will just each ask one quick question and start the second panel.

The question I have for Mr. Herdman is, in your testimony you suggested that if the FASB is not able to make progress on important issues as they arise, the SEC should take action. However, you also stated that FASB was better able to set quality accounting standards than the SEC. How do you reconcile those two statements?

Mr. HERDMAN. I think, Mr. Chairman, that the fact of the matter is that FASB has more resources than we do. They are better able to conduct research. They are better able to reach out to various constituencies, and they have a lot more money. But if there are situations where, because of their process, because of delays, we find that an area desperately needs attention and isn't receiving that attention, then we are going to have to step up and do it.

Our solutions might often be more directed toward improved disclosure as opposed to improved underlying accounting principles because the SEC's expertise is much greater in the area of disclosure and the rulemaking processes that surround it.

Mr. STEARNS. Just for the record, Mr. Herdman, how long have you been with the SEC in your present position?

Mr. HERDMAN. About 4 months.

Mr. STEARNS. Thank you. Mr. Towns?

Mr. TOWNS. Thank you, Mr. Chairman. Mr. Castellano, you raised a question, or you made a statement that really, really I would like for you to explain further. The statement was, "The focus of auditors must now change." What do you really mean by that? That statement bothered me.

Mr. CASTELLANO. I am happy to clarify, Congressman. What I was talking about is if we can look to the future, toward financial reporting that will be more real-time, on-line reporting, that our profession must be in position to provide assurance to investors that the underlying systems providing that information are reliable. That is what I am talking about, that as financial reporting evolves from periodic reporting, annual reports, quarterly reports, looking back at what happened in the past, to a new model eventually that has more forward-looking information, information about the real drivers of future success in enterprises, our profession has to be poised with audit approaches, audit standards to provide assurance to investors that they can rely on that information and that they can rely on the underlying system that is providing it. That is what my point was.

Mr. TOWNS. So that would deal with documents as well?

Mr. CASTELLANO. May deal with documents, but I foresee an environment where auditors are expressing assurance on the system that is providing the information. We have an assurance service that we have invested a substantial amount of intellectual capital to develop called "SysTrust," which is available today, that boards of directors and companies could take advantage of to employ the accounting profession to provide assurance that their underlying system is reliable, available when needed, and maintainable. It is processes like that that we as a profession are thinking about investing in, so that when this business model evolves over time, we are poised with a vibrant accounting profession to provide the kind of assurance that investors will need.

Mr. TOWNS. Thank you. Thank you very much.

Mr. STEARNS. Mr. Bass has indicated he is going to take a pass. Ms. DeGette. What we are trying to do is just one question before we have our vote.

Ms. DEGETTE. Thank you, Mr. Chairman. My question for all three panelists is this. Last week, in our full committee hearing, we heard a proposal which was endorsed by several of our witnesses that outside auditors should be chosen on a rotating basis, and one of our witnesses at least said that they should be chosen on a rotating basis by the shareholders of the corporation. Arthur Andersen made $52 million last year from Enron, and slightly more from consulting and auditing, but a lot from both.

So, my question to all three of you is, what do you think about the proposal to have the outside auditors rotate and, second, how do you feel about having them chosen by the shareholders? If you agree, why, and if you disagree, why?

Mr. HERDMAN. Congresswoman, those are among the issues that we will be considering as we go forward with respect to what modifications to the independence rules are necessary. I have no present opinion about them.

Ms. DEGETTE. Thank you.

Mr. BASS. If the gentlelady would yield, I was under the impression that shareholders do select the outside auditors. Is that true?

Mr. HERDMAN. Congressman, I believe it is generally a matter of State law as to whether the shareholders are required to elect the auditors, or are required to ratify the appointment of the auditors by the board of directors.

Ms. DEGETTE. Reclaiming my time, what normally happens, at least as I have been told, Mr. Bass, is that the auditing team is selected by the management of the company, and sometimes ratified by the shareholders, and that there is no requirement that the auditors rotate.

Mr. JENKINS. That question is outside the purview of financial reporting standards, so I don't have an opinion, as the Chairman of the FASB.

Ms. DEGETTE. Mr. Castellano?

Mr. CASTELLANO. On the issue of mandatory rotation of auditors, I think, is what you are asking. My concern with that really is impact on audit quality, and I think that is what we all want, is to make sure that the quality of audits is the best that it can possibly be. And this concept of rotating auditors raises a question in my mind as to whether or not the loss of experience with the entity—these businesses are complex, as you know, they are incredibly complex—and——

Ms. DEGETTE. So I guess you are saying you don't agree with the idea of rotating auditors?

Mr. CASTELLANO. I think we have to very seriously and carefully consider such far-ranging proposals like that so that we don't have unintended consequences, which could include actually a deterioration of audit quality. That would be my concern.

Ms. DEGETTE. What about having the auditors chosen by the shareholders, the second half of my question?

Mr. CASTELLANO. I don't have an opinion about that.

Ms. DEGETTE. Mr. Chairman, let me just say—I know we are about done with this panel—what I have heard is everybody saying they are concerned about what happens, and they are looking at it and they are thinking about it. I don't hear anybody saying what they want to do about it, or when they are going to figure it out. I think we need to get some answers from the industry, so I would hope that the gentlemen would take this very seriously, and I would hope, Mr. Chairman, you would consider bringing these gentlemen back in a few months so they can tell us what, if anything, they have decided to do.

Mr. STEARNS. That is a good idea. And I would point out also that five former Chairmen of the Securities and Exchange Commission, when talking about the collapse of Enron, all expressed the flaws in the present accounting system and financial reporting system, and they say, all five of them, we need major reform to restore investor confidence.

The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, very much. Mr. Castellano, in the 1995 Private Securities Litigation Act which AICPA lobbied powerfully to pass, there was a provision which limited the liability of the accounting industry, even if the accounting company was also providing consulting services to a particular outside firm like Enron, so that subsequent to 1995 defrauded investors and employees of Enron public companies would not be able to receive from Arthur Andersen the same level of damages that they would have before 1995.

Now, in light of what happened with Enron, Mr. Castellano, my question to you is, would you support restoring liability for accounting companies when they also provide consulting services to a company, so that the full joint and several liability would be available to defrauded investors, rather than the much limited settlement which they can receive today?

Mr. CASTELLANO. Congressman, I think the 1995 Act has accomplished just what Congress intended. I think it is working.

Mr. MARKEY. I am just talking about this one area where the accounting firm is a consultant—they are playing the game and keeping score at the same time inside of a firm—they are not just the accounting firm, they are the accounting firm and the advisor, simultaneously.

Mr. CASTELLANO. There is a supposition that the accounting firm's independence is impaired in that statement, and I think that I don't agree that the accounting firm's independence is always impaired——

Mr. MARKEY. I think that is the most troubling statement I have heard in the whole hearing, that he does not believe that when a firm is an accountant and a consultant at the same time, that its independence is impaired, Mr. Chairman.

