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THE EFFECTS OF THE GLOBAL CROSSING BANKRUPTCY ON INVESTORS, MARKETS, AND EMPLOYEES

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE EFFECTS OF THE GLOBAL CROSSING BANKRUPTCY ON INVESTORS, MARKETS, AND EMPLOYEES

THURSDAY, MARCH 21, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Sue W. Kelly, [chairwoman of the subcommittee], presiding.

Present: Chairwoman Kelly; Representatives LaFalce, Tiberi, Oxley, Jones, Capuano and Clay.

Also present: Representatives Slaughter and Baker.

Chairwoman KELLY. Good morning. This hearing of the Oversight and Investigations Subcommittee of the House Financial Services Committee will come to order.

I want to thank all Members of Congress who are present today, and without objection, all Members present will participate fully in the hearing. Their opening statements and their questions will be made part of the official hearing record. In the interest of ensuring proper subcommittee consideration of H.R. 3763, The Corporate and Auditor Accountability, Responsibility, and Transparency Act, known as CARTA, we are here today to examine the status of the telecommunications industry.

We will hear from the executives of the companies, from the industry experts, and from an accounting expert at the Securities and Exchange Commission. Global Crossing's bankruptcy in January marked the fourth largest bankruptcy in the history of the United States.

It serves as an ominous warning to the financial and business community and has had far-reaching consequences. While the overall downturn in the telcom industry was a factor in the collapse, the fall of Global Crossing raises serious questions about current accounting practices, disclosure requirements, and corporate management.

Just yesterday we learned that Global Crossing did not disclose a complex communications deal, several months before the company filed for bankruptcy in January. Experts called the lack of disclosure a serious lapse by management.

An estimated 500,000 jobs have been lost in the telecom industry. Global Crossing's bankruptcy resulted in the loss of an estimated 9,000 jobs, and has caused real harm to investor confidence.

It has had an impact on my home State of New York. Statewide, Global Crossing has eliminated hundreds of local jobs, and the New York State Pension Fund lost $63 million as a result of the collapse.

How did a company that was perceived by all conventional measures as healthy, fall so far so fast? By all accounts, Global Crossing was a winner, but now we know that it was actually a financial time bomb.

Did some top executives know that the clock was ticking and that time was running out? One thing is certain. We do know that the bomb was tossed right in the lap of employees and investors who didn't have a clue that the company was going under.

The collapse of Global Crossing calls into question, how much confidence employees, investors, and the public should have in financial information that's released by companies, particularly the pro forma financial projections. Since these pro forma statements are not required to use Generally Accepted Accounting Principles, known as GAAP Principals or GAAP Accounting, a company such as Global Crossing can massage the numbers on these pro forma financial statements, or, in other words, these pro forma statements can provide an easy opportunity to cook the books.

In the case of Global Crossing, the company's pro forma statements may have misinformed investors and employees as to the profitability and performance of the company. In an examination of Global Crossing's filings submitted last spring with the SEC, the company reported an additional $531 million in earnings in the pro forma statement, pumping up earnings by nearly 50 percent as the result of controversial swaps activities.

However, the $531 million was not included in the company's GAAP-compliant statement of earnings. Why not? Because under present required disclosure regulations, it didn't exist. It wasn't required to exist.

In addition, we need to examine the way in which companies report their swaps of indefeasible rights of use known as IRUs. It appears that swaps are being used as a quick and easy way to inflate earnings, and make a company look more profitable than it really is.

Investors deserve accurate information and in some cases, they appear not to be getting it. We need to know how the SEC views these IRUs, since some have alleged that this accounting practice has misled investors and the companies' employees as to the true profitability of the corporations.

Other issues raised by the collapse of Global Crossing include corporate governance and responsibility, including blackout periods imposed on employee 401K plans. At the highest levels of Global Crossing, top executives were selling stock and pocketing millions before the company's collapse. Former CEO Gary Winnick, sold stock worth $734 million before the company collapsed, while this winter, employees of his company watched their savings, investments, and severance packages disappear.

The purpose of this hearing is to take an honest look at the issues surrounding this collapse. The ultimate goal is to protect workers and investors and prevent this from happening in the future through new legislation, if it's necessary.

Accounting methods, financial disclosure, and transparency and corporate governance are matters that the Full Committee is deliberating right now. I believe that CARTA provides a comprehensive solution to our concerns and will restore investor and employee confidence in company disclosures.

I would like to note for the record that we invited the President of the Communications Workers of America to testify, however, he was unable to join us due to scheduling problems. In addition, we also invited the American Institute of Certified Public Accountants to testify, but they were also unable to accept the invitation.

[The prepared statement of Hon. Sue W. Kelly can be found on page 50 in the appendix.]

Chairwoman KELLY. Unfortunately, my friend, the Ranking Member, Mr. Gutierrez, is unable to join us today, so I will now recognize the Ranking Member for the Full Committee, Congressman LaFalce, for his opening statement. Mr. LaFalce.

Mr. LAFALCE. Thank you very much. First of all, I am delighted that you are having this hearing today. I think it's very, very important, and I am pleased we have such distinguished witnesses.

Once again, investigation into the companies, most particularly Global Crossing's conduct, by the Securities and Exchange Commission and by the Justice Department have raised the specter of another major United States company that may have been engaged in very deceptive accounting practices.

While we do not yet know for certain if Global Crossing engaged in fraudulent accounting practices, there are certainly very serious questions as to whether it engaged in practices that had far more to do with meeting analysts' earnings estimates than with economic substance.

While its ultimate failure may have had to do primarily with its underlying business model, and also—and very importantly—excess industry capacity, Global Crossing may well have succeeded in keeping its share price inflated much longer than was justified, based upon its true value.

Global Crossing may not be alone within the world of companies or within the world of telecommunications companies. The Financial Services Committee is currently considering legislation aimed at correcting the systemic weaknesses that have become all to apparent in our financial reporting system.

Mrs. Kelly has mentioned one of them, CARTA. That's been introduced by the Chairman and co-sponsored by many individuals in this subcommittee. There is another approach, too. While there's nothing wrong with the CARTA approach, in my judgment, as far as it goes, I just don't think it goes nearly far enough, and so I've introduced a bill, CIPA, The Comprehensive Investor Protection Act, and it, too, has been co-sponsored by a great many Members of our subcommittee and others within the House.

Some of the witnesses in our past hearings have warned that we should not overreact to the collapse of Enron and some other companies. Well, I don't think we should overreact to anything, but I don't think we should under-react, either.

The failure of Global Crossing, Enron, and so forth, is a powerful reminder that this is not just about the foibles of one or two companies, but it's about fundamental weaknesses that afflict our finan-

cial reporting system. The safegaurds intended to protect investors have been overwhelmed by the temptation for companies to sometimes cheat, but more often, overstate or obscure their financial disclosure to improve short-term results, to improve market capitalization, to meet analyst or investor expectations or analyst hype.

If we are to break out of this cycle of improprieties, I believe that we must fundamentally do a number of things. We must alter the relationship of the auditor to its client, making sure that everybody realizes that the auditor's responsibility is a fiduciary responsibility to the public.

We must strengthen corporate governance. I just think that the line between the boards of directors and the offices sometimes has been blurred, and boards of directors too often become passive puppets of officers—not always, to be sure, but too often. This is especially true with respect to audit committees, and we must provide meaningful oversight to both the accounting profession and the securities industry analysts.

I've introduced a bill, as I've said, that seeks to do exactly that. I look forward to working with the Members of our subcommittee as we seek to learn the facts of the failure of Global Crossing and its management practices, its accounting practices, as I look forward to hearing today from other participants within the telecommunications industry to gain their perspective. And I hope that we can create a legislative response that will not simply follow the lead of either the Chairman or the Ranking Member, but a legislative response that will take each issue, issue-by-issue, and attempt to come up with a response that is the best way to deal with a particular issue, regardless of which side of the aisle it originated on. I thank the Chair.

Chairwoman KELLY. Thank you very much, Mr. LaFalce.

We turn now to the Chairman of the full Committee on Financial Services, Mr. Oxley.

Mr. OXLEY. Thank you, Madam Chairwoman, for this timely and, we hope, illuminating hearing today. It seems that each day brings us new allegations about the use or misuse of complex accounting practices that hide the information needed by the markets to assess a company's health.

When this happens to a healthy company during a period of growth, the company can work its way through it, but when the company is already experiencing a severe downturn in its business and then has its accounting question, as was the case with Global Crossing, it can be devastating.

There are two sets of victims who get burned in this cycle: Investors suddenly receive new and damaging information about the company, and then lose confidence in it, and worse yet, the employees then lose their jobs and their pensions when the businesses turn bad and the capital markets freeze, because the good news they had about the company was not necessarily true.

While the Enron bankruptcy first brought these issues to our attention, it appears that Global Crossing, which has also declared bankruptcy, and other telecom companies accounted for key activities in a way that raises serious concerns. Employees and investors need to know whether they engage in swaps of capacity that had

a legitimate business purpose or did not, and whether they were accounted for properly or in a way that just pumped up their projected cash flow and stock prices.

Global Crossing entered into these capacity swaps with a number of companies, including Qwest, Cable and Wireless, and WorldCom at a time when the entire telecom world was experiencing an excess of capacity. We need to understand how the industry's overall problems intersected with the use of those swaps.

I want to thank the CEO and CFO of Global Crossing and executives of Qwest, WorldCom and Cable and Wireless for agreeing to appear before us today to explain these issues to the subcommittee and to the American people. It is only by investigating these practices that we can help investors to base their decision upon a company's real financial condition, not just a projection released without an objective opinion by an independent party.

Just as important to my way of thinking is the desire to protect shareholders and employees from the kinds of activities that are often characterized as sweetheart deals that might have had an adverse impact on shareholder's value. Some of these practices include special treatments for loans, bonuses and pension payouts.

We need to discuss the propriety of 401K blackout periods wherein some employees are precluded from selling stock for specified periods of time. This hearing will be of enormous assistance in assuring that H.R. 3763, The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, or CARTA, is successful and effective.

In order for our Nation's economy to remain on sound footing and to continue its recovery and anticipated growth, it is vital for the American investor to have access to the most recent, meaningful, and accurate information possible. Good corporate governance is necessary for such an environment to exist, and that is one of the things we are seeking to accomplish by the introduction and implementation of the CARTA legislation.

