TESTIMONY OF

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ON BEHALF OF

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON COMMERCE, TRADE AND CONSUMER PROTECTION

AT A HEARING ON

Are Current Financial Accounting Standards Protecting Investors?

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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.

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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.