Mr. CASTELLANO. I believe, as I have testified, Congressman, that our code of ethics very clearly states that accountants must be independent, and there are safeguards, checks-and-balances in our code of ethics that we, as CPAs, must comply with to protect our—to be sure that we are independent. And that includes not acting in the capacity of management, not being in position to audit our own work. Auditors can't do that.

Mr. MARKEY. I think what we saw in this case, though, was that the accountants were intimately involved in the Enron process, and that it was impossible to separate out the auditing from the consulting services, and it has just become one huge kind of hot-tub in which the Enron employees and the Arthur Andersen employees were working together constructing a strategy for Enron, and yet Arthur Andersen is not liable in a way that they would have been before 1995 and, as a result, there is much more of an incentive for this new accounting profession that wants to play the game as well as keeping score to turn a blind eye to activities which then led to serious damage to investors.

Mr. CASTELLANO. Congressman, as I understand the law, Arthur Andersen, should they be found liable, will be subject to their proportionate share of the liability.

Mr. MARKEY. Right, proportionate, but not joint and several. They were a part of the corporation. That is the problem, see. You continue to maintain this distinction when consulting services are provided. You can't say that when a company is paid $25 million for consulting services, that they are not inside the corporation creating a plan. That is not just keeping score. And anyone who is making a plan for the company has joint and several liability, with the exception now of the accountants who are supposed to be protecting the public.

So, you are saying you just will oppose any changes that ensure that that protection is built-in for the investor?

Mr. CASTELLANO. Let me say that I don't know what Arthur Andersen was going at Enron. I don't believe that any of us know quite yet. But to the issue of the 1995 Act, I just will reiterate I believe it is accomplishing what was intended. The number of suits, as I understand, have not declined, but those that essentially have no merit are being dismissed, and those that do are proceeding——

Mr. MARKEY. This is not a question of how many suits are brought, it is a question of who is liable when a suit is brought, and the accountants, Arthur Andersen, is not liable in this case. Do you understand that? I mean, that is——

Mr. CASTELLANO. But they are liable.

Mr. MARKEY. Not as a player. They are players. They are as guilty in Enron in this case as the consultant, as the company that helped put together the plan. They are not just keeping score.

Mr. STEARNS. Let me let the gentleman finish and just make a comment. One, in your behalf, Mr. Castellano, do you realize that the five top accounting firms have already voluntarily decided that they are not going to—as we understand it—in the newspaper, they have decided they are not going to do consulting and accounting together. Is that true?

Mr. CASTELLANO. Yes, Congressman, and I have said earlier in my testimony that we do not oppose restrictions on auditors of public companies from providing——

Mr. STEARNS. You don't oppose, but five top accounting firms thought it is not good and they are not going to do it, which is in line with Mr. Markey's question, don't you think that this is a conflict of interest?

Mr. CASTELLANO. As I said before, those two services, internal audit outsourcing and financial statements system design and implementation, it is apparent that there is a perception that when the auditor for a public company provides those same services, there is a perception, the appearance of independence is impaired and, for that reason, we don't oppose those restrictions.

Mr. STEARNS. Okay.

Mr. MARKEY. If I may, so you are saying the five big companies are separating now consulting from auditing, but it is only because of this perception, in your mind, that there is a conflict? But in your mind, there is no conflict. You continue to maintain there is no conflict, is that correct, Mr. Castellano?

Mr. CASTELLANO. I maintain that as long as the safeguards are followed, that auditors exercise their professional judgment and follow the safeguards, that there would be—there should be no independence impairment in fact, but there is apparent that there is a conflict in appearance in these two services, and for that reason we don't oppose——

Mr. STEARNS. Mr. Castellano, you can make the argument that you should have a consultant and accountant together when you are acquiring other property. If I am going out to acquire a property and you are doing my books, I am going to need you to help acquire that property. Also, if the IRS is coming in to audit me and you are my accountant, I am going to need you as a consultant, too.

So, I think your argument could be that there are areas where it is not a conflict and in fact it is necessary—I don't know all those are, those are just two I can think of, but across-the-board, over a long period of time, is that a problem, if you keep the same accountant in the position as auditor and consultant for 10 years, don't you think somewhere in that range there should be maybe a stop and we say at the end of 3 years you have got to change auditors, or at the end of five—don't you see that that kind of relationship over 10 years gets to create "go along to get along?" Am I off?

Mr. CASTELLANO. Well, it shouldn't, and that is where audit committees should be exercising their fiduciary responsibility to the shareholders, to make sure that that doesn't happen, Congressman. I think there are instances where——

Mr. STEARNS. You need a consultant and an auditor.

Mr. CASTELLANO. There are certain nonaudit services that are deeply rooted in accounting. We just have to be cautious about dismantling an entire structure that could create unintended consequences, and that is my caution.

Mr. STEARNS. Okay. Let me just also come to your defense a little bit, Mr. Markey, he's talking about the Securities and Exchange Reform Bill. What it did is you are still liable for civil and criminal penalties, but you are only liable to the effect that your accounting affected the loss. And what happens is, a lot of these lawsuits were frivolous in the fact they went to the deepest pockets. So, Mr. Markey and I will disagree on the legislation's intent, but from my standpoint, you know, you are still, from a civil and criminal standpoint, liable, and you can be sued. And right now, suits are going against Arthur Andersen as we speak, and there is a lot of them building up. So, the bill didn't stop it, it just tried to say the liability on these accounting firms should not go because of the deepest pockets—they might be doing a small company—but they are there to help the small company, and if they are sued they will pay according to their losses.

So, I think this has been a helpful exchange.

Mr. MARKEY. If I may, Mr. Chairman, just to follow up on what you were saying, I think what Mr. Castellano is telling us is that from now on none of the big firms are going to provide auditing and consulting services to the same company, and they are just going to do that voluntarily.

Mr. STEARNS. Mr. Castellano, is that true? I mean, that is what I read in the paper. Is that true, to your understanding? You should know more than I.

Mr. CASTELLANO. Well, I believe all have reported that they are divesting themselves of their formal consulting businesses, but I believe their statements have been that they are no longer going to provide internal audit outsourcing services nor financial system design and implementation services for the public company clients that they audit.

Mr. MARKEY. Does that mean that they won't be consultants any longer?

Mr. CASTELLANO. I don't know that that means that they won't be consultants any longer.

Mr. MARKEY. So they still retain the right to become consultants and auditors for the same company, is that correct?

Mr. CASTELLANO. In certain instances, following the safeguards that must be followed, I believe that is right.

Mr. MARKEY. There you go. So, if I may, you see, I am willing—I think we are going to wind up—let me just say this——

Mr. STEARNS. We are going to complete this because you and I have taken——

Mr. MARKEY. Can I tell you, there is kind of a first principle of politics—always try to start out in the same place you are going to wind up because it is prettier that way. Now, the accounting industry is going to wind up where—what this committee, I think, is all saying—the industry should wind up, which is separating consulting from auditing. You are saying, no, they are going to retain the right to do consulting. And what I am saying to you is, the longer they do that, the more pressure is going to be applied to the accounting industry to then accept the liability for that, the responsibility for that, because they are still playing the game while they keep score, and the Enron investors and employees are going to stand in silent, though loud, testimony that that is not right. We have got, I think, a very serious issue here that has been raised.