Madam Chairwoman, we were pleased to have testimony yesterday from the Chairman of the SEC, who indicated very strongly, his support of our legislation and for a new way of looking at things in this modern world, particularly in the telecommunications sector. And for that, I think all of us can learn a great deal, not only from Mr. Pitt's testimony, but certainly from our witnesses today. And I thank you for the opportunity, and I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 69 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Chairman.

We turn now to Mrs. Jones.

Mrs. JONES. Thank you. To Chairwoman Kelly; Vice Chairman Paul; Full Committee Chairman, Mr. Oxley; Ranking Member, Mr. LaFalce; and Members of the subcommittee, the witnesses who have come here this morning, thank you for coming.

In the wake of Global Crossing we have seen firsthand, the effects of poor corporate governance, perhaps, and financial irresponsibility, perhaps. The issues have been complicated, at best. The misdirection, finger-pointing, and complexity of personalities and accounting involved in the situation have made the root issues difficult to parse.

However, when the Gordian Knot has been tied by the Globals of the world, I think that it's best that we get back to basics and move forward to evaluate our position as a Nation with regard to corporate responsibility, governance, and ethics.

Let me first address those directly responsible for the well being of those least able to protect themselves. At a basic level, it is the role of the board of directors of any company to protect and act in the best interest of the shareholders. Protecting shareholders is a task simple enough to speak of, but seemingly infinite in its difficulty to perform.

Shareholders have no choice but to trust the board as fiduciary agents to act in their best interest, and it is because of this dependence that we must carefully evaluate what led to the down fall of Global Crossing. Second, we must examine the role that Global's corporate auditors had in effecting the company's downward spiral.

Is it more than a coincidence that Global Crossing and Enron were both audited by Andersen? Perhaps. But we are sure that both Enron and Global shared the same fate in Chapter 11 bankruptcy.

The notion of true auditor independence is at issue, and, specific to this hearing, how big of a factor it was in Global Crossing's demise, we hope to learn today.

Finally, I would like to acknowledge the employees of Global, who have often been overlooked in the media storm surrounding its once proud employer. I received several letters in my Congressional office from many of my constituents saying, why isn't Global getting the same attention as Enron? To each of my constituents who wrote to me, today we're going to address that issue.

Over 9,000 people lost their jobs as a result of the Global bankruptcy, most of which were unaware of the accounting improprieties that may have cost the company its life. The reach of the Global Crossing debacle into the telecommunications sector was deep: By some estimates over 500,000 jobs and $2 trillion in market capitalization in the sector was lost as a direct result of Global Crossing's bankruptcy.

This is reason enough why we must continue to scrutinize what happened to Global Crossing so that it will never happen again. Madam Chairwoman, I am pleased that you are hosting this hearing today. I thank everyone who has come out to testify, and I trust that we will get to the bottom of many of the issues that have been raised by both corporate leaders, by shareholders, by auditors, and by the general public. I yield the balance of my time; thank you very much.

[The prepared statement of Hon. Stephanie T. Jones can be found on page 72 in the appendix.]

Chairwoman KELLY. Thank you very much, Mrs. Jones.

We turn to Mr. Tiberi. You have no opening statement at this time? Thank you, Mr. Tiberi.

We turn to Mr. Capuano.

Mr. CAPUANO. Thank you, Madam Chairwoman. I have no opening statement, because anything I said would probably be unprintable, based on this issue.

Chairwoman KELLY. Thank you, Mr. Capuano.

We turn to Mr. Baker.

Mr. BAKER. Thank you, Madam Chairwoman. I especially want to express your appreciation for your courtesy, not being a Member of the subcommittee, to allow my participation this morning.

I'll be very brief, but, I hope, to a specific point. I first want to express my appreciation for the gentlemen's appearance here today in helping the subcommittee to understand the mechanics of how this reporting difficulty occurred, and hopefully leading us to some resolution. It appears, preliminarily, that although there was compliance with the letter of the law, the letters weren't necessarily in an order that spelled anything.

In my review of the pro forma financials, even after the July 1999 1043 revisions, it appears that compliance, technically, with the warning statement, "Read at Your Own Risk," sort of like a Surgeon General's warning, that if anyone wanted to get to the details of the content of corporate structure, you would go primarily to the pro forma, because there appeared to be more information than as to the GAAP standards.

It does indicate to me, at least, preliminarily, that the metrics included increasingly greater amounts of cash receipts for future sales and services that were not provided at the time of the revenue being reported, on the belief that those sales would eventually close.

In my simple calculation, that's called counting your chickens before they hatch, but there may be reasons for that conduct. Clearly, there is extraordinary pressure from Wall Street for corporations to meet quarterly expectations for cash revenues and the adjusted EBITDA, as it's called, and I can understand the pressure to generate a report that indicates that the cash is coming or is in the bank.

However, the definitions that were utilized, whether it's cash, cash receipts, adjusted EBITDA, are not apparently consistent from one telecom company to another in the methodology by which these quantities are measured or reported.

For example, a cash receipt in this instance would have been for, I believe, the sale of broad band capacity for portions of the network not yet complete. Madam Chairwoman, let me make that point. If I'm understanding the reports properly, they booked revenue in the current quarter for sale of broad band capacity for a portion of the network which was not yet constructed. I think that is something that needs to be thoroughly discussed.

And, further, the company would incur substantial out-of-pocket expenses to fulfill these obligations at a later time, but that deduction was not taken in adjusted EBITDA. It appears that some of the transactions were actually swaps and not cash revenues, or, stated another way, money round tripped between parties that did not add value.

All of this apparently is within the context of the law, as I understand it, under the preliminary cover of legitimate business purpose, which is not a regulatory not statutory definition, but an accounting convention.

I think we need help in examining legitimate business purpose. It appears that the reporting, although consistent with rule and regulation, would lead a person to come to conclusions about cash

adequacy that were entirely inappropriate in relation to the actual cash standing at the time of the report.

Madam Chairwoman, I don't have sufficient time to examine all of these questions this morning, and I would ask your further diligence, Madam Chairwoman, if I could perhaps provide more clarity with my questions in a written comment for the Chair to consider forwarding at the appropriate time, and I thank you for your courtesies.

Chairwoman KELLY. With unanimous consent.

Mr. Baker, you had mentioned that you were not a Member of the subcommittee, but you are a Member of the full Financial Services Committee, and, as such, you are welcome here at this panel.

We turn now to Mr. Clay. Have you an opening statement, Mr. Clay?

Mr. CLAY. Madam Chairwoman, at this time, I will forego an opening statement, and wish to hear from the panel and have questions for them, thank you.

Chairwoman KELLY. Thank you very much.

Ms. Slaughter.

Ms. SLAUGHTER. Madam Chairwoman, I thank you very much for allowing me to be here this morning. As you know, I'm not a Member of this subcommittee, and you are very gracious in allowing me to come. I appreciate the opportunity to submit my statement for the record.

And my interest in this hearing stems from the fact that thousands of people from my district have been affected by Global Crossing's bankruptcy filing. Actually, all the people in my district have been affected by it, because the economic displacement has the possibility of being quite profound.

Global Crossing's North American headquarters were located in Rochester, New York, and I hope they still are. They owned Frontier Communications which had an outgrowth from the Rochester Telephone Company, which had given wonderful service to the people of Rochester area for over 100 years. And then their 13,000 workers were taken over by Global Crossing with 220 workers.

Now, as I said, the effect is devastating, and came as quite a surprise, as we had every indication in Rochester that Global was doing well, and, indeed, was planning to consolidate and move, and had gotten from the local IDA some $400,000 to help expedite that, on the grounds that they would immediately hire 72 new workers.

The bankruptcy came as a surprise to a lot of people because, indeed, the company still had adequate assets according to most people that I've spoken to, to continue. As a matter of fact, one of the first things that struck us as strange was that the offer for Global Crossing of $750 million was going—I think that was something like 69 percent ownership of that company, which claimed to have assets of $22 billion.

On March 9th, we hosted a public forum in Rochester, and over 250 people came to talk about their experiences, and it was heartbreaking. I'd like to quote from an article I received, written by a former employee, who summarizes the general sentiment at the forum:

"Many former employees have been economically devastated as the result of corporate greed and the mismanagement of Global

Crossing. People spent their life savings, they've had to cash in their deflated—since the stock market plummeted—retirement 401K plans, just to survive the last few months, after Global Crossing abruptly ceased their promised severance payments.

"Some former employees are forced to file bankruptcy themselves, while others may lose their homes, have had to drastically change their lifestyles, and are barely surviving." Again, another impact on my community is that many of those extraordinarily talented and gifted people may have to leave our community altogether, because they are not able to find jobs that they can take care of their family.

According to the press reports, there appears to be striking parallels between the cases of Enron and Global Crossing, including a lack of auditor independence, questionable executive mismanagement, misleading accounting methods, and questions on the accessibility of employees' 401K accounts before the bankruptcy filing.

And unlike the small shareholders and company workers, current and former top executives walked away the winners. This hearing begins the process of Congress asking the tough questions on how this occurred. Where did the system break down and allow this to happen?

Hearings like this will serve as a wakeup call to Congress, and, we hope, to corporate America, particularly those who are organized in Bermuda, that these types of business practices and bankruptcies can be neither sustained nor tolerated.

Additionally, current law must change to better protect the workers and investors, and, across the board, investors are now skiddish about relying on auditors' reports and analyst recommendations and that is a tragedy.

I certainly look forward to listening to the witnesses' views, their experience, and their suggestions on how Congress can take effective action, and I thank you again, Madam Chairwoman.

[The prepared statement of Hon. Louise Slaughter can be found on page 73 in the appendix.]

Chairwoman KELLY. We thank you.

If there are no further opening statements, I will introduce our distinguished panel of leaders of the telecommunications industry. We sincerely appreciate the effort that it took for you to prepare testimony on this difficult issue, and to travel here today. Mr. McGrath, you came from England, and I think you get our award for the longest traveled visitor to get here today, and for that, you get a free glass of water. I thank you all for making the effort.

Our panel consists of Mr. John Legere, the Chief Executive Officer; and Mr. Dan Cohrs, the Executive Vice President and Chief Financial Officer of Global Crossing, Ltd. Next, we have Mr. Afshin Mohebbi. I'm pronouncing that wrong. Mr. Mohebbi, is that correct?

Mr. MOHEBBI. Yes.

Chairwoman KELLY. Thank you, Afshin Mohebbi, the President and Chief Operating Officer of Qwest Communications International; Mr. Michael Salsbury, Executive Vice President and General Counsel of WorldCom, Incorporated, and, Mr. Salsbury, we welcome you; and finally, Mr. Andrew McGrath, President of Service Providers Channel, Cable and Wireless Global.

