Susan S Bies: Effective accounting and disclosure for financial transactions and financial institutions

Remarks by Ms Susan S Bies, Member of the Board of Governors of the US Federal Reserve System, at the National Conference on Banks and Savings Institutions, American Institute of Certified Public Accountants, Washington, DC, 7 November 2002.

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Good morning. I appreciate the invitation to speak today at this important conference of the American Institute of Certified Public Accountants (AICPA). This last year has been an extraordinary time for the accounting profession. Large corporate bankruptcies, significant restatements of financial reports, weak corporate governance practices, a criminal conviction of an accounting firm for obstruction of justice, and the perceived failure of auditors elevated accounting to the front pages of our nation's newspapers. A recent Government Accounting Office report states that about 10 percent of all listed companies announced at least one restatement from January of 1997 through June of 2002. As you know, this resulted in billions of dollars in lost market capitalization and in serious concerns about the quality of accounting and auditing practices and the integrity of management, auditors, and analysts. These unprecedented problems fueled a bipartisan congressional effort to help restore investor confidence in U.S. capital markets through legislative reforms affecting both the accounting profession and corporate management and directors.

During the past few months, accounting has become a far more regulated profession, a major accounting firm was destroyed, and the once-glistening CPA designation as certified public accountant has been tarnished. We know that quality and integrity cannot be legislated, and although the leaders of the profession were not the driving force in the recent reforms, it will, nevertheless, be their challenge-as preparers, auditors, and analysts--to improve their quality control processes and restore lost confidence in the profession.

The Federal Reserve Board has long supported sound accounting and auditing practices and meaningful public disclosure by banking and financial organizations, with the objectives of improving market discipline and fostering stable financial markets. Before joining the Board, I served as a corporate chief financial officer and risk and audit manager, primarily in the banking industry, and as a member of the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB), so I share your interest in improving accounting, auditing, and disclosure.

In my comments today, I will address four areas. First, disclosure practices should evolve from sound risk management. Banks have expertise in assessing and managing risks, and they should actively participate in improving the scope and types of disclosures necessary to provide for the enhanced transparency the market is demanding. Second, I plan to touch on the topic of fair value accounting for financial transactions as it relates specifically to banks. As I will explain, certain aspects of this approach may not provide transparent accounting for banks. Third, I will discuss the potential benefit of moving toward principles-based accounting standards when these are implemented in conjunction with cultural changes in the accounting profession that strengthen oversight and auditing processes. And my fourth topic will be the need for greater integrity in the audit process, which is a critical element in restoring investor confidence in the capital markets. These four broad topics are of increasing importance to standards setters, bankers, auditors, and regulators both in the United States and internationally.

Risk disclosures

The last decades of the twentieth century were, without doubt, a period of dramatic change in financial engineering, financial innovation, and risk-management practices. Over this period, firms acquired effective new tools for managing financial risk, such as securitization and derivatives. As corporations, and banks, continue to increase in size and complexity, investors are finding it harder to understand financial performance and risk exposures.

The surprises that have occurred at banks are due to the nature of risk exposure and the quality of risk management practices, including use of off-balance-sheet vehicles. To keep both boards of directors and investors aware of these unseen risks, bankers should turn to their internal control and risk-reporting systems. Banks are taking a leading role in the evolution of risk management, and this discipline can provide a framework for better disclosure.

Public disclosure consistent with the information used internally by risk managers could be very useful to market participants, as would information on the sensitivity of risk profiles to changes in underlying assumptions. Companies should do more than meet the letter of the standards that exist; they should be sure that their financial reports and other disclosures focus on what is really essential to help investors and other market participants understand their businesses and risk profiles.

Thus, bankers should be leading the development of more transparent financial reporting and disclosures. Disclosures required by Generally Accepted Accounting Principles (GAAP) tend to be focused on point-in-time information. These point-in-time snapshots fail to convey information to readers of financial statements that helps them understand the quality of earnings and the risk exposure of the firm going forward.