Mr. STEARNS. And I encourage the gentleman, we are going to have another hearing on this. With that, I would say to the first panel, thank you very much, and appreciate your waiting through our voting, and also I would say that all members can submit their statements for the record as well as ask questions, which the panel can answer.

Our second panel today is Grace Hinchman, Senior Vice President of Public Affairs, Financial Executives International; Mr. Thomas J. Linsmeier, Associate Professor of Accounting and Information Systems, Eli Broad College of Business, Michigan State University, and we were waiting for Sarah Teslik, Executive Director of the Council of Institutional Investors. We have called her numerous times this morning. She indicated to us that she accepted our invitation. She was to be here, and for some reason, we have not been able to get to her and for some reason she has decided not to testify this morning, and obviously we are disappointed, but we would like to welcome the two of you and thank you for your patience for waiting, and at this point we would like to have your opening statements.

STATEMENTS OF GRACE L. HINCHMAN, SENIOR VICE PRESIDENT FOR PUBLIC AFFAIRS, FINANCIAL EXECUTIVES INTERNATIONAL; AND THOMAS J. LINSMEIER, ASSOCIATE PROFESSOR OF ACCOUNTING AND INFORMATION SYSTEMS, ELI BROAD COLLEGE OF BUSINESS, MICHIGAN STATE UNIVERSITY

Ms. HINCHMAN. Thank you, Mr. Chairman. Good morning, Mr. Chairman, Mr. Towns, and members of the subcommittee. My name is Grace Hinchman. I am Senior Vice President, Public Affairs, of the Financial Executives International, the leading professional association representing 15,000 CFOs, treasurers and controllers from corporations around the world.

The subcommittee has identified three areas where it believes deficiencies in the present financial reporting model may exist. They are consolidation rules, particularly as they relate to special purpose entities, mark-to-market accounting practices, and related party transactions. I would like to comment on two of those areas.

First, let me say that more consolidation does not automatically yield better accounting. With the FASB consolidation project, FEI has been recommending for some time that FASB drop the control solution portion of this project and focus instead on the area of limited purpose entities, which includes the now infamous SPEs.

We made this recommendation not so much because we think the existing rules are unclear, but because consolidation without control is quite simply an oxymoron. While FEI has long supported reexamination and rationalization of SPE consolidation rules, it is not because of the cases like Enron, rather, members of FEI would like to make sure that the information being presented is meaningful because SPE assets could threaten to introduce irrelevant information into the financial statements.

Another area of concern I would like to mention is related party transactions. The GAAP disclosure rules regarding such arrangements are clear and have been in place for more than 20 years. In addition, the SEC's proxy rules require a very thorough analysis to be presented to shareholders.

In looking at existing arrangements, FEI is unable to suggest any meaningful improvements that would better protect investors beyond those already recommended by the SEC in its Financial Reporting Release 61.

There remains a more fundamental concern of accounting standards and the challenges that face this subcommittee. The broad body of literature that we call "generally accepted accounting principles" has evolved into a puzzle palace of complexity. The days of the onsite audit team being capable of fielding the majority of accounting questions that arise at corporations have long since passed, standards are so complex today that finance executives, out of necessity, are moving into a brave new world of accounting specialization.

One has to question whether anything of value, especially accounting information, should become so complex that it defies the ability of even the most diligent investor to understand. A cry for relief was voiced last year by the finance community and FASB heard the plea. They have embarked on a project that will address accounting simplification, but FASB has its work cut out for it.

As we begin this effort, we must be careful in the identification of the root causes and distinguish the problems that arise from fraud and misapplication of the rules from those problems which arise from the rules themselves.

That concludes my prepared remarks. I would like to thank the chairman for allowing FEI the opportunity to testify.

[The prepared statement of Grace L. Hinchman follows:]

PREPARED STATEMENT OF GRACE L. HINCHMAN, SENIOR VICE PRESIDENT-PUBLIC AFFAIRS, FINANCIAL EXECUTIVES INTERNATIONAL

My name is Grace Hinchman. I am Senior Vice President, Public Affairs of Financial Executives International (FEI). FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the United States and Canada.

The Committee has identified three key areas where they believe deficiencies in the present model may exist: consolidation rules, particularly as it relates to Special Purpose Entities (SPE's), mark to market accounting practices, and related party transactions. In FEI's view, these are only symptoms, however, of the problems confronted by a profession that is in crisis.

CONSOLIDATION RULES

FASB split its consolidation project into two parts this past year: one dealing with the control situations and another dealing with limited purpose entities, which includes SPE's as well as other, less well-defined entities. For its part, FEI has been recommending that the first approach be dropped and examination be directed to the latter area, although putting all SPE's into sponsor's financial statements does not necessarily improve the clarity of financial reporting. We have made this recommendation, not so much because we think the existing rules are unclear, although they are in some respects, but because consolidation without control is quite contrary to our consolidation model. Even in the present framework, it would be helpful for the FASB to referee priorities between the existing rules.

While FEI has long supported reexamination and rationalization of SPE consolidation rules, it is not because of cases like Enron, which we believe the existing rules address cleanly. Rather, we would like to make sure that the information we are presenting is meaningful, and SPE assets threaten to introduce irrelevant clutter in the financial statements.

MARK TO MARKET ACCOUNTING

A second area of concern raised by the Committee concerns mark-to-market accounting. As you are aware, Enron was applying guidance for energy trading activities that was approved by the FASB' Emerging Issues Task Force (EITF Issue 98-10). That issue permitted energy trading operations to mark to market through earnings all of its derivative contracts. Questions have been posed by analysts and journalists about the propriety of methodologies underlying the valuations of these energy contracts. FEI members do have experience with fair values of non-traded instruments. We must report annually such fair values related to finance receivables that are not traded. FEI's experience is that, in the absence of active, liquid markets, these valuation exercises are imprecise. Some of our members, in fact, ensure that this fact is communicated clearly by disclosing ranges of values in their disclosures.

For all of its proven flaws, support for mark to market accounting among its few proponents has not abated. Unfortunately, the FASB is one of those few proponents and has issued several fair value documents, including a so-called Preliminary Views in 1999. Equally unfortunate, the International Accounting Standards Committee (predecessor of the International Accounting Standards Board) issued a similar preliminary document for comment in 2000. Both strongly support moving to a new accounting model under which all financial instruments are reported at fair value and changes in fair value are reflected in earnings. As detailed in our written statement, there are a number of conceptual and practical issues associated with this objective.

RELATED PARTY TRANSACTIONS

A third area of concern raised by the Committee is the area of related party transactions. The GAAP disclosure rules regarding such arrangements are clear and have been in place for 20 years. In addition, the SEC's proxy rules require a very thorough analysis to be presented to share owners. In looking at existing requirements, we are unable to suggest meaningful improvements, beyond those recommended by the SEC in its Financial Reporting Release 61, that would better protect investors.