We welcome you all here today, and we are looking forward to your testimony, and we thank you for appearing here. We begin with you, Mr. Legere.

Mr. LAFALCE. Madam Chairwoman, a parliamentary inquiry.

Chairwoman KELLY. Yes, sir?

Mr. LAFALCE. It is my understanding—not that it is necessary to tell the witnesses, but it won't hurt—the laws of perjury that obtain when you are asked to stand and be sworn in are the same, even though you're not asked to stand and be sworn in. The mere fact that you're testifying before Congress makes you fully subject to all the laws of perjury; is that correct, Madam Chairwoman?

Chairwoman KELLY. That is correct.

Mr. LAFALCE. Thank you, Madam Chairwoman.

Chairwoman KELLY. You are still liable for your statements in front of this subcommittee, even though we are not swearing you in as witnesses. We all look forward to listening to your views on these important issues we touched on in our opening statements, and without objection, your written statements and any attachments will be made part of the record.

You will each now be recognized for 5 minutes for a summary of your testimony. There are lights in front of you and they indicate the amount of time you have. The green light signifies that you're in your first of the 4 minutes. The yellow light will turn on when you have 1 minute remaining; the red light will turn on when your time has expired. If possible, I would like to ask you to keep your summaries within the 5-minute sequence, so that people can ask questions.

And we'll begin with you, Mr. Legere.

STATEMENT OF JOHN J. LEGERE, CHIEF EXECUTIVE OFFICER, GLOBAL CROSSING, LIMITED

Mr. LEGERE. Good morning, Chairwoman Kelly and Members of the subcommittee. We prepared a longer statement, which I understand will be filed for the record. Now, this is my first appearance before a Congressional subcommittee, and I'm honored to contribute to your effort to take a serious look and a substantive look at the difficult financial issues facing the telecommunications industry.

Our difficulties at Global Crossing and the measures we are taking as we continue our restructuring in bankruptcy, is a microcosm of an industry under tremendous economic pressure. I'm accompanied here today by Dan Cohrs, Global Crossing's Chief Financial Officer, and Ralph Ferrara, who is our outside counsel.

In response to the questions posed in your letter of invitation, we would like to respond to the three issues you raised. Dan Cohrs will respond to the first two of your questions, and I would like to provide a brief overview of Global Crossing and our efforts to rebuild our company.

My written statement amplifies on these remarks to respond to your final question, and to address steps that can be taken to enhance investor confidence in the accounting for and disclosure of financial information in the telecommunications industry.

Now, it's all too easy to dismiss Global Crossing's bankruptcy as the failure of yet another dot.com company or to attribute its col-

lapse to fancy or misleading accounting. The media in this post-Enron environment, continue to focus on these issues.

The reality is that thousands of our employees continue to operate the real Global Crossing. Today, Global Crossing has over 85,000 customers, corporations, governments, associations, and organizations in over 200 cities in 27 countries who transmit voice and data over our global network.

Every day our employees keep coming to work, keep helping the customers keep the data moving, and keep their spirits high. I want to take this opportunity to thank them publicly and to thank our thousands of loyal customers who have supported us through this challenging time.

A few facts about what Global Crossing really does: We transmit over $5 trillion U.S. dollars in financial transactions every business day. We connect over 7,000 financial institutions and hundreds of scientific research centers across the globe.

The Global Crossing network carries CNBC's video between Ft. Lee and London, over our high-capacity sub-sea fiber optic cables, something previously only satellites could do. NBC transported hundreds of hours of Winter Olympic news broadcasts to its affiliate stations across America over our network.

Because of our network, customers in KB Toy Stores can charge their purchases five times faster, and diplomats in over 240 British Embassies and Consulates can correspond with their colleagues, 24/7, reliably and securely. Many people who will see these hearings on television and reported on the nightly news shows, will be watching signals transmitted over our network.

Now, our pride in what we have accomplished is, of course, offset by tremendous disappointment. Although our network infrastructure is unique and unparalleled in the industry, building it came at a very high price, in excess of $15 billion U.S. dollars.

Global Crossing, like many other telecommunications companies, built aggressively as the forecasts of industry analysts, financial analysts, and technology experts predicted that our world would soon be one where classrooms would reside on computer desktops; movies would flow electronically on demand; and millions of people would be able to communicate through millions of personal channels.

And though we continue to believe that people will one day be able to take advantage of this expansive infrastructure, the demand simply hasn't materialized as quickly as predicted. In what became a very volatile environment for the entire telecommunications industry, our company simply could not cut costs back fast enough to accommodate the sudden changes.

We need to take a more realistic approach. Part of what we're doing through the Chapter 11 bankruptcy process and through a continued series of painful cost reductions, is to restructure our balance sheet and realign our operations.

Since my arrival 6 months ago, my prime focus has been to realize the true potential of our company. With our restructuring now well underway, and despite the necessary and often painful actions we have had to take, my belief is that we will come back stronger than ever.

You asked for our views on H.R. 3763. We believe it provides a useful framework for discussions on auditing accountability, and we have offered several specific suggestions in our written testimony.

While our company and our industry continue the challenging, critical process of building the new business model in the more realistic context, we fully support the efforts of this subcommittee to develop, in parallel, ways of encouraging financial accountability that will enhance investor confidence in financial reporting in the telecommunications industry.

We have an opportunity, working together with you, with the SEC, with the accounting industry, and with our telecommunications industry colleagues here today, to improve the way we communicate. Whether this is through reformed accounting principles or clearer and more timely reporting practices, we support and intend to be the market leader, not only in how we run our business, but also in how we report on what we're doing. I'm confident, with our joint efforts, this industry, and Global Crossing, in particular, will once again be in a position to contribute strongly to this great Nation's prosperity. Thank you very much.

[The prepared joint statement of John J. Legere and Dan J. Cohrs, Ph.D., can be found on page 74 in the appendix.]

Chairwoman KELLY. We turn to you, Mr. Cohrs. Do you have a statement?

STATEMENT OF DAN J. COHRS, Ph.D., EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, GLOBAL CROSSING, LIMITED

Mr. COHRS. Yes, ma'am, if I may. Good morning, Chairwoman Kelly and Members of the subcommittee and also the Full Committee. John Legere has asked that I briefly address the accounting issues raised in your invitation to appear here.

Our industry and the accounting profession have struggled with how to adapt historic concepts of accounting for leases and real estate to purchases and sales of fiber optic capacity. Global Crossing settled upon an accounting model that our independent accountants advised was most appropriate to our business.

The accounting for the majority of our revenue, which is derived from providing voice and data services to our 85,000 customers, is not controversial. The accounting for the company's sales to other carriers of fiber optic capacity on its network raises the issue of the proper accounting for transactions known as sales of IRUs.

An IRU, which is an indefeasible right of use, is a contract like a lease, granting the right to use a fixed amount of capacity for a specified period. IRUs have been used in the telecom business for many years.

Typically, the sale of an IRU involves an up-front cash payment of the full contract amount. However, revenue from the sale of an IRU is recorded only over the life of the lease. For example, for a 20-year lease for $20 million of capacity, only $1 million is recorded as GAAP revenue in the income statement for the first year and each year thereafter.

The other $19 million of cash paid up front on the contract is not recorded as revenue, but is recorded on Global Crossing's GAAP

balance sheet as a liability called deferred revenue. Although Global Crossing has the cash in its bank account and the cash is nonrefundable, it earns the revenue only over the 20-year life of the lease.

Not surprisingly, banks and investment analysts who need to assess the company's ability to service its debt were interested in our cash flow, including the amount of cash collected through IRU sales, which was shown as deferred revenue. The cash entering the deferred revenue account was not reflected in GAAP revenue or earnings.

To present a clearer picture of cash flow, two measures—cash revenue and adjusted earnings before interest, taxes, depreciation and amortization, which we called adjusted EBITDA—were reported to the market to supplement our GAAP revenue and earnings. These measures included the cash from IRU sales; they were clearly defined, and we believe they were well understood by the marketplace.

Some questions have been raised about the quality of the company's disclosure respecting cash revenues and adjusted EBITDA. We are confident that Global Crossing fully and fairly disclosed the meaning of these terms in its press releases and SEC filings, and we believe that the additional information provided by these measures was useful to investors.

The focus of virtually all the attention to Global Crossing's accounting model has been directed at how the company accounted for the relatively simultaneous purchase and sale of IRUs to the same counterparty. As the Global Crossing network grew, we and other carriers understood that it was sometimes cheaper and faster to buy capacity from another carrier than to build it ourselves.

In our case, we needed additional capacity on certain routes, redundant capacity to provide backup for potential network problems, and extensions of our network into new markets where building would not have been economic. Accordingly, we purchased IRUs for cash, as well as sold IRUs for cash, sometimes with the same counterparty.

These were two, independent transactions, each evaluated on its own merits. Nonetheless, due to the proximity in time of the two transactions, the question has been presented of whether revenue should be recognized on these sales with the purchases recorded as capital expenditures, rather than simply netting the sale and purchase amounts.

According to the accounting model that was developed and approved by our independent accountants, revenue and capital expenditures should be recognized on the two transactions, if, first, there was a valid business purpose for the asset we bought, and, second, the assets bought and sold embodied different risks and rewards of ownership.

In our case, the second test can be satisfied if the rights to the capacity sold had the risk profile of an operating lease and the rights to the capacity purchased had the risk profile of a capital lease. Today, some have raised questions as to whether the process we conducted adequately established the valid business purpose for our purchase of assets; that is, did we satisfy the first test? And that is the crux of the controversy.

It's the subject of a detailed review by our Board of Directors and its independent counsel. The SEC and our independent accountants are also reviewing these transactions.

As we conduct these reviews, it's critically important to consider only the facts and circumstances that existed at the time the transactions were closed, not use hindsight. We now know that since the second quarter of 2001, the astounding deflation in the demand for fiber optic capacity has devastated our industry.

As demand waned in the industry, there was less need for both the capacity that we had built and for the capacity that we had purchased. These difficulties have also been experienced by others in our industry.

We hope to have fully considered conclusions on these matters in the very near future, and I'll be pleased to respond to any of your questions, thank you.

Chairwoman KELLY. Thank you very much, Mr. Cohrs.

We turn to you, Mr. Mohebbi.