I particularly want to emphasize that disclosure need not be in a standard accounting framework or exactly the same for all--otherwise we would be certain to create statistical artifacts and the impression that safe harbors exist. Rather, each entity should disclose what its stakeholders need to evaluate its risk profile. The uniqueness of risks and business lines in complex organizations means that some disclosures--to be effective--should be different. That is the approach recommended by the private-sector Shipley Group last year and it is the approach being taken in developing the Basel II Capital Accord. While comparability among firms is important, disclosure rules that are built too rigidly while risk-management processes evolve may make them less effective in describing the risk profile of a specific organization. But if bankers do not voluntarily improve disclosures, new rules will be written by accounting and regulatory authorities. Indeed, we are seeing this already this year after massive accounting and disclosure problems came to light. For example, the Sarbanes-Oxley Act requires new management certifications of the financial reports of public companies and directs the Securities and Exchange Commission to issue new rules on disclosure of off-balance-sheet transactions.

Fair value accounting

The FASB has stated that it believes that all financial instruments should be reported at fair value when the conceptual and measurement issues of fair value are resolved. Resolution of those issues is a formidable task, especially given the nature of financial instruments held in a typical bank's loan portfolio and the nature of non-interest- bearing deposits. For example, the Federal Reserve has raised concerns about the potential unreliability of fair value estimates for financial instruments for which no active markets exist. The lack of reasonably specific standards for the estimation of fair values for non-traded, illiquid instruments could lead to problems for auditors and bank supervisors in verifying the accuracy of fair value estimates. We have also questioned whether the quality of financial reporting is strengthened when a firm reports increased profits as its own creditworthiness deteriorates because of the mark-to-market approach for liabilities. Therefore, the Federal Reserve has questioned the usefulness of comprehensive fair value accounting for all financial assets and liabilities in the primary financial statements.

We see benefit in fair value information as it relates to financial instruments intended to be traded or sold. Nevertheless, if the purpose is to provide meaningful information that investors can use to assess bank risk profiles and performance and determine the quality of a bank's earnings, we need to ask ourselves if fluctuations in fair market values provide information leading to the transparency that we desire for investors. In other words, will the change in fair market valuation of certain financial instruments give users of financial statements additional insight into the nature of the bank's revenue streams? On certain transactions, including those involving substantial servicing activities, fair value accounting could serve to front-end income that is better recognized over time.

Principles-based accounting standards

During my six years as a member of the FASB's Emerging Issues Task Force, I developed a better appreciation for the challenges that standards-setters face when dealing with topics that are becoming increasingly complex.

Informed and objective professionals can legitimately disagree on the best accounting standard to apply to new types of transactions. That is part of the challenge of keeping accounting standards current. The rapid pace of business innovation makes it impractical to have rules in place to anticipate every business transaction. Rather, the more complex and dynamic the business world becomes, the more important it is that accounting be based on strong principles that are sufficiently robust to provide the framework for proper accounting of new types of transactions.

But improvements in accounting and auditing standards are also needed to address other problems that have been identified. In particular, it would be very helpful if fundamental principles and standards could be revised to emphasize that financial statements should clearly and faithfully represent the economic substance of business transactions. Standards should also ensure that companies give appropriate consideration to the substantive risks and rewards of ownership of their underlying assets in identifying whether risk exposures should be reflected in consolidated financial statements.

To effectively implement such accounting principles, every corporate accountant and every outside auditor must follow clear, overriding professional standards. Corporate accountants and external auditors should be required to ask themselves whether a particular accounting method adequately represents the economic substance of the transaction and whether it provides readers with sufficient information to evaluate the impact of the transaction on a company's risk profile, cash flows, and financial condition and performance. If not, it is likely that the procedure is not the best accounting method to apply.

In a proposal recently issued for comment, the FASB acknowledged that the amount of implementation guidance provided has increased significantly, adding to the complexity in applying accounting standards. Thus, it is considering adopting a principles-based approach to U.S. standards-setting, one similar to the approach used in developing International Accounting Standards and accounting standards used in other developed countries, such as the United Kingdom.