OTHER ISSUES WITH ACCOUNTING STANDARDS

In addition to discussing the issues raised by the Committee, I would like to take the opportunity to raise a more fundamental point on the present direction of accounting standards. The body of literature we call generally accepted accounting principles has evolved into a labyrinth of specificity and complexity. The days of the on-site audit team being capable of fielding the majority of the accounting questions that arise at corporations have long since passed—the standards we have now are so complex that we are, of necessity, moving into the brave new world of fragmentation and specialization. One has to question whether anything of value, especially accounting information, should become so complex that it defies the ability of even the most diligent investor to understand. And yet in an era when "plain English" disclosure has become the centerpiece of our new reporting model, standards on securitization and derivative accounting stand as monuments to opacity dressed up as rigorous standards. I mentioned the 800 pages of guidance on derivatives. In comparison, the guidance on securitization is a mere 150 pages (of course that excludes the 100+ questions and answers that need to be considered). The cry for relief was sounded late last year and the FASB has embarked on a project that would address accounting simplification. The Board has its work cut out for it on this one, and I am hopeful that it will ultimately yield some tangible results.

In closing, FEI supports the interest of this Committee in effective accounting standards. However, we urge necessary steps to make sure we are responding appropriately to the problems that exist. In that regard FEI offers its support and the assistance of its leaders to help the Committee identify a way forward. However, as we embark on this journey, let's be sure that we take the time to think carefully about the issues, to be thorough in the identification of root causes, and based on that analysis to distinguish problems that arise from fraud or misapplication of the rules from those that arise from the rules themselves.

Perhaps most important, in an environment flush with cries for change, let's not confuse action and progress.

This completes my prepared remarks. I should like to thank the Chairman and the members of the Subcommittee for allowing FEI the opportunity to testify.

Mr. STEARNS. Thank you.

Mr. Linsmeier, we welcome your opening statement.

STATEMENT OF THOMAS J. LINSMEIER

Mr. LINSMEIER. Chairman Stearns, Ranking Member Towns, and members of the subcommittee, I appreciate the opportunity to testify here today.

I will address the specific question posed to the panel by sharing with you ten lessons I have learned, or relearned, about accounting standards as a result of Enron.

Lesson 1 is a no-brainer, accounting matters.

Lesson 2: Accounting standards were not the primary problem with Enron. I think we have covered that well with Enron today.

Lesson 3 is that accounting standards do not reflect well the economics of some special purpose entities, or SPEs. SPEs commonly are created to contractually isolate the risks and rewards relating to a specific asset or project. The typical SPE charter explicitly specifies the operating activities of the entity. Thus, from the beginning, the SPE is on autopilot, existing only to carry out its contractually specific sharing of risks and rewards. Its managers essentially have nothing to control.

Curiously, however, the current accounting is primarily based on the concept of control. Assets are transferred from the books of the sponsoring company once the SPE obtains control, however, the key accounting question should be determining whether the sponsoring company retains any risks or rewards from the transferred assets, and how those risks and rewards should be reported. In part, this is a consolidation issue. However, for the types of assets transferred by Enron, current accounting rules provide only limited guidance on when the SPE needs to be consolidated, and no guidance requiring recognition of risks and rewards retained by the sponsoring company when the SPE is not consolidated.

To properly reflect the economics of SPEs and to prevent accounting abuses similar to Enron, comprehensive accounting and disclosure standards must be developed to address both these issues.

Lesson 4: Accounting standards that are too narrow can lead to abuse. The limited accounting guidance that does exist for determining the consolidation status of SPEs similar to Enron's was meant to pertain only to leasing transactions. That guidance specifically states that it should not be applied to other transactions. Yet, in the absence of any other guidance, a member of the SEC staff announced that consolidation decisions for non-leasing SPEs also could be based on the 3 percent outside ownership of assets standard used for leasing transactions. This is not unusual. In absence of accounting standards that are directly applicable, accountants often find guidance by analogy to a similar standard. While there is some economic intuition provided for the 3 percent standard in the leasing industry, there is no economic basis for using a similar standard in other settings. Thus, in absence of alternative guidance, making decisions by analogy to a related but narrow standard can lead to accounting that fails to protect investors.

Lesson 5: Accounting standards with bright line tests fail to protect investors. A bright line test, like the 3 percent standard for non-consolidation of SPEs, allows companies to structure transactions to avoid an undesired accounting result. These transactions are engineered to lie on one side of the line. The undesirable accounting representation that results from being on the wrong side of the lie tends to force transactions to be accounted for one way, causing the accounting benchmark to define the economic depiction of the transaction. As a result, investor protection suffers.

Lesson 6: accounting standards that are too general also can lead to abuse. In addition to SPE transactions, Enron also traded in a considerable number of long-term contracts to sell energy at specified prices for periods up to 20 years. The accounting standard in this area is general, requiring that these contracts be marked-to-market, but not specifying how the market price should be determined. While, in general, mark-to-market accounting leads to better investor protection by providing an early warning when prices move south, its implementation in these contracts is subject to manipulation because it requires significant judgment to estimate how observable short-term energy price movements will extrapolate to the long-term, potentially allowing huge swings in reported gains and losses. While there is no evidence that Enron manipulated its accounting numbers through these estimates, the fact remains that general guidance such as this can provide an opportunity for abuse.

Lesson 7: Accounting standard setting is complicated and takes time. Lessons 4 through 6 suggest that for an accounting standard to facilitate investor protection, it should be broad and neither too specific nor too general. Given the complexity of modern business transactions, developing broad standards that both satisfy these constraints and accurately depict the economics of the transaction is a complex task that naturally takes time. That said, there is no good explanation for why the FASB has not been able to set a consolidation standard for SPE for over a decade. Efforts need to be undertaken to make the standard setting process more efficient.

Lesson 8: The accounting standard setting process has become too political, which slows progress to improved standards. Standard setting profits from the political nature of its activity. However, of late, the standard setting has become too political. Emboldened by their success in opposing the FASB's proposal to expense stock option compensation, opponents of FASB's proposals have found that complaints to Congress have been quite successful in impeding FASB's progress, with congressional hearings becoming commonplace before a final standard can be passed. These hearings often produce arguments suggesting that the proposed standard will materially alter business, as we know it, significantly affecting the competitiveness of U.S. companies. However, I have seen no evidence of the significant deleterious effects claimed by businesses after the proposal has passed. Yet the delay for lobbying activities significantly slows FASB's progress, hindering its ability to develop timely standards that may serve to reduce accounting abuses, such as those found at Enron.

Lesson 9: For the reasons discussed in my written testimony, accounting standard setting should remain in the private sector. However, I have one suggestion I believe should be given consideration. Currently, FASB funding is provided, in part, by companies and audit firms that at times are strong opponents to its proposals. Consideration should be given as to whether a different funding structure for the FASB could improve the efficiency and effectiveness of the standard setting process.

