

Financial Accounting Standards Board

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The FASB's Role in Serving the Public

A Response to the Enron Collapse

By Edmund L. Jenkins, Chairman, Financial Accounting Standards Board

The Enron collapse has caused the American public to raise questions about United States accounting standards, why Enron restated its financial statements to comply with those standards and the role of the Financial Accounting Standards Board (FASB). As the public learns more about the Enron story, the FASB's role as a financial reporting standard setter, with authority to develop new and ever-evolving standards, has recently received attention.

While the FASB is an independent, private, not-for-profit organization, some observers believe it is not independent enough from the Big-Five accounting firms. In fact, the Board comprises a broad range of constituencies representing accounting firms, academia, corporations and the investor community. Board members serve the FASB on a full-time basis and are required to sever all connections with their prior employers.

For nearly 30 years the FASB has had the responsibility of establishing standards governing accounting and financial reporting in the United States. The FASB's responsibility as standard setter is carried out in a fully open due process. Our focus is on the investor and other users—the "customers" of financial information.

The FASB has no authority to enforce its standards. Responsibility for ensuring that financial statements comply with accounting requirements rests with the officers and directors of the reporting entity, the auditor of the reporting entity's financial

statements, and for public companies, the Securities Exchange Commission (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 FASB's vision and mission summarize our responsibilities in serving the public:

Our vision is "to serve the public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process."

Our mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information."

High-quality financial reporting is essential to maintaining a robust and efficient capital market system. A highly liquid capital market requires the availability of transparent and complete information so that all investors and potential investors can make informed decisions as they allocate their capital among competing alternatives. While not all information needed by investors is available from high-quality financial reporting, financial reporting is essential to the process.

While many have commented on the importance of financial reporting, Lawrence Summers, former Secretary of the Treasury, said it perhaps best:

The single most important innovation shaping [the American capital] market was the idea of generally accepted accounting principles.

The importance of an independent, private-sector, open due process system to establish financial reporting standards cannot be over-emphasized.

An independent standard setter is necessary so that standards can be set in an objective manner and without bias. Information provided from applying the standard must be neutral so that it faithfully reflects the underlying transaction or event of the reporting entity.

A private-sector standard setter is important because it avoids politicizing the setting of standards. A government standard setter, like the SEC, would be subject to significantly greater political pressures to reflect public policy goals into financial reporting. This would reduce the transparency of information to investors.

An open due process is essential to the credibility of financial reporting standards. It is important that standards be debated and set in public forums. Preliminary ideas and proposed standards need to be commented on by all constituents so that the best answers are achieved in the end. The FASB's open due process is extensive. Board meetings are open to the public, constituent comments are sought at several stages during the course of developing a new standard, and public hearings and open meetings of constituent task forces often are held. The FASB listens carefully to what it hears and learns from that process.

The FASB does not know many of the facts relating to Enron's financial accounting and reporting. Enron, however, publicly acknowledged in its filings with the SEC that its financial statements did not comply with existing accounting requirements in at least two areas. The Report of Investigation by the Special Investigative Committee of the Board

of Directors of Enron 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.

Over the years the FASB has issued many financial reporting standards to continuously improve the transparency of information available to investors. Several examples are:

- Requiring that reporting entities recognize liabilities for retirement benefits when those entities promise them to employees rather than when they later pay them.
- Requiring significant disclosures about the separate operating segments of an entity's business so that investors can evaluate the differing risks in the diverse operations.
- Requiring that derivative instruments and hedging transactions be reflected in financial statements, which, previously, were not reflected.
- Requiring that the acquisition of one company by another be accounted for in the same way for all entities and that the total amount paid for the acquisition be reflected in the financial statements. In the past, that was not often the case.

The Board has active projects under way 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 the FASB has 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 special-purpose entities (SPEs).

The Board also understands the concerns that some, including SEC Chairman Harvey L. Pitt, have raised about the speed of our standard-setting activities. The FASB has begun pursuing a number of projects and activities focusing on improving the Board's efficiency and effectiveness without jeopardizing the openness and thoroughness of our due process.

High-quality financial reporting is essential to an efficient capital market, and establishing and maintaining comprehensive standards is the key. But the FASB and its standards cannot alone achieve high-quality financial reporting. Others must be involved, and they too must carry out their responsibilities in the public interest. Reporting entities, auditors and regulators all have important roles.

Reporting entities seeking to access the capital markets for financing prepare the financial reports and present those reports to investors. Those entities must apply the standards developed by the FASB in a way that is faithful to the intent of the standards. Seeking loopholes to find ways around the standards obfuscates reporting and does not result in a transparent and true reflection of the economics of the underlying transactions.

Auditors examine the application of standards established by the FASB by entities to determine that those standards have been fairly applied. They also must assure that the intent of the standards are followed and not accept an argument that the reporting is acceptable just because the standards do not say an entity cannot report in a certain obfuscating way. Auditors have a primary responsibility to the public, since investors and other users do not have access to the underlying facts about an entity's operations and transactions.

Regulators, principally the SEC, also have an important role to play. Their responsibility is investor protection. Through their oversight and enforcement activities they assure that entities report based on following financial reporting standards and that auditors are independent and examine financial statements using accepted auditing standards.

With respect to the FASB, the SEC has oversight responsibilities. The SEC assures that the FASB agenda is addressing issues where improved reporting is desirable. Generally, the SEC does not influence the resulting standards, but it could. The Securities Acts of the 1930s gave the SEC the power to set financial reporting standards, but early on the SEC said it believed the accounting profession was best equipped to set standards and it would look to that profession to do so.

So, we can see the importance of the FASB to our efficient U.S. capital markets. The high-quality standards established by the FASB are the cornerstones to providing investors with the financial information they require. Standards provide all parties with the same benchmarks. Investors can know what reporting should result from applying a standard to a particular transaction. Entities preparing financial statements can look to the standards for a consistent and transparent application to underlying transactions.

Auditors can audit an entity's reporting against the standards, and regulators can use the standards to test that entities and auditors are providing and examining financial statements that reflect those standards.

Without the high-quality financial reporting standards established by the FASB, each party to our capital market system would need to determine for itself how to present, read and examine financial information. There would be no consistency, no comparability, little transparency and a lack of trust in the information, which would lead to higher costs for capital and increased risks for investors.

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 that transparent financial accounting and reporting do matter and that the lack of transparency imposes significant costs on all who participate in the U.S. capital markets.

The FASB is prepared and committed to proceed expeditiously to resolve any financial accounting and reporting issues that may arise as a result of Enron's bankruptcy so that the transparency of information available to participants in our capital markets is maintained and enhanced.