This proposal is timely and important to consider in the profession's environment of reform and could result in more-effective accounting standards. Successful implementation of a principles-based approach is, however, dependent on cultural changes occurring in the accounting and auditing profession and effective oversight. Without these two factors, a principles-based system could easily be used as the basis for manipulating financial information for reasons other than improving its quality and transparency. Principles alone, however, do not ensure good financial reporting, which leads me to the integrity of the audit process.

Integrity of the external audit process

At the heart of questions about the quality of accounting, auditing, and disclosure practices of major U.S. companies are weaknesses in the external audit process. Many auditors have been too focused on cross-selling new services to corporations and have lost sight of the fact that the credibility of their independent opinion regarding the fairness of a financial statement is the core value that they bring to the marketplace. Congress and others have determined that the industry cannot regulate itself, and the implementation of regulatory reform now rests with the SEC and the new Public Company Accounting Oversight Board. It is in your professional interest to support this new entity as it endeavors to strengthen the auditing process.

Let me be clear about my message. The root causes of the breakdown in corporate accounting practices that have been widely disclosed in the past few months are ineffective corporate governance, financial reporting, and risk-management practices. The lessons from recent events are not new. Rather, recent events should serve as a wake-up call to corporate boards, management, corporate accountants, and auditors to follow through on their fundamental and traditional professional and ethical standards of conduct and control processes. Although the issues are not new, the scope and frequency of breakdowns are of concern. As new reports and congressional investigations on various aspects of the breakdowns occur, corporations and auditors should address the issues raised so that they do not compromise the reputation of their organizations.

At Enron and other companies, weak corporate governance practices apparently permitted managers to engage in sham transactions and misleading financial reporting. Some outside auditors erred in trying too hard to please an important client, to the point of engaging in criminal conduct. They seem to have lost sight of their professional role of assuring users of financial reports that the statements fairly represent the condition of the corporation and of the fact that reports should communicate, not conceal, the level of risk. Some observers have asserted that new accounting standards--or, as I have

discussed, a principles-based method of setting standards--are needed. In some ways that may be true. But judging from publicly available information, I believe that what we need is to restore the integrity of corporate governance, company accountants, and the audit process, rather than impose extensive new rules.

Recent abuses of corporate accounting practices and other matters provide good lessons in risk management for bankers, as they try to increase earnings by cross-selling more products. We have seen, for example, how conflicts of interest and errors in corporate governance within a major accounting firm contributed to its downfall. Similarly, banks that compensate line officers on the basis of sales and cross-selling must guard against the adverse incentives that those compensation structures can provide. There, too, a strong corporate governance function is essential. Given the dominant role of credit risk at banks, the chief credit officer should ensure that pressures to increase fee income do not lead to unacceptable levels of credit risk through maintaining independence of credit administration from line functions.

To bolster the independence of external auditors, the Sarbanes-Oxley Act prohibits them from providing certain internal audit and other consulting services to their clients. It created the new Public Company Accounting Oversight Board, independent of the accounting industry, to regulate audits of public companies. These are all changes for the better.

One reason that accounting in the United States has become so rule-based is that we tend to add new accounting standards when abuses occur, even when the abuses resulted from corporate accounting and independent audit failures. Rather than creating new accounting rules, forming the new Public Company Accounting Oversight Board established by Sarbanes-Oxley may be a better approach and help refocus public accountants on core principles and away from more-aggressive and misleading practices. Given human nature and the complexity of many accounting issues, we must expect that rules will sometimes be broken or misapplied. But a new, authoritative oversight board--combined with more-rigorous reviews by corporate boards--should be able to discourage and address severe abuses.

For its part, the Federal Reserve is also willing to challenge accounting practices that it sees as too aggressive. By no means do we intend to supplant accounting authorities in making rules, but we do intend, however, to provide discipline, when necessary, in the application of their guidance--particularly in the context of publicly available regulatory reports and in light of the weaknesses in quality-assurance processes in public accounting firms. For example, the Federal Reserve required nonperforming loan pools at one large banking organization to be re-consolidated into its financial statements when it was determined that the risks and control of the assets were not removed from that organization through the creation of special-purpose vehicles, as required by GAAP.