Lesson 10, and the most important: Accounting standards cannot protect investors, proper implementation of standards by accounting professionals leads to investor protection. Enron's collapse has called into question the functioning of auditors, audit committees and accounting standards. In the end, however, I must conclude that the accounting problems surfaced by Enron had little to do with the quality of accounting standards but arose primarily due to failures in their application. This fundamental problem arises because auditors and audit committees are hired not by the investors they are obligated to serve, but by the companies they must scrutinize. For me, the ultimate public policy issue is to find a way to mitigate this conflict of interest, thereby serving better the ultimate objectives of investor protection and continuing efficiency of U.S. markets.

Thank you for your attention. I will be pleased to answer any of your questions.

[The prepared statement of Thomas J. Linsmeier follows:]

PREPARED STATEMENT OF THOMAS J. LINSMEIER

Chairman Stearns, Ranking Member Towns, and members of the Subcommittee, I appreciate the opportunity to testify here today. I will address the specific question posed to the panel, "Are current financial accounting standards protecting investors?", by sharing with you ten lessons I have learned or relearned about accounting standards as a result of Enron.

LESSON 1: ACCOUNTING MATTERS

Rarely has a corporate bankruptcy had such wide repercussions on the accounting profession. Capital markets, and indeed capitalism itself, can function efficiently only if the highest standards of accounting, disclosure, and transparency are observed. The collapse of Enron is raising significant questions about the institutions governing public capital markets, and especially the role of the accounting profession. Issues are being raised about the regulation of auditors, the functioning of audit committees, conflicts of interest in accounting firms, and the quality of U.S. accounting standards. Clearly accounting matters. The purpose of the hearings today is to address one of these issues: the quality of accounting standards. I commend the Committee for addressing this important issue.

LESSON 2: ACCOUNTING STANDARDS WERE NOT THE PRIMARY PROBLEM WITH ENRON

Enron has admitted in its November 2001 filings with the SEC and through its February 2002 report by a committee of its board of directors that it *failed to comply* with U.S. accounting standards for most of the transactions at issue. Proper application of existing accounting and disclosure standards for Enron's off-balance-sheet partnerships (sometimes called special purpose entities) would have increased the reported amounts of debt and decreased the reported amounts of net income in Enron's 1997-2001 financial statements, making transparent to capital markets its declining financial fortunes.

LESSON 3: ACCOUNTING STANDARDS DO NOT REFLECT WELL THE ECONOMICS OF SOME SPECIAL PURPOSE ENTITIES (OR SPE'S)

SPEs commonly are created to contractually isolate the risks and rewards relating to a specific asset or project. The typical SPE charter explicitly specifies the operating activities of the entity. Thus, from its beginning, the SPE is on autopilot, existing only to carry out its contractually specified sharing of risks and rewards; its managers have essentially nothing to control.

Curiously, however, the current accounting by sponsoring companies is primarily based on the concept of control. Assets are transferred from the books of the sponsoring company once the SPE obtains control. However, the key accounting question should be determining whether the sponsoring company retains any risks or rewards in the transferred asset and how those risks and rewards should be reported. In part, this is a consolidation issue. However, for the types of assets transferred by Enron, current accounting rules provide only limited guidance on when the SPE needs to be consolidated and no guidance requiring recognition of risks and rewards retained by the sponsoring company when the SPE is not consolidated.

To properly reflect the economics of SPEs and to prevent accounting abuses similar to Enron, comprehensive accounting and disclosure standards must be developed to address both these issues. I understand the SEC has charged the FASB with achieving this outcome by June of this year. Given that the FASB has struggled with this issue for over a decade, I am not optimistic about its ability to succeed in such a short time frame. However, to protect investors, it must succeed.

LESSON 4: ACCOUNTING STANDARDS THAT ARE TOO NARROW CAN LEAD TO ABUSE

The limited accounting guidance that does exist for determining the consolidation status of SPEs similar to Enron's was meant to pertain only to leasing transactions. That guidance specifically states that it should not be applied to other transactions. Yet, in the absence of any other guidance, a member of the SEC staff announced that consolidation decisions for non-leasing SPEs also could be based on the 3% outside ownership of assets standard for SPE leasing transactions. This is not unusual; in absence of accounting standards that are directly applicable, accountants often find guidance by analogy to a similar standard. While there is some economic intuition provided for the 3% standard in the leasing industry, there is no economic basis for using a similar standard in other settings. Thus, in absence of alternative guidance, making decisions by analogy to a related but narrow standard can lead to accounting that fails to protect investors.

LESSON 5: ACCOUNTING STANDARDS WITH BRIGHT LINE TESTS FAIL TO PROTECT INVESTORS

A bright line test, like the 3% standard for non-consolidation of SPEs, allows companies to structure transactions to avoid an undesired accounting result. These transactions are engineered to lie on one side of the line. The undesirable accounting representation that results from being on the wrong side of the line tends to force all transactions in this fuzzy area to be accounted for one way, causing the accounting benchmark to define the economic depiction of the transaction and constraining auditors' ability to require an alternative accounting representation when it better reflects economic reality. As a result, investor protection suffers.

LESSON 6: ACCOUNTING STANDARDS THAT ARE TOO GENERAL ALSO CAN LEAD TO ABUSE

In addition to SPE transactions, Enron also traded in a considerable number of long-term contracts to sell electricity or buy natural gas at specified prices for periods up to 20 years. The accounting standard in this area is general, requiring that these contracts be "marked-to-market" but not specifying how the market price should be determined. While in general "mark-to-market" accounting leads to better investor protection by providing an early warning when energy prices move south, its implementation in these contracts is subject to manipulation because it requires significant judgment on the part of management to estimate how observable short-term energy price movements will extrapolate to the long-term, potentially allowing huge swings in reported gains and losses. The FASB currently is working on a project to make "mark-to market" accounting guidance more specific. While there is no evidence that Enron manipulated its accounting numbers through these estimates, the fact remains that general guidance such as this can provide an opportunity for abuse.

LESSON 7: ACCOUNTING STANDARD SETTING IS COMPLICATED AND TAKES TIME

Lessons four through six suggest that for an accounting standard to facilitate investor protection it must (1) be broad enough to contemplate all related transactions to which it may be analogized and (2) be specific enough to mitigate opportunities for manipulation without providing bright line cutoffs. In other words, effective standards should be neither too specific nor too general. Given the complexity of modern business transactions, developing broad standards that both satisfy these constraints and accurately depict the economics of the transaction is a complex task that naturally takes time. That said, there is no good explanation for why the FASB would need more than a decade to set a consolidation standard for SPEs. Efforts need to be undertaken to make the standard setting process more efficient.