STATEMENT OF AFSHIN MOHEBBI, PRESIDENT AND CHIEF OPERATING OFFICER, QWEST COMMUNICATIONS INTERNATIONAL

Mr. MOHEBBI. Thank you, Madam Chairwoman, and Members of the subcommittee. My name is Afshin Mohebbi, President and Chief Operating Officer of Qwest Communications International, Incorporated. I want to thank you for inviting me to appear today at your hearing.

Permit me to tell you a little bit about Qwest. Qwest is the fourth largest local telephone company in the United States with 25 million customers. We provide local services in a 14-state area that covers nearly 40 percent of the land mass of the United States. We have about 60,000 employees and annual revenue of more than $19 billion.

About 80 percent of our revenues, and more than 90 percent of our profits come from our local phone service. We also provide data and long distance services to businesses in 27 cities outside our 14-State local area, and we are the Nation's fourth largest long distance company.

In addition, we have about half a million high-speed internet service customers, more than a million wireless customers, and a large Yellow Pages business, and a product line that ranges from the most basic telephone service to the most sophisticated internet and data technologies available.

We're also very proud that we just completed one of the most technically trouble-free Olympics in history in Salt Lake City, where Qwest was one of the primary providers of communications services to the Olympics event.

Qwest has a state-of-the-art, worldwide fiber optic network in the United States, Asia, and Latin America and through its related company KPN Qwest in Europe. In addition to its fiber optics network, Qwest has 16 web-hosting centers that safeguard the critical data of banks, corporations, healthcare providers, and Government agencies, among others. Qwest does business with 60 percent of the Fortune 1000 companies around the world.

Qwest's strategy in building its domestic network was to provide facilities for our own use, as well as constructing facilities for sale. Conduit, fiber, and capacity sales have paid for substantial portions of the cost of building our U.S. network.

As we completed our domestic network, we began to expand overseas. We made decisions whether to build or buy these international facilities. Based upon the analysis of time and cost, we purchased facilities to connect our network to Europe, Asia, and Latin America.

It was in this context that we entered into IRU transactions with a number of companies, including Global Crossing. The IRUs Qwest sold to Global Crossing were principally on domestic routes we built to sell. The IRUs that Qwest purchased from Global Crossing enabled us, quickly and cost-efficiently, to build our network internationally to locations that we could not otherwise serve.

An IRU is an indefeasible right of use, which is the exclusive right to use a specific amount of capacity or fiber for a specific period of time, usually 20 years or more. An indefeasible right is one that cannot be revoked or voided. IRUs are for specific point-to-point assets. IRUs are not services and are generally asset sales.

Once sold, they belong to the customer and cannot be moved without the consent of the customer. An IRU allows the purchaser to carry voice, data, video, or other traffic on that specific fiber or channel asset.

In some cases, Qwest enters into two transactions that occur at about the same time: One, to sell IRUs to companies; and, second, to acquire optical capacity from such companies. The agreements for the sale of such optical capacity are separate legal agreements that are enforceable, regardless of whether the other company performs under the separate purchase contract.

In accounting for the purchase and sale of IRUs, Qwest complies with Generally Accepted Accounting Principles known as GAAP. Qwest's auditors review our IRU transactions in the context of reviewing our financial statements each quarter.

When Qwest sells IRUs, the customer receives the exclusive rights to a specific asset, and the risks and rewards of ownership passes to the buyer. Under the relevant accounting rules, Qwest recognizes revenue when Qwest delivers the asset, the buyer accepts it, and Qwest receives adequate consideration for those assets.

Where the purchase and sale transactions occur at about the same time, Qwest applies the more restrictive rule for revenue recognition on what the accountants called a non-monetary transaction. The revenues attributable to IRU sales that occurred at the same time as purchases of an IRU in 2000 and 2001, were approximately 2 percent in 2000 and 3.5 percent of total reported revenues of Qwest, respectively.

Qwest publicly disclosed the network expansion plans and the nature, size, and the accounting treatment of the IRU transactions undertaken to further that strategic objective. In various press releases and filings with the Securities and Exchange Commission, Qwest made appropriate disclosure of the existence of the IRU transactions and the way Qwest accounted for them.

In conclusion, as part of our business strategy to build a worldwide fiber optic network, we bought and we sold IRUs. When appropriate and in compliance with GAAP, we recognized revenue as well as costs from these transactions, when we entered into them, and although IRUs were not a material component of our revenues in the last 2 years, we publicly disclosed them and how we accounted for them.

We're proud of the state-of-the-art network we have built and the services it enables us to provide, and I will be glad to answer any questions that you may wish to ask. Thank you for the opportunity.

[The prepared statement of Afshin Mohebbi can be found on page 104 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Mohebbi.

And we now turn to Mr. Salsbury.

STATEMENT OF MICHAEL H. SALSBURY, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, WORLDCOM, INC.

Mr. SALSBURY. Thank you, and good morning. My name is Michael Salsbury, and I am the General Counsel of WorldCom, Incorporated. The questions and issues that the subcommittee seeks to address in this hearing, how accounting standards and Federal policies may have contributed to the problems experienced by Global Crossing and the industry are valid and important.

There has been a lot of press recently about swap transactions, whereby carriers record revenue from selling capacity that is not likely to be used, in return for a purchase of capacity that is not used and is capitalized rather than expensed. WorldCom does not participate in such transactions.

WorldCom sells IRUs and occasionally purchases them where needed, but in all cases, accounts for them appropriately. To put this into perspective, during 2001, WorldCom recorded recurring revenues of approximately $23 million out of total 2001 revenues for WorldCom of $35.2 billion from the sale of IRUs.

During December 2001, WorldCom entered into two IRU transactions with Asia Global Crossing—not Global Crossing. WorldCom purchased needed capacity on AGC's East Asia Crossing Cable and AGC purchased capacity on WorldCom's Australia-Japan Cable.

Each transaction was for $20 million over a 10-year term. Because neither lease has yet become operational, WorldCom has not yet recognized either transaction on its P&L. As each IRU becomes operational, WorldCom will recognize approximately one-half million dollars per quarter in revenue and in operating expense over a 10-year period. Again, to place this into perspective, our 2001 revenues were $35.2 billion.

The subcommittee also asked to what extent certain factors served as a trigger for industry problems. WorldCom does not use unique accounting standards and does not issue pro forma revenue projections.

As many companies do, WorldCom issues pro forma profit and loss statements in conjunction with our regular financial statements to show the effect of acquisitions or of revenue from consolidated entities. WorldCom believes such statements assist investors in understanding the impact of certain transactions.

It has become fashionable recently to blame the large number of failures in competitive sectors of the telecommunications industry on bad planning. These claims, which generally emanate from the monopoly sectors of the industry and their pundits, but occasionally also from regulators, suggest that new entrants invested too much in new facilities and mis-forecast the demand for telecom services.

There may well have been invalid assumptions by new entrants, but they related more to the expectation that Federal regulators would fairly and vigorously enforce the telecommunications and antitrust laws than to assumptions about consumer demand. By repeatedly favoring monopoly interests and undermining competition, these regulators increased the costs for new entrants, which led directly to higher prices and lower consumer demand for local telephone services and high-speed data services such as DSL.

The current problems in the competitive sectors of the telecommunications industry were not caused primarily or even significantly by accounting issues or assumptions about capacity utilization; rather, those problems resulted directly from the unrelenting efforts of the Bell Companies to retain their monopoly power, and the fundamental failure of the FCC and the DOJ to properly and effectively implement and enforce the law.

In WorldCom's view, those failures have destroyed far more market capitalization and robbed far more value from shareholders' investments than any accounting issues. Thank you.

[The prepared statement of Michael H. Salsbury can be found on page 118 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Salsbury.

Mr. McGrath.

STATEMENT OF ANDREW McGRATH, PRESIDENT, SERVICE PROVIDERS CHANNEL, CABLE & WIRELESS GLOBAL

Mr. MCGRATH. Good morning, Chairwoman Kelly, Congressman LaFalce, and Members of the subcommittee. My name is Andrew McGrath, and I am the President of Cable & Wireless's Service Providers Division. Cable & Wireless is a global provider of telecommunications services, headquartered in the United Kingdom.

Cable & Wireless, with annual revenues of $11 billion, provides services ranging from local telephone services to internet backbone and web-hosting services in more than 70 countries. Cable & Wireless has been in business for over 100 years. It is well financed and has no net debt.

We are proud to have a substantial presence in the United States, where we provide IP and data services and solutions to business customers. I have been with Cable & Wireless since 1991, and currently head the Global group within Cable & Wireless that provides a broad range of services to carriers, ISPs and content owners.

I hold an engineering degree from Surrey University in the United Kingdom, and an MBA from London Business School. I have been invited to appear today to address the subcommittee's inquiry regarding telecommunications capacity transactions, typically called Indefeasible Rights of Use, or IRUs.

The nature of the telecommunications industry makes it essential for carriers to contract with each other to provide services to

their respective customers. It is not always cost-effective for a carrier to build all aspects of its global network for its own exclusive use.

It has been a long-established industry practice for carriers to interconnect with other carriers and to purchase network capacity from other carriers, either through leases or IRUs. Cable & Wireless has undertaken IRU purchases for the purpose of obtaining the network capacity necessary to support its customer requirements.

Our internal governance policies are designed to ensure that, in each case, our acquisition of capacity serves a legitimate commercial need. Cable & Wireless has also sold network capacity to other carriers.

These IRU sales are a very small part of Cable & Wireless' business. At their peak, in the year ending March 31, 2001, such sales accounted for less than 5 percent of Cable & Wireless' revenues and have since declined as carriers have largely completed their network build-out programs.

In building its global network, Cable & Wireless has purchased capacity from several operators. A small proportion of these transactions has been with Global Crossing. As always, the network capacity we obtained through these transactions served specific commercial needs.

Cable & Wireless states its accounts in accordance with Generally Accepted Accounting Principles—GAAP—as adopted in the United Kingdom, as it must do as a U.K. public limited company. As an additional disclosure, Cable & Wireless separately reports the amount of its IRU sales.

Our accounting policies with regard to the treatment of such transactions are disclosed as part of our financial statements and are readily available to the public. Because Cable & Wireless ADRs—American Depository Receipts—trade on the New York Stock Exchange, it also discloses its financial results in SEC Form 20-F.

For these purposes, Cable & Wireless states its results, including IRU transactions in accordance with U.S. GAAP. A reconciliation of the net income under U.K. GAAP and that under U.S. GAAP is disclosed as part of our financial statements and is also readily available to the public.