In another example, the banking regulators have jointly issued for comment new guidance related to credit cards. This guidance not only deals with unacceptable practices, but also clarifies that earnings recognition of fees billed to customers should reflect the expected ability to collect those fees.

We have also recently seen a number of cases in which internal control weaknesses and a general lack of documentation were identified through the examination process, but not through the audit attestation process. These situations were significant enough to raise safety and soundness concerns. Accordingly, in considering these matters, we are reviewing the workpapers of external auditors, in order to get a better understanding of how the attestation process can best meet our objectives. In some cases, auditor attestation reports on internal controls, as required by FDICIA, have become too routine. With Sarbanes-Oxley requiring these reports for all public companies, it is time for the banking industry and accounting profession to revitalize procedures and efforts in this area.

While evaluating the risk of inaccurate or incomplete financial information, we have traditionally placed a high degree of reliance on the work of the external auditor--as well as the internal auditor for that matter. So I urge you today to redouble your efforts in examining financial statements and evaluating internal control systems, as well as insisting on adequate levels of documentation.

Accounting and auditing in a global arena

The topics that I have addressed in my presentation today are receiving increased attention not only in the United States but also internationally. Indeed, the international accounting profession is proceeding at a rapid pace on a global scale to enhance standards and practices. The European Union plans to require its publicly traded companies to adopt the standards of the International Accounting Standards Board (IASB) in 2005. The international auditing standards-setter-the

International Audit and Assurance Standards Board-is also engaged in efforts to improve governance, audit standards, and transparency. High-quality control practices by member firms continue to be sought by the International Federation of Accountants. We have been actively working with these organizations, primarily through the Basel Committee on Banking Supervision, to promote the adoption and implementation of standards, which will improve global banks' accounting, auditing, and disclosure practices.

Internationally, the Federal Reserve actively participates in the Basel Committee on Banking Supervision's Accounting Task Force and the Transparency Group that are seeking to enhance international accounting, auditing and disclosure standards and practices for global banking organizations. For example, our chief accountant was the Basel Committee's lead representative at meetings of the former international accounting standards-setter and is a member of the IASB's Standards Advisory Council, which advises the IASB and its Trustees on the IASB's agenda, proposals, and standards. The Basel Committee has also issued numerous policy papers, surveys, and other releases that address bank transparency, enhanced practices for loan-loss reserves and credit risk disclosure, sound bank internal and external audit programs, and sound risk-disclosure practices. Moreover, the Basel Committee's approach to its new Capital Accord, with its market-discipline component in Pillar 3, signals that sound accounting and disclosure will continue to be important aspects of our supervisory approach for many years to come.

Many U.S. banking organizations have assumed that international accounting standards are essentially irrelevant to their financial reporting activities. However, the Sarbanes-Oxley Act includes a directive that U.S. accounting standards should seek convergence internationally. In view of this, the FASB and the IASB announced in October 2002 a major agreement to intensify their projects that seek international convergence and harmonization of accounting standards. The SEC and the Federal Reserve strongly support efforts to harmonize international accounting standards in ways that achieve high-quality standards for global firms, including banking organizations. I believe that U.S. banking organizations and their auditors should focus more attention on the initiatives of the IASB in view of these developments and the requirements of the new legislation.

In conclusion

In conclusion, steps to restore public confidence in the U.S. capital markets have begun, yet the need for a cultural change in the accounting profession, in addition to more regulation, is evident. We have seen all too well that the actions of a few can easily bring down a firm built primarily of good practitioners. Although I've been critical of the profession, in many cases the public doesn't look beyond the reputation of our firms, and in some cases individuals, when they evaluate the integrity of the profession. It is, therefore, up to auditors to embrace the professional standards and ethics that have made their attestation function so effective and accepted in the past.

A cultural change in the profession today is a prerequisite for an effective principles-based system of standards that can serve to guide us through accounting for new and innovative financial transactions. Along with enhanced disclosures based on sound risk-management information, high-quality financial information will become the rule and not the exception in the eyes of the public.