LESSON 8: THE ACCOUNTING STANDARD SETTING PROCESS HAS BECOME TOO POLITICAL, WHICH SLOWS PROGRESS TO IMPROVED STANDARDS

Standard setting profits from the political nature of its activity by surfacing valuable questions and potential implementation issues that when addressed can materially improve the final standard. In addition, by following an open due process, the resulting accounting standards gain better acceptance from various accounting constituencies. However, of late, standard setting has become too political. Emboldened by their success in opposing the FASB's proposal to expense stock option compensation, opponents of FASB' proposals have found that complaints to Congress have been quite successful in impeding FASB's progress, with Congressional hearings becoming commonplace before a final standard can be passed. These hearings often produce arguments suggesting that the proposed standard will materially alter business, as we know it, significantly affecting the competitiveness of U.S. companies. However, I have seen no evidence of the significant deleterious effects claimed by businesses after the proposal has passed. Yet the delay for lobbying activities significantly slows FASB's progress, hindering its ability to develop timely standards that may serve to reduce accounting abuses, such as those found at Enron.

LESSON 9: ACCOUNTING STANDARD SETTING SHOULD REMAIN IN THE PRIVATE SECTOR

To make standard setting most efficient and to ensure that the constructive political attributes of the process are focused exclusively on pertinent economic issues, standard setting should reside in an organization that is not influenced by other important but unrelated issues of the day. Private sector standard setting has performed this function well and with improvements in its efficiency and reductions in the amount of political intervention, I fail to see a better alternative. In this regard, I have one suggestion that I believe should be given consideration. Currently FASB funding is provided, in part, by companies and audit firms that at times are strong opponents to its proposals. Consideration should be given as to whether a different funding structure for the FASB could improve the efficiency and effectiveness of the standard setting process.

LESSON 10: ACCOUNTING STANDARDS CANNOT PROTECT INVESTORS; PROPER IMPLEMENTATION OF STANDARDS BY ACCOUNTING PROFESSIONALS LEADS TO INVESTOR PROTECTION

In the United States, well-policed stock markets, fearsome regulators at the Securities and Exchange Commission, rigorous accounting standards, and confidence in audit skills of CPA's and audit committees, have long been seen as crucial to the biggest, most liquid and admired capital markets in the world. Enron's collapse has called into question the functioning of auditors, audit committees and accounting standards. In the end, however, I must conclude that the accounting problems surfaced by Enron had little to do with the quality of accounting standards but arose primarily due to failures in their application. The fundamental problem arises because auditors and audit committees are hired not by the investors they are obligated to serve but by the companies that they must scrutinize. For me the ultimate public policy issue is to find a way to mitigate this conflict of interest, thereby serving better the ultimate objectives of investor protection and continuing efficiency of U.S. capital markets.

Thank you for your attention. I will be pleased to answer the Committee's questions.

Mr. STEARNS. I thank both of you. I will start out the questions. Mr. Linsmeier, do you think that are more Enrons out there?

Mr. LINSMEIER. Well, let us consider what Enron—what happened with Enron. To the best of my knowledge——

Mr. STEARNS. Because you are saying here FASB has taken 10 years to come up with consolidated standards. You are pointing out some of the slowness of the process, and you are pointing out some of the conflicts of interest, and you are pointing out these things which would lead me to believe that Enron is not alone, that there are other Enrons. And so is that——

Mr. LINSMEIER. Perhaps there are companies out there that are not following GAAP and that is not being detected by their auditors, to the extent that we will not find out about those problems for a period of time. Perhaps that is true.

Mr. STEARNS. You know, some of the technical aspects in these SPEs, these special purpose entities, when I first saw that they used a 3 percent outside ownership test for nonleasing of SPEs, I thought that seemed pretty doggone small.

Mr. LINSMEIER. So did I.

Mr. STEARNS. Do you think Congress, or FASB, or the American Institute of Accounting, or SEC should stipulate it should be 20 percent, or 10 percent, and is that problematic, or would that actually—if that practice is instituted, would we actually see a better understanding of these sheltering of debt?

Mr. LINSMEIER. Well, first of all, the reaction to the 3 percent, let me give you a little background. The reason why 3 percent might make some economic sense for leasing transactions is the margin is that industry is so slow and so small and the competition is so high that giving away 3 percent of the return——

Mr. STEARNS. Is their profit.

Mr. LINSMEIER. [continuing] is their profit. And it materially changes the economics of that SPE. But, now—and then let us think about the 3 percent standard. You asked about a 3 percent standard versus a 10 percent standard. Part of my testimony is any bright line test will create incentives for someone to be just on the other side. What Enron tried to do is be just on the other side, but failed. They didn't do it right. And that is why we can say that existing accounting standards were not the problem with Enron.

If they had structured their transactions sufficiently to be on the other side and not transferred some of the risk in that process, they could have potentially been following GAAP.

Mr. STEARNS. Ms. Hinchman, Mr. Bass wanted to introduce you. I guess he worked with you.

Ms. HINCHMAN. Yes, he did, in another lifetime.

Mr. STEARNS. And so I'm sorry Mr. Bass——

Mr. BASS. Congratulations, Grace, you have come a long way in the last 25 years.

Ms. HINCHMAN. Thank you, Mr. Congressman, so have you.

Mr. BASS. Where are those tough questions you had, I want to ask a couple of those.

Ms. HINCHMAN. Don't you have to go to a vote or something on the floor?

Mr. STEARNS. Ms. Hinchman, you stated that valuation of non-traded instruments is imprecise and that "some of your members ensure that this fact is communicated clearly by disclosing ranges of values in their disclosures." Do you think the disclosure of a range of values should be mandated?

Ms. HINCHMAN. Well, you are talking about the valuation aspect in the mark-to-market.

Mr. STEARNS. Nontraded instruments.

Ms. HINCHMAN. Correct. And that is something that we are currently working with FASB in one of our technical committees right now, and we are not yet at a position to make a statement on that, but I will certainly get back to you and the subcommittee with our findings.

Mr. STEARNS. Is it possible that Beerstown Ladies who did the investment out there in the Midwest in mutual funds, and they did so well they beat all the people on Wall Street, and they used to study all these financial accounting reports.

Ms. HINCHMAN. It was an investment club, or something like that.

Mr. STEARNS. Yes, investment club, the Beerstown Ladies, I remember. Can we have effective financial accounting standards without this labyrinth of complexity? I mean, is it possible—are we as Members of Congress being Don Quixote, thinking that we can make it so that the average person out there can understand something he is investing in, or does he have to go to a stockbroker, stock analyst, or somebody that he has got to rely on? Is there any way that we would somehow have a financial accounting standard that people, the common man or woman, could understand?

Ms. HINCHMAN. Well, that is certainly what we, our membership of FEI, would like to see have happen, and that is why we did go to the FASB pleading with them to try and make more simple the current panoply of standards that they have to abide by because it has become virtually impossible.

One example that has often held out, which is in my more complete comments, is the FAS 133 on derivatives. It is, I am told, unusable. It is 800 pages of uninterpretable, unusable standards for guidance. And it has been a huge problem for our members in order to apply that to their businesses. And that is why we have begun to work with FASB in terms of making more simple a board range of principles for these standards instead of having the actual rules in terms of abiding by the standards. And we hope to work with them, but it is a tough challenge, but it is something that we have to do because today the investors cannot use the standards for the purposes that they are intended.

Mr. LINSMEIER. Could I comment on that just briefly?