Thank you for the opportunity to appear today. I welcome any questions from the Members of the subcommittee.

[The prepared statement of Andrew McGrath can be found on page 126 in the appendix.]

Chairwoman KELLY. We thank you, Mr. McGrath.

One of the issues that I'm most concerned about here is the issue of the pro forma financial statements by telecommunications companies. I'd like the entire panel to respond to my first question, and I'd appreciate it then, if you will, answer my followup questions.

I'd like to know how common pro forma financial statements are in your industry, and we will begin with anyone who wants to start the answer, but I'm going to ask each one of you to answer that. Mr. Cohrs, Mr. Legere?

Mr. COHRS. Yes, Ms. Chairman. My understanding is that in the industry, the use of pro forma statements is relatively common for

the purposes of explaining the impacts of merger and acquisition activities, so that the presentation of pro forma statements can provide an apples-to-apples comparison from one period to the next when a significant number of companies have been either bought or sold by the company. And, in fact, I know that Global Crossing has used that to provide fair comparisons between one quarter and the next.

I believe that your question probably refers to the use of measures like cash revenue and adjusted EBITDA, which are pro forma measures, and those measures became common as the industry of selling fiber optic capacity developed. It's a new industry.

I indicated in my opening remarks that there's a big divergence between the cash coming into the company and what's reflected in the GAAP statements, that is, in my example, $20 million IRU sale only is recorded as $1 million of revenue, even though the cash is in the bank and non-refundable. And so in our case, we adopted the practice of using pro forma measures to supplement our GAAP reporting so that we were showing investors the full picture of cash in addition to the GAAP picture.

Now, that practice was adopted by a number of other companies who went public after Global Crossing. Global Crossing was essentially the pioneer among publicly traded companies in the sub-sea business, and therefore, I believe we were the first to use those particular measures, and they were adopted by others in the industry after that.

Chairwoman KELLY. Mr. Mohebbi.

Mr. MOHEBBI. Madam Chairwoman, in terms of Qwest, the primary reporting vehicle that we have is GAAP revenues and GAAP accounting. However, Qwest is a company that was created as a result of six acquisitions, so sometimes as a supplement to our GAAP reporting, we provide, for the purposes of the investors who have specifically asked for it, pro forma numbers as a supplement, but our purpose, our main purpose of reporting and way or reporting our results are GAAP financials.

Chairwoman KELLY. Mr. Salsbury.

Mr. SALSBURY. I think I would sort of reiterate what the others have said.

Chairwoman KELLY. Well, the others said two different things, sir, I'm sorry.

Mr. SALSBURY. Right. As I said in my testimony, our primary method of conveying our financial results is GAAP accounting and our regularly reported financial statements. Occasionally, as noted earlier, I think by Mr. Cohrs, we have obviously had acquisitions, and it's useful to supplement our financial statements with pro formas showing the effect of acquisitions over time, so that you have an apples-to-applies comparison.

Most companies, not just in telecommunications, do this. I certainly have been reading about occasions where companies have not done this. I was reading the paper this morning, and that's been criticized, because it gives a misleading—looks like companies are growing faster, when you don't show the effect of acquisitions.

We also have an investment in Embratel in Brazil, and it's not a consolidated entity, but it's often useful to show, with a pro forma statement to our investors, the effects of—a pro forma statement,

with Embratel and without. So those are the two examples I'm aware of. I'm not an accountant, and I don't pretend to know every single instance that the company may have used them, but we do not use pro forma revenue statements.

Chairwoman KELLY. Thank you.

Mr. McGrath.

Mr. MCGRATH. Cable & Wireless provides a full disclosure of its accounts, consistent with U.K. GAAP. In addition, we provide separate disclosure of all IRU transactions. Our accounts are audited by KPMG, who have always provided an unqualified, clean audit report.

We find that with that level of disclosure, that we don't need to provide pro forma statements, and we haven't done so.

Chairwoman KELLY. Thank you. Mr. McGrath, you were saying that you do not file pro forma statements; is that correct?

Mr. MCGRATH. That is correct.

Chairwoman KELLY. Just for clarification, could you all just answer with a simple yes or no, did all of your companies file pro forma statements last year.

Mr. Salsbury.

Mr. SALSBURY. I don't know the answer.

Chairwoman KELLY. Mr. Mohebbi.

Mr. MOHEBBI. I believe we did, but I'm not sure of it.

Chairwoman KELLY. Mr. Cohrs.

Mr. COHRS. Yes, we did.

Chairwoman KELLY. Do you all know if you all used the same methodology, if you filed pro forma statements?

Mr. Cohrs.

Mr. COHRS. I just can't speak to any other companies' statements. I haven't studied them, so I just don't know the answer to your question.

Chairwoman KELLY. Do any of the rest of you know the answer?

Mr. MCGRATH. No, ma'am.

Chairwoman KELLY. So you don't know if there is a consistent methodology in preparing a pro forma; is that correct? I'd like an answer from the three of you, since Mr. McGrath doesn't have a background in the pro formas.

Mr. COHRS. Well, if I may respond?

Chairwoman KELLY. Yes, Mr. Cohrs.

Mr. COHRS. The objective of a pro forma statement can serve various purposes. For example, if the pro forma statement is designed to normalize for the results of merger and acquisition activity, then the methodology, I believe, is relatively consistent across companies, because it's an attempt to show apples-to-apples comparison, as if that merger had not happened.

In the case of measures like cash revenue and adjusted EBITDA, as I said, I just don't know the details of other companies' disclosures, and so I'm just not aware if there are any differences. I believe that the measures are, you know, relatively similar, but I'm just not aware if there are differences in reports from other companies.

Chairwoman KELLY. Mr. Mohebbi, do you have any knowledge of that?

Mr. MOHEBBI. Madam Chairwoman, I certainly have no knowledge of how other companies, obviously, report on the pro forma basis, so I cannot say that there is a uniform or a non-uniform way. I do know that in some cases, again, as an appendix or a supplement to our GAAP reporting, which is our primary reporting of revenues, profits, and activities financially, we have provided pro forma to show the investors the differences between before and after acquisitions, but I can't give you an answer on an industry-wide basis or multi-company look.

Chairwoman KELLY. Mr. Salsbury, is it safe to assume that your answer would be similar?

Mr. SALSBURY. Yes.

Chairwoman KELLY. I guess the nature of my question is, the investing public will look at a pro forma and try to make some sense out of it. And if the pro formas are not based on the same types of procedures, the same type of methodology, it would be very difficult, if you wanted to invest in the industry itself, to determine between companies, which company had a better pro forma, if there is no structure that's a solid methodology underneath each one of the pro forma statements. Would that be a correct statement? And you can just answer quickly by saying yes or no.

Mr. Legere.

Mr. LEGERE. I think inherent in your statement is that the answer would have to be yes. I mean, when we were reviewing H.R. 3763 and looking at some of the things that the industry could benefit from, one item is that at times when an industry is going through revolutionary change, as opposed to an evolutionary process, sometimes accounting or information disclosure could use some assistance from an otherwise staid set of rules.

And, you know, in the period we're talking about, this may have been an environment where some governing body could have enhanced the ability for the industry to have consistency in understanding so that this transparency that you speak to could be attained.

Certainly we look to our individual sets of auditors to provide us guidance from an industry expertise standpoint, but looking forward, I think we would all benefit from some knowledge about industry standards, things that we could apply to ensure that our information would be consistently viewed.

Chairwoman KELLY. OK, thank you. I am out of time. I am turning now to Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Madam Chairwoman. Mr. Legere, first of all, thank you for coming to my office before the meeting. I'm sorry we didn't have more of an opportunity to discuss the issues.

I have the honor of representing over 90,000 in Monroe County and all of the almost 45,000 people in Orleans County, most of whom are serviced by Global Crossing, formerly Frontier, formerly Rochester Telephone. In this morning's *Rochester Democrat and Chronicle*, Mr. Legere, there's an article on the business page, entitled "Ex-Frontier Group to Bid on Global."

It is written by Richard Mullins, and it says "A Rochester group of former Frontier executives wants to buy a major part of the now-bankrupt Global Crossing. Leading the group is Anthony Casara,

the former President of Frontier's Carrier Services Division. Also involved is Louis Massaro, the former Chief Financial Officer of Frontier. 'The group knows the business, the customer requirements, the infrastructure, and we understand how to realize its underlying potential with the right strategy,' said Casera. 'I believe there isn't a management team better suited for this opportunity than the team who originally built Frontier's North American business.'"

Mr. Legere, as the ranking Democrat of the Financial Services Committee, I just want you to know that I strongly endorse, support, the effort by this local group of Rochester businessmen to repurchase that portion of Global Crossing. And I know that this is a business judgment that you, under the auspices of the Bankruptcy Court, will have to make, but I hope that our judgments will coincide. Fair enough?

Mr. LEGERE. Congressman, we know these individuals. They're fine telecommunications people, and at this point in time, as part of the Chapter 11 restructuring process, we are engaged in period of time where any interested bidder can come forward through our advisors, the Blackstone Group, and make a proposal that they believe can maximize the return to all constituents who have a piece of the estate. And we look forward to seeing their proposal, along with, right now, over 40 interested parties that have gone to the point of non-disclosures to look further at the company. So, we certainly look forward to it.

Mr. LAFALCE. I appreciate that there are 40 bidders. I also appreciate the fact that these individuals are from Western New York; they're from Monroe County, in particular. They are the ones who originally built Frontier's North American business; they are the ones who are most likely best suited to enhance the future prospects for the company, its employees, the community in which it exists, and I think that that should be given great, great weight.

Now, Mr. Legere, I have about 20 questions, and I'm not going to be able to get through more than a few of them. And so I am going to submit them to you in writing, and ask you to respond for the record to each of them. Would you be willing to do that?

Mr. LEGERE. Anything that can be provided to our counsel, I'll be glad to do that.

Mr. LAFALCE. We will do that.

Chairwoman KELLY. If the gentleman will yield.

Mr. LAFALCE. Yes.

Chairwoman KELLY. Its my intention to hold the record open for 30 days. There are Members who are unable to be here today, and we will hold the record open for written questions and written answers to be inserted into the record, thank you.

Mr. LAFALCE. I thank the Chairlady for that.

Sir, it's my understanding that the auditor was hired by Global Crossing to become the Executive Vice President for Finance; is that correct?

Mr. LEGERE. Joseph Perone, who is currently our controller of the company is a former Andersen employee; that's correct.

Mr. LAFALCE. OK, well, did the Audit Committee ever think that this might compromise the independence of the audit to have the

CFO, the former partner in charge of the audit from the auditing firm?

Mr. LEGERE. This hiring took place before I arrived, but it is my understanding that those were considered by the Audit Committee.

Mr. LAFALCE. OK, well, do we know if the Audit Committee ever spoke with the auditor out of the presence of the corporate officers? Do we know that?

Mr. LEGERE. I'll defer to Mr. Cohrs, who was there.

Mr. COHRS. Yes, Congressman, our Audit Committee had the practice, at each Audit Committee meeting, which were held regularly, of asking the senior executives to leave the room and to speak privately with the auditors.

Mr. LAFALCE. For 5 minutes? Was this done regularly? Was it done in-depth? Did they spend a half a day going over the various books, or was this just a pro forma thing?

Mr. COHRS. Well, since I wasn't in the room, I actually don't know the content of the conversations, but that was the purpose of asking me to leave the room.

Mr. LAFALCE. About how long did these meetings usually last, when you weren't in the room?

Mr. COHRS. It was done regularly.

Mr. LAFALCE. But about how long did they last?

Mr. COHRS. I would say that they lasted anywhere from 10 minutes to an hour. And they were done regularly at every meeting of the Audit Committee.

Mr. LAFALCE. OK. My point is, very often the Audit Committee—that's a superficial meeting. Let me go on to two other areas, securities analysts and attorneys:

When representatives of Global Crossing met with securities analysts, did they ever ask you or your colleagues about these swap transactions or your pro forma presentations? Did they have any questions about them?

And who were these security analysts, especially those that were hyping the Global Crossing stock?

Mr. COHRS. Yes, Congressman, we had regular contact with securities analysts, and since the beginning of the company, there were——

Mr. LAFALCE. Did they ever question the swap transactions or your pro forma presentations?

Mr. COHRS. We had discussions about swap transactions, so-called swap transactions, which were——

Mr. LAFALCE. Did they ever challenge the so-called swap transactions?

Mr. COHRS. They asked questions about the transactions, and we explained to them, actually, an explanation which is very much the same as was in my opening remarks, which was that these were independent transactions, separately negotiated, and that the proper accounting for the transactions was not to account for them as swaps. And we explained the economic reason for buying the assets and for selling the assets. We did have those discussions with securities analysts.

Mr. LAFALCE. Well, I'm going to be going into the economic reasons for buying and selling at considerably greater length. I can't

do it now; I don't have time. But I'm going to question the so-called economic rationale.

What was the role of your outside counsel in reviewing your public disclosure, outside a formal capital-raising scenario, and did they look at your 10K before it was filed? Did they look at your 10Qs?

Mr. COHRS. Our outside counsel reviewed all of our filings, and they reviewed our earnings releases, as well as all of our SEC filings, and all of the filings that we made in the process of the public securities offerings that we did. Those filings were reviewed by our outside counsel and by our outside auditors at some length.

Mr. LAFALCE. Let me just tell you what I'm getting at right now. I think it's imperative that we look at the propriety of the actions of corporate officers, who I have a lot of questions about, because so often their salary is based upon their stock options—or their compensation is based upon their stock options, and, therefore, they have a tremendous interest in enhanced market capitalization.

The same thing is true with respect to the audit committees, and then the accounting firms have their own conflicts. And the primary focus has been placed upon the auditing profession, but I think we need to put much greater focus, too, on the securities industry and the quality of their analysis.

Most investors don't look to what's said by corporate presidents—they expect puffery—or even the boards of directors or even the accountants. And most investors don't look at your statements, your 10Ks, your 10Qs, your financials, your pro formas; they look to the recommendations of the securities analysts.

And so I really think we need to focus in on them more, because I think that sometimes there's an awful lot to be seen that wasn't seen and conveyed by the securities industry. And also there's a fiduciary responsibility on the part of attorneys, too, and attorneys hired by a firm should not be in the business of giving firms advice and counsel that the firm wants to hear, but they should be in the business of giving companies the advice and counsel that they need to hear. And I don't know that that has been done.

My time has expired, Madam Chairwoman. I appreciate that. I will submit the balance of my questions in writing.

Chairwoman KELLY. Thank you very much, Mr. LaFalce.

We go to the Committee Chairman, Mr. Oxley.

Mr. OXLEY. Thank you, Madam Chairwoman.

Mr. Legere and Mr. Cohrs, in his letter to the Global General Counsel on August 6th, Mr. Roy Olafson asserted, among other things in his letter, that the terms that the company used do not really mean what you said that they mean; that there were amounts included in the cash flow definitions that shouldn't have been included, and that although Asia Global Crossing was a global subsidiary, it defined and calculated its cash flow differently.

Can both of you address the points made in Mr. Olafson's letter?

Mr. COHRS. Yes, Congressman, the first question had to do with an allegation that the measures that we reported were somehow not what we claimed them to be. The pro forma measures, the cash flow and adjusted EBITDA, were very precisely defined in every

one of our filings. Our press releases and our SEC filings defined exactly what these terms meant.

In fact, the origin of cash revenue and adjusted EBITDA was in our loan covenants. The bankers who were lending money to the company designed the loan covenants using adjusted EBITDA, and so these were very well understood by the banking community as representations of cash flow. The definitions were precise and they were well understood by the banking community and by the securities analyst community.

Mr. OXLEY. So, there was really full disclosure—from your perspective, there was full disclosure and transparency going forward with that issue?

Mr. COHRS. We believe there was.

Mr. OXLEY. Let me ask you also, in this complaint, Mr. Olafson referred to swaps of about $100 million in capacity between Qwest and Global in each of the first two quarters of 2001, but that each company accounted for the transactions differently, despite having the same outside auditor.

It's not clear from your quarterly statements if that is true. Did the swaps actually happen?

Mr. COHRS. We did transactions with Qwest and, you know, we had transactions, capacity transactions, with Qwest. We accounted for them in the manner I described in my remarks, and I just couldn't comment on any accounting practices at Qwest.

I would say that the accounting treatment for any transaction depends on the facts and circumstances of that transaction, and accounting treatments can differ, based on different facts and circumstances, but I certainly couldn't comment on how Qwest did any accounting.

Mr. OXLEY. Mr. Mohebbi, would you care to comment on that?

Mr. MOHEBBI. Congressman Oxley, again, we did transactions with Global Crossing in 2001. The specific amount is not exactly $100 million, as you indicated. However, the transaction involved Qwest buying capacity, international capacity that we needed to build our business strategy, which was to expand our international network.

And we had a number of bids from, if I'm not mistaken, three different providers, and Global Crossing's terms and conditions for those purchases were deemed to be the best, and we purchased those assets from Global Crossing.

Mr. OXLEY. Do you recall who the other bidders were?

Mr. MOHEBBI. I don't exactly recall, but I believe that there were a number of providers in this particular transaction who I believe were in Asia, and I believe that there are a number of providers in Asia that have the capacity where we wanted it, and we received bids from them. But I don't remember the specific names, Congressman.

Mr. OXLEY. Was that a common practice, to bid that out and to have a competitive arrangement for that capacity?

Mr. MOHEBBI. As an internal process in Qwest, again, as we are buying capacity, part of the process is to look at the market-based pricing and see what other providers have as price. So that's one of the conditions in the process for reviewing what the winning proposal looks like, Congressman.

Mr. OXLEY. Are you able to supply for the subcommittee at a later date, the identification of the other bidders?

Mr. MOHEBBI. I will be certainly happy to go back to our files and look at the information that we had on those transactions.

Mr. OXLEY. I would appreciate that.

Let me ask actually all of you on the panel, in Mr. Legere's testimony, he said that the IRUs did not play a significant role in Global Crossing's problems, but have the revelations about the cash flow presentations of a number of telecom companies has that led to a loss of confidence by the investing public? Or what has happened with the overall perception of stock in the telecom sector, and has this led to a lack of support and confidence in that sector by the investing public? Anybody?

Mr. SALSBURY. Congressman, let me just take a crack at it. I do believe that the—as I mentioned in my testimony—that some of the policies that have been followed by the FCC and the Department of Justice clearly have had a negative impact on the results of companies in the competitive sector. And I think that has led, with a combination of other events like the downturn in the economy last year, and so forth, to having poor results. And I think that has led to the sector somewhat being out of favor. I think accounting issues are a relatively small part of it.

Mr. LEGERE. Congressman, if I could just add that I think there is a cause-and-effect situation. I'd just like to go back to some of my initial comments. The bankruptcy of Global Crossing is not the reason for the loss of 9,000 jobs. The 500,000 jobs that have been lost in the industry are indicative of an industry that has for a period of time, going across the board, pretty significant declines in market capitalization, because many companies in the sector found themselves over-capitalized, needing to reduce costs significantly, just to survive. So the restructuring that Global Crossing has gone through, which unfortunately led to a Chapter 11 restructuring, is similar to what the entire industry has gone through, and, I believe, you know, needs to go through in order to prepare itself for, hopefully, the return to normalcy of the industry.

But certainly that has been a period of shareholder concern, not only about the situations of reporting, but about the industry and the ability to make returns on the significant amount of capital that has been put into the industry over the last several years.

Mr. OXLEY. So it is—at least the perception by the layman would be—and I think you touched on it—that over-capacity in that sector really caused the downturn and the ultimate loss of confidence in the market; is that correct?

Mr. LEGERE. Well, it's important to note that the perception of over-capacity is just as damaging in customer purchases as real over-capacity, because, in effect, carriers who are larger purchasers of capacity, will delay purchases in anticipation of huge amounts of increase in capacity, which generally will lead to significant price declines.

So we have, at least as a minimum, a perception of an over-capacity of supply, globally. There are differing opinions, including this morning's *USA Today*, which are presenting information that suggests that the capacity and the supply of fiber optic capacity may not be as over-supplied as perceived.

But, I think we did have a time in the industry where demand was suppressed, because of a perception, at a minimum, of over-capacity, and, therefore, the value of the investments made by many players in capacity was, and still is, suppressed.

Mr. OXLEY. And do other witnesses share that same view, from the other companies?

Mr. MCGRATH. Yeah, I think, from my perspective in Cable & Wireless, I think that one of the visible signs that the industry is becoming extremely competitive is that companies start to fail and exit the market.

I think that's a very visible sign which is seen by shareholders, and it will affect confidence. It's a visible sign that there has been potentially over-supply, real or perceived; that the shareholders will see that and will demand increased scrutiny and be more conservative about investing in the sector. I think the simple answer to your question is yes.