Mr. STEARNS. Yes.

Mr. LINSMEIER. I think there is something that is useful to understand. There is a difference between complexity of standards and complexities of financial statements that investors read. And there is the possibility that standards should be complex to control the activities or to monitor or help focus the activities of people within corporations, and auditors and their aspects, and yet not have the financial statements be complex. I think there is a distinction. We want those financial statements, those reports, to communicate fairly the economics of a company and hopefully have some people understand that. The business is complex.

Mr. STEARNS. But you heard the expression I said earlier, which is "cash is fact and everything else is opinion." Let me have the distinguished ranking member ask, and then we will finish up.

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me ask, why didn't the analysts in companies such as J.P. Morgan and, of course, CitiBank, loan officers see this coming? Did they, in fact, use the same accounting standards to make their loans? I mean, why wouldn't the analysts be able to figure this out? I mean, there is talk, I think, J.P. Morgan and Chase appears to have lost approximately $1.3 billion, and CitiBank maybe $800,000, almost a million. Wouldn't analysts sort of—I am trying to see why wouldn't they see this.

Mr. LINSMEIER. Well, remember, for Enron, the accounting was incorrect. They have admitted that in their filings. So, we trust those reports to indicate that what is being said is correct, that then their analysts have a difficult time to be able to ferret that out, if, as what has been publicly stated, they didn't follow GAAP.

In addition, though, I think we had a circumstance for a company that is doing extremely well, and a lot of people want to believe that it was doing that well and didn't scrutinize it as carefully because reading the financial statements of Enron is a very difficult task, and they did work very hard at not saying things in their reports.

Ms. HINCHMAN. Congressman, I think from FEI's perspective, this has been a huge wake-up call for our members. And I think because of the investigations that are going on, which will yield the answer to your question, we don't know specifically, but it certainly has caused our membership to wake up and be more scrutinizing and be more demanding on the part of its auditors, on the part of its investment analysts all up and down the line, so we can avoid anything like this happening again.

Mr. TOWNS. Well, let me ask this question. What should the Congress do to try to prevent this kind of stuff from happening ever again?

Ms. HINCHMAN. Well, not to take the other side of my co-witness here, but FEI just recently submitted a letter to the Wall Street Journal, New York Times and Washington Post in support of the oversight of Congress in the role of accounting policy, legislation, standards, et cetera. And we certainly endorse that and think it is appropriate. A proactive oversight role on the part of Congress on these issues I think is timely, warranted, and potentially very productive, but we would like to see the actual standards developed in an organization like a FASB, a private sector organization, because that is where the independence of the private sector from the business community and the accounting community can come into play and develop the best standards.

I think you would probably agree with me that you all do not want to be legislating accounting standards, and FEI would not want you to do that either, quite honestly, but I think a consistent oversight role, I think, is a healthy, warranted and helpful role that you all can be playing.

Mr. TOWNS. Because I look at the J.P. Morgan situation, of course. and according to testimony in another committee, it said that some people saw it and a red flag went up, and of course others didn't, and that bothered me. I mean, a person is an analyst, and one person is able to see it and another one doesn't see it. You are talking about a lot of money here, $1.3 billion.

Ms. HINCHMAN. And a lot of lives, too, have been ruined.

Mr. TOWNS. Yes, a lot of people are hurt by this, so I was just wondering, from that standpoint—because some were able to see it, others were not able to see it, and of course now we have this mess. So, I was just wondering in terms of what could we do to try to further prevent this kind of situation, and you answered that part, and I thank you for it.

Did you want to add anything, Mr. Linsmeier?

Mr. LINSMEIER. I don't think we are in disagreement. I mean, my comments about congressional involvement was not ones looking at the overall oversight or structure of the profession. I mean, what I mention in the testimony is that, in part, we have problems in the standard setting area in that it is not very timely. And if there is a structural issue to try to induce more timely standard setting by, in part, not being involved with the individual standards but the overall structure of the process, that is important.

But I think, more importantly, there are some conflicts that arise where money flows here, and the two issues that I brought up were the FASB is funded by public accounting firms and by companies that tend to lobby them. That is one, but that is not as significant.

To me, the big significant issue, if there was an application of standards problem here, is why didn't the auditors and the audit committee perform their oversight here? And what I raised to you is—and I don't know that there is a natural automatic response—but what I raised to you is the auditors are paid by the company. The audit committee, even though they represent the shareholders, receive much of their resources from the company. We have a natural conflict of interest that has gone on from the time of the Treadway Commission to this time period, that money comes from the people that the auditors and the audit committees are trying to scrutinize, think that is a natural conflict of interest.

Mr. TOWNS. I yield back.

Mr. STEARNS. Are you saying the auditor of the board of directors has failed?

Mr. LINSMEIER. I am saying the audit committee——

Mr. STEARNS. Audit committee of the board of directors.

Mr. LINSMEIER. It seems yes.

Mr. STEARNS. We have a vote, we have about 3 minutes left, so I am going to thank you and adjourn the subcommittee. And thanks again for your patience in waiting through the first panel.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

Congress of the United States
House of Representatives
Washington, DC 20515–2107

March 7, 2002

The Honorable Robert K. Herdman
Chief Accountant
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Mr. Herdman:

I am writing to follow-up on an issue raised by your testimony during the February 14, 2002 hearing of the Subcommittee on Commerce, Trade and Consumer protection.

As you will recall, during that hearing I raised concerns about reports I had heard indicating that one of the first acts taken by Chairman Pitt when he took office was to remove the top accountant in the Corporation Finance Division and announce that the Commission was planning not to force companies to restate earnings. I had also heard that the number of accounting slots at the Commission's Division of Corporation Finance might have been reduced. In response to my concerns, you testified that:

> "I respond that you have been misinformed. The Chief Accountant of the Division of Corporation Finance resigned that position. As to the question of whether the number of accounting slots has been cut, that is not consistent with what I believe to be the case."

Subsequent to the hearing, I have obtained additional information that bears upon your testimony. This information suggests that your response may have contained certain "material omissions."

Attached you will find a September 28, 2001 memorandum from Mr. Robert Bayless, then-Chief Accountant at the Division of Corporation Finance, to Mr. David Martin, Director of the Division of Corporation Finance. From reading this memorandum, it is clear to me that Mr. Bayless did not merely resign his position. Instead, he was forced by your office to request reassignment to a position of less responsibility and lower grade. This appears to have occurred because he had some serious concerns about policy changes taking place with respect to the Commission's full disclosure and investor protection mission.

Specifically, the Bayless memorandum indicates that your office had made it clear to Mr. Bayless that "OCA [Office of Chief Accountant] no longer believed it could

The Honorable Robert K. Herdman
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continue to deal with me as the chief representative of the Division regarding accounting and financial reporting matters." As a result, Mr. Bayless determined that " I could no longer effectively serve in the capacity of Chief Accountant under those circumstances" and requested "reassignment at a time convenient to the Division to another position of less responsibility and lower grade."