Mr. OXLEY. And that's not necessarily a bad thing; is it?

Mr. MCGRATH. I think increased scrutiny, greater understanding in detail and the reality of business plans being understood is probably a good thing.

Mr. OXLEY. I think that's been shared, Madam Chairwoman, by other witnesses that we've had in Mr. Baker's subcommittee as well as yours, that perhaps after all of this, we will have learned some valuable lessons in the marketplace, and that, indeed, markets can be very punishing, perhaps even more so than the Government as we work our way through some of these difficult problems. I thank the Chairlady for her indulgence, and I yield back.

Chairwoman KELLY. Thank you, Mr. Chairman.

Mrs. Jones.

Mrs. JONES. Thank you, Madam Chairwoman. There are so many questions I want to ask that 5 minutes won't allow me, but let me try and get started.

Mr. Legere, in an article around the time of the filing of the bankruptcy of Global Crossing, you're quoted as saying: "Ours is a balance sheet issue, not an operational one. Today's actions are intended to directly address this issue. Even with financial uncertainty, we've recently experienced that customers have continued to choose our network over many others." And it goes on and on and on.

But, I want to go back to "ours is a balance sheet issue, not an operational one." Would you be a little more specific and tell me what you meant?

Mr. LEGERE. I'd be glad to. When I became the chief executive on October 3rd, I immediately started a process of refocusing the company, lowering its cost structure, and significantly preparing it to do what every family in American needs to do, which is live on existing means.

We have over $3 billion in service revenue, and I had prepared the company to start to generate enough cash to service its operating capital expenditures. The issue we have is, we were paying between $2 and $3 million a day on interest to service our debt. And that debt burden was just too large for us to be able to, as a young company, to be able to create the underpinnings of an organization and operations to support that debt.

Mrs. JONES. Thank you. Now, however, the debt was not so large as for them to pay you. How much did you receive to become the CEO of Global Crossing?

Mr. LEGERE. I think my salary is public information.

Mrs. JONES. I asked you, what did you receive, sir?

Mr. LEGERE. My salary is $1.1 million a year.

Mrs. JONES. And you received a signing bonus, also, sir?

Mr. LEGERE. I had a $3.5 million signing bonus.

Mrs. JONES. And in another article, there is a young lady by the name of—let me see if I can find her name real quickly. I just had it cleared—ah-hah—oh, here she goes—a Ms. Hinton said that: I was required to take—her severance pay in spread-out payments, rather than a lump sum. Note that all of her medical benefits were terminated, all of her 401K retirement plan was held for more than 30 days. Is that a correct statement, sir?

Mr. LEGERE. I'm not familiar with the situation.

Mrs. JONES. Well, assume its a correct statement for purposes of this question. The employees of Global Crossing weren't able to receive a lump sum payment to pay their debts. They weren't able to receive any medical benefits, but what did you tell me your salary was, again, sir?

Mr. LEGERE. My salary is $1.1 million.

Mrs. JONES. And you got a signing bonus of how much?

Mr. LEGERE. $3.5 million.

Mrs. JONES. And if Ms. Hinton made $79,000 a year, how many Ms. Hintons could you have paid or could your company have helped with the $3.5 million bonus that you received, sir?

Mr. LEGERE. Well, first of all, you know——

Mrs. JONES. My question is, how many Ms. Hintons could you have helped if you had paid——

Mr. LEGERE.——tremendous—for the issues——

Mrs. JONES. Hold on a second. I asked a question.

Mr. LEGERE. And I also——

Mrs. JONES.——and you give the answer.

Mr. LEGERE. I also believe that my pay——

Mrs. JONES. Sir, Mr. Legere, stay with me, sir. My question is, how many Mrs. Hintons could you have helped or paid if they made $79,000 a year, with your $3.5 million bonus?

Mr. LEGERE. As a rule, I don't do math in public.

Mrs. JONES. Well, as a rule, would you pull out a calculator and do it for me, please?

Mr. LEGERE. Well, I don't——

Mrs. JONES. I mean, I don't want—I'm trying to be real clear in my questions, and I'm not looking for smart answers, sir. You're here to help Congress come up with some decisions about how they handled this situation, Mr. Legere.

Mr. LEGERE. I understand.

Mrs. JONES. And I do not appreciate the quirk.

Mr. LEGERE. I certainly understand as well——

Mrs. JONES. And I hope you will apologize.

Mr. LEGERE.——That there's a difficulty in trying to understand the complexities of a Chief Executive Officer in a turnaround situation of a major telecommunications company. To believe that any-

one would have those skills is an understatement of the complexity of the task that we face.

Mrs. JONES. Mr. Legere, I don't believe that's what I said. I merely asked you, how many Ms. Hintons could you have helped with your $3.5 million, and seeing how you don't choose to do my math, let me proceed.

Is Arthur Andersen still your auditor, sir?

Mr. LEGERE. Yes, they are.

Mrs. JONES. And you've chosen to stick with them, even amidst all that's been going on; is that a fair statement?

Mr. LEGERE. Yes, we have.

Mrs. JONES. Can you give me a statement as to how much information is provided to your Audit Committee from Arthur Andersen, and are they serving also as consultants in addition to auditors?

Mr. LEGERE. I'll defer to Mr. Cohrs on that question.

Mr. COHRS. Well, on your first question, Congresswoman, we provide all of the information that we need to provide to the auditor and all the information that they request. And so they have full access to any information that they need to do their audit.

The second question is, have we used Arthur Andersen as consultants? Yes, we have.

Mrs. JONES. But are you using them currently as a consultant, sir?

Mr. COHRS. We have some consulting engagements. For example, Arthur Andersen has helped us collect the information required, which is a massive amount of information, to prepare our bankruptcy filings.

Mrs. JONES. Are they still your auditors, sir?

Mr. COHRS. Yes, they remain our auditors today.

Mrs. JONES. Are you aware, Mr. Legere—I'm going to go back to him—that of the question in the industry with regard to the impropriety, ethically, of having auditors as both accountants and consultants? And I'm going to terminate in this area, Madam Chairwoman, if you'll allow me.

Mr. LEGERE. I don't believe there is any impropriety associated with the roles that Andersen is playing in our company.

Mrs. JONES. That wasn't the questions. I said, are you aware, sir, in the industry, the concern about an auditor serving both as an auditor and as a consultant?

Mr. LEGERE. I'm aware of it from the standpoint that I reviewed H.R. 3763 and understand that it's one of the issues that is potentially going to be addressed, so, in that sense, I do understand.

Mrs. JONES. And you just did tell me, sir, that you have all these great qualifications to be a CEO, and so forth, in the industry, and that's why you were paid $3.5 million?

Mr. LEGERE. The pay was decided by the Compensation Committee with outside experts; the Committee offered me to take on the role.

Mrs. JONES. The point I'm trying to make to you, sir, is, right now, in these United States, there are investors and shareholders, and employees out here who are concerned about auditors serving both as auditors and consultants, but that doesn't appear to be an issue for your company; is that a fair statement, Mr. Legere?

Mr. LEGERE. In my understanding, I don't believe there's anything improper in the roles that our auditors are playing inside of our company.

Mr. OXLEY. [Presiding] The time of the gentlelady has expired. The gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Legere or Mr. Cohrs, whoever is appropriate to answer, has your company ever received a qualified audit?

Mr. COHRS. I'm sorry, Congressman, are you referring to a qualified audit?

Mr. CAPUANO. Has your audit ever come back with a qualification?

Mr. COHRS. No, it has not.

Mr. CAPUANO. Has it ever had a disclaimer?

Mr. COHRS. No, it hasn't.

Mr. CAPUANO. Has it ever had an adverse opinion of any kind?

Mr. COHRS. No, our audit opinions have been unqualified.

Mr. CAPUANO. Thank you. Mr. Mohebbi, relative to Qwest, have you ever had a qualified report?

Mr. MOHEBBI. I'm not aware of one, Congressman.

Mr. CAPUANO. Have you ever had a disclaimer of any kind or an adverse opinion of any kind.

Mr. MOHEBBI. I'm not aware of one.

Mr. CAPUANO. OK, Mr. Salsbury, has your company ever had an adverse report, a disclaimer, or a qualification?

Mr. SALSBURY. Not to my knowledge.

Mr. CAPUANO. Mr. McGrath, you earlier said that you had not qualifications of any kind. I would take all of you and suggest to you that Enron also never had a qualification or a disclaimer or an adverse report, so, therefore, when you tell me you have clean audit reports, at this point in time with your auditors, it doesn't mean anything to me, and I would just suggest that it doesn't mean much to the general public as well.

Mr. McGrath, I would also suggest that—I don't know exactly the makeup of your company, but I know very well that the auditing rules and accounting rules in England are much more strict than we have in the United States, and for whatever businesses you do here, keep your eyes open; use your English requirements as opposed to your American requirements; you'll be safer and we won't have to call you back here at a future time.

Mr. MCGRATH. Thank you.

Mr. CAPUANO. I guess it's not a real surprise that my understanding is that four of the five companies sitting in front of us have the same auditor and the same auditing company, and it is no surprise at all to me that Global Crossing has retained Arthur Andersen. When they were here, they did a very good job defending their relationship with you, so, therefore, I'm not surprised at all that the camaraderie is a two-way street.

But I'm going to tell you that I don't have a whole lot of questions, because, honestly, I don't like the answers I'm getting. I don't think we're going to get the answers, I don't think. I think this is the greatest forum. I think the SEC and the appropriate legal jurisdictions will be the ones who will ask tougher questions and will

get the appropriate answers, and I will have to trust them at this point in time.

But I've got to tell you, from where I sit, the whole thing you're talking about is nothing more than a much more fancy and, you know, certainly larger Ponzi scheme, nothing new. You bought something you didn't need with money you didn't have, and sold it to somebody who didn't need it and didn't have any money, and you hid the bookings.

Gee, never heard that before. You're just doing it with a lot bigger money, nice, fancy technical terms, because you're in a new business. But the result is the same. The result is the same.

And that's why earlier I didn't have a whole lot of opening statements. I don't appreciate the way you do your business. I do appreciate the businesses you do. I find it unfortunate, to be perfectly honest, for the American public and for the entire business community, that we have to be sitting here having these hearings.

I don't like doing them. I don't like overreacting to individuals in the business community that do these kinds of things. And I'm not going to sit here and blame any one of you individually. I'll leave that to the appropriate people as well, including your shareholders, who may or may not come after you.