I am greatly concerned that the reassignment of Mr. Bayless and other staffing changes and recent departures of professional staff from the SEC's Division of Corporation Finance may impair the Division's ability to effectively carry out its work, and impair the morale and effectiveness of those who remain on the staff. I have heard from a number of SEC employees who are concerned that policy changes currently taking place at the Commission may result in less effective reviews of corporate filings, fewer restatements of earnings (even in cases where such restatements might be warranted due to false or misleading disclosures), and a less effective full disclosure program. This troubles me. If the Subcommittee is to properly oversee accounting and financial disclosure issues, we need the SEC's Chief Accountant to level with us regarding what is going on at the Commission. It would be particularly damaging at this time for the public or Congress to have doubts about the reliability of information provided by such a critical component of our regulatory structure.

I would also note that the Division on Corporation Finance remains understaffed. When I recently asked Commissioner Hunt to explain why the SEC had not fully reviewed Enron's filings between 1997 and the initiation of its enforcement inquiries, he blamed underfunding. While I still think that the SEC should have been reviewing the filings of such a large and rapidly growing corporation, budget and staffing limitations are clearly a problem at the Commission.

As you will recall, during the hearing I raised concerns about reports of staffing reductions in the Division. I appreciate receiving your February 21, 2002 letter on this subject. This letter in turn transmitted a copy of a February 14, 2002 memorandum to you from Ms. Shelley Parratt addressing accountant-staffing issues in the Division of Corporation Finance. In is memorandum, Ms. Parrett stated that "you asked whether the reduction in the agency's staffing ceiling has caused the Division of Corporation to reduce the number of its accounting positions," and reports that "since the reduction in the staffing ceiling, the Division's accounting staff has grown by five." (Emphasis added)

Clearly, there has been a reduction in staff ceilings in recent years. Following receipt of this letter, I asked my staff to ascertain exactly what these reductions in the staff ceilings were, and what impact they may have had on the staffing at the Division of Corporation Finance. In response to that request, my staff obtained information from the SEC staff (see attachment 2) indicating that the number of accountants at the Division of Corporation Finance has dropped from 115 in FY97 to 109 today, and that the number of overall positions in the Division of Corporation is currently 15 employees below the authorized level. I am greatly concerned about the fact that the Congress has not been

The Honorable Robert K. Herdman
March 7, 2002
Page 3

fully funding the SEC up to the authorized staffing level. As you may know, in the past I have cosponsored legislation to make the SEC a self-funded agency in order to help prevent exactly these types of shortfalls. But since such legislation has not been enacted, I believe that the SEC's appropriation should be increased to at least the authorization level in order to assure the agency has the resources needed to carry out its important mission. There are many in Congress, like myself, who want to assure the agency receives the funding it requires. But we need to know what the Commission's staffing needs are and when cuts are threatened if we are going to be in a position to convince our colleagues to provide additional funds. I would therefore appreciate it if you could assure that I am kept fully informed of the Commission's budget and staffing needs as the appropriations process unfolds.

Thank you for your consideration.

Sincerely,

Edward J. Markey

Edward J. Markey
Member of Congress

Attachments

ATTACHMENT 1

MEMORANDUM

September 28, 2001

To: David Martin, Director
Division of Corporation Finance

From: Robert Bayless, Chief Accountant
Division of Corporation Finance

Re: **Request for Reassignment**

As you know, late in the afternoon of September 14th, I rushed to the Office of the Chief Accountant upon learning that John Morrissey had decided to omit a comment proposed by the Division for a letter from OCA to a registrant. I hit my fist hard against the door of his office, and objected angrily and loudly to John's decision. In a loud and angry voice, I challenged whether his discomfort with issuing the comment was reasonably based.

On September 17th, you and I discussed that incident. I quickly acknowledged that my behavior was improper. You informed me that OCA no longer believed it could continue to deal with me as the chief representative of the Division regarding accounting and financial reporting matters. We agreed that I could no longer effectively serve in the capacity of Chief Accountant under those circumstances.

The Division must be represented in an effective manner in all important financial reporting and accounting matters; cordial relations with OCA are critical to that end. To facilitate your appointment of a new Chief Accountant so that the Division can have that representation, I confirm by this memorandum my request for reassignment at a time convenient to the Division to another position of less responsibility and lower grade.

I look forward to this new chapter in my career with the Commission, which follows many wonderful chapters in my 19 years with the Division. I enjoyed the privilege of contributing to investor protection and market efficiency through the resolution of many difficult registrant issues, the adoption of many important rules, and the development of many policies and procedures observed in the daily operations of the Division. I believe my experience, skills, and dedication to the SEC's missions will continue to be valuable to the Commission in whatever role you think is appropriate. I look forward to being a member of a team, rather than its leader, and working with and for the Division's new Chief Accountant.

ATTACHMENT 2

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

OFFICE OF
THE CHIEF ACCOUNTANT

February 21, 2002

The Honorable Edward J. Markey
U.S. House of Representatives
2108 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Markey:

During my February 14th testimony before the House Subcommittee on Commerce, Trade and Consumer Protection, you asked that I check on the number of accounting positions in the Commission's Division of Corporation Finance and whether that number had increased or decreased in recent months.

Enclosed is memorandum from Shelley Parratt, the Principal Associate Director for the Division. Ms. Parratt's memorandum notes that the Division had 104 accountants on staff on December 11, 2001 and now has 109.

I hope that this information responds to your request. Please do not hesitate to contact me at (202) 942-4400 or Ms. Parratt at (202) 942-2830 if we may be of any further assistance.

Sincerely,

Robert K. Herdman

Robert K. Herdman
Chief Accountant

Enclosure

Cc: The Honorable Cliff Stearns
Chairman
Subcommittee on Commerce, Trade and Consumer Protection
House Committee on Energy and Commerce

The Honorable Edolphus Towns
Ranking Member
Subcommittee on Commerce, Trade and Consumer Protection
House Committee on Energy and Commerce

M E M O R A N D U M

To : Robert Herdman
Chief Accountant

From : Shelley Parratt
Division of Corporation Finance

Date February 14, 2002

You asked whether the reduction in the agency's staffing ceiling has caused the Division of Corporation Finance to reduce the number of its accounting positions. The answer is no. In fact, since the reduction in the staffing ceiling, the Division's accounting staff has grown by five.

The number of slots allocated to each of the primary professions of the Division, legal and accounting, is fluid. We do not have a set number of slots allocated to accounting positions. On December 11, 2001, accountants filled 104 of the Division's 350 authorized slots and 6 offers of employment to accountants were outstanding. Since that date, 5 of these offers were accepted (one person declined the offer) and accountants currently fill 109 of the Division's 337 authorized positions.

ATTACHMENT 3

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	Actual FTEs at end of Fiscal Year	Positions Authorized in the Budget*	Accountants			
FY1997	321	342	115			
FY1998	316	342	110			
FY1999	321	347	111			
FY2000	304	350	100			
FY2001	310	360	106			
FY2002 (Enacted)	326	351	109			
FY2003 (Requested)	326	351				
authorized is not fully funded.						