But I will tell you that what you have done or what your companies have done or what your predecessors have done, no matter how you measure it, and no matter what you have said here today on the record, we all know in our hearts what you have done. I hope—I don't think—I'm sure you're not embarrassed. I'm not sure you're not repentant, and it's not for me to make you so.

But I will tell that that's why I'm not asking questions today, because I don't expect to get answers that are going to be clear and concise. I don't expect to get answers that are going to do anything to help the employees that you have hurt, the shareholders that you have hurt, and I don't see any way that we can take steps to reconstitute the trust the American people once had in the American business community.

It will take time, and these kinds of auditing procedures, this kind of greed, absolute, unfettered greed, I don't think it's good for America. And I'm sorry that you or your predecessors did it, and I'm terribly sorry that your auditors allowed you to do it.

Mr. OXLEY. The gentleman's time has expired.

The gentlelady from New York, Ms. Slaughter.

Ms. SLAUGHTER. I thank you, Mr. Oxley.

Mr. Legere, I can appreciate the difficulty that you face in trying to reconstitute a company, but I want to add on to what my colleague, John LaFalce, said, and to make a plea to let my people go in Rochester, and look favorably, if you can, to trying to reconstitute Frontier. The 13,000 jobs there mean the world to us.

Mostly I want to talk about some things that I've read in the papers that I'm really dying to talk to you about. First there's a piece from the *New York Times* on February 19th which says "Mr. Perone authored a memo dated February 10, 1999, before his hiring by Global Crossing, in which he recommended how to best account for capacity swaps. The suggestions contained in the memo were to keep the contracts 60 days apart, apparently to avoid suspicion that the deals were reached merely to help each party meet

its quarterly financial objectives, and to require each party to submit separate cash payments, apparently to create the look of a valid deal."

To the untrained eye, gentlemen, that looks like you were trying to fool the public. Actually, I think that Global Crossing did decide that this was a pretty smart fellow over there at Andersen, and frankly, you decided to hire him for the company, perhaps to overlook this or look it over. I understand that he did have several relatives that he was also able to contribute.

What was the intent, other than fooling the investors and Wall Street, to have that kind of a system put together, which basically said that this will make it look all right?

Mr. COHRS. Congresswoman, there are a number of memos, as I described in my testimony. The accounting for the transactions that we're talking about, any IRU transaction, whether they are relatively simultaneous or whether they are stand-alone IRU transactions, there are very difficult accounting questions.

We were struggling to adapt accounting rules that were originally applied in real estate and the leasing industry, because those were the only accounting standards available. And so our industry—the entire industry, as well as the entire accounting profession—was struggling to understand the right way to account for these transactions.

I described in my opening remarks that the GAAP treatment that's used now bears no relationship to the cash flow of the company. Now, for example, there was a meeting sponsored by Arthur Andersen, in which Global Crossing participated, in which all of the major accounting firms, the SEC, the FASB, at least one law firm, and participants from the industry met to try to develop the correct accounting for these transactions.

So that's the environment that we——

Ms. SLAUGHTER. But, Mr. Cohrs, what I read here, what I understood from this, is that you were not looking for correct accounting procedures.

Mr. COHRS. Well, if I could——

Ms. SLAUGHTER. But you were looking for a way that if you didn't—that your revenue appears to have come from bookkeeping, right?

Mr. COHRS. Well, if I could just finish.

Ms. SLAUGHTER. All right.

Mr. COHRS. In that context, the accounting memos that were developed by Arthur Andersen were extensive, going through a great deal of accounting theory on how these transactions should be developed, and a particular accounting model was developed that we applied.

And we were advised that that was proper GAAP accounting. But in addition——

Ms. SLAUGHTER. But when it says that it is being done to avoid suspicion, wouldn't that make you feel a little peculiar about it?

Mr. COHRS. Congresswoman, we applied the accounting to the best of our ability. In addition to applying the accounting, in our press releases, when we did these transactions that were relatively simultaneous, we disclosed the transactions. We described the transactions that we were doing. We can provide you with the

earnings releases that we issued in the first, second, and third quarter of 2001.

Ms. SLAUGHTER. In which you never made a profit; isn't that true?

Mr. COHRS. Well, as I said, we disclosed these transactions in those releases. In those releases——

Ms. SLAUGHTER. Because that was the only transaction——

Mr. COHRS.——We also——

Ms. SLAUGHTER.——That you had, were the swaps. Let me go on.

Mr. COHRS. No, that's——

Ms. SLAUGHTER. I don't want to use my time up here.

Mr. COHRS. They were a small number of the transactions that we had, to correct the facts.

Ms. SLAUGHTER. Let me just comment on this, because this is another statement. "Instead of a stampede of customers to fill up the fiber optic highways, the industry found itself with too many vacant lanes, way too many. What had once seemed a brilliant idea, carriers buying and selling future access on the networks to meet expected demand, became a swap meet unto itself with its own peculiar bookkeeping," which reiterates, again, what you were saying.

But their own peculiar bookkeeping and the fact that Arthur Andersen was so close with what you were doing that you hired the man who authored it, I think is really a matter of some suspicion.

There are a couple of other things here that I want to comment on: One is that in an August, 2001, letter Mr. Olafson said that Global Crossing's Chief Financial Officer, Daniel J. Cohrs, had sent an e-mail message to Thomas Casey, who was chief executive, and to other high-ranking executives, expressing concern about a news release that Qwest had issued, giving the details of the IRU agreements, because Mr. Cohrs was worried that the Qwest statement would draw unwanted attention to Global Crossing's IRUs, Mr. Olafson said. Would you comment on that? You may not have had an opportunity to comment on that since it was printed.

Mr. LEGERE. I'll comment on it, Dan. I think the most important thing was——

Ms. SLAUGHTER. I was asking Mr. Cohrs, since he was the author of the memo.

Mr. LEGERE. Well, I think that since it refers to Mr. Cohrs, if I could make one quick comment?

Ms. SLAUGHTER. Certainly, Mr. Legere.

Mr. LEGERE. And that is that, as was mentioned before, the SEC is doing a very detailed investigation of all the items that you spoke about. Our Board is doing the same, and we very much look forward to participating in those. I think the information that we can jointly share is the output, which will answer a lot of these questions, including most of what was written in Mr. Olafson's letter.

Ms. SLAUGHTER. All right, well, let me just close with reiterating what Ms. Tubbs Jones said, and that is that it's very real, the pain in Rochester. I've talked to people who have had to put their homes up for sale, people who have no jobs, brilliant people who had very high positions in your company who are looking to see if they can run filling stations or something for a little while until they can tide themselves over; people who have lost their healthcare; people

who are terrified of the future, young people, and scared that they're going to have to move and start all over again and look at something else.

Then there are the other people. The people who worked forever for Rochester Telephone, going out in the dreadful weather at night, going up those poles, making sure that the phone service worked. They are going; they have great concern about their pensions. And in that regard, I want to say that we are very much concerned that Global has not turned over the pensions to Citizens Communication. That, in itself, would moderate a great deal, I think, some of the fear of the workers up there.

But those who were let go who were promised severance and didn't get it, I don't think, unless you've had an opportunity to talk to them or look into their faces, that you could ever gauge the depth of the pain. These were people who liked your company, Mr. Legere. These were people who invested everything they had in it. Many of them left good jobs, enticed over because they thought that they saw the future.

Suddenly, 4 years later, it's all over, and they are left in an economy that's pretty bad, with very little hope, and it's devastating. So, let me say again to you, if there is an opportunity for us to back up and reconstitute Frontier, please give us every consideration to let us do it.

Rochester's economy really needs it, and we ask you most sincerely to give that your utmost attention and to let that survive, so that these people can again have a job and a decent wage.

Mr. OXLEY. The Congresswoman's time has expired.

Mr. LEGERE. We feel the pain more than I think you understand. It's a very horrible thing that we've had to do to try to do something that I believe is in the best interests of Rochester, which is to save this company, save the jobs that exist, and hopefully get back to a time when we can grow jobs and bring new jobs back into Rochester.

Ms. SLAUGHTER. We do want you to save those jobs; they're very important to us. Thank you.

Mr. OXLEY. The gentleman from Washington State.

Mr. CLAY. Mr. Legere, one of the great outrages in the Enron collapse was the decision by management to black out their employees' ability to sell their stock while the executives retained their ability to sell their stock as the company was collapsing.

I've been told—and I'll just ask you—that there was a similar blackout for almost a month in your situation from December 14th to January 18th, while your employees were essentially blocked out, shackled, not allowed to sell their stock, and executives were allowed to sell theirs.

Regardless of what was happening in the market at that time, was that the case, and if so, how would you justify blacking out, locking down, your employees during that situation, particularly in light of the fact that the world came to know what happened to the Enron employees, even before you ordered that lockdown?

Mr. LEGERE. I appreciate the opportunity to address this, and I'll start, and then ask Mr. Cohrs for some specifics.

What you're referring to is a lockdown period of our 401K plan, and it was locked down for everyone who participates, regular em-

ployees, as well as executives. It was announced first to the employees on October 2nd, and it was part of a move from Putnam to Fidelity as the manager of the plan.

Between October 2nd and the time from December to January when it was shut down, they were notified multiple times. And just for the record, one of the major differences here is on October 5th, our stock was trading at 83 cents. On October 9th, our stock was trading at 38 cents.

When the plan closed down on December 18th, approximately, the stock was trading at 67 cents. When it reopened in the middle of January with plenty of time to continue to sell, the stock was trading at 54 cents, so we're dealing with a very different scenario from the standpoint of what happened during the period of time. It was a planned, scheduled change between Putnam and Fidelity. It was announced many times in the time period going up to it, so it does have the similarities in that there was a blackout, but that's where the similarities cease to exist.

Mr. COHRS. If I could just add, Congressman, the reason for the blackout period, as it's called, as Mr. Legere said, was the transition from one provider to the other. That was necessary because we had multiple 401K plans because of the acquisitions we had done.

So we had multiple plans with different levels of service, and we were in the process of consolidating those plans so that we could actually provide better service in the plans. And it's just necessary when you change providers to freeze the activity so that all the data can be transferred over. But as Mr. Legere said, this was announced 2½ months before the blackout period began.

Mr. CLAY. And the executives who held stock themselves were free to sell their stock outside the 401K during that time; is that the situation?

Mr. LEGERE. All 401K participants were blacked out at the same time. All shareholders could sell under the rules, and executives who were not subject to a blackout period or a period of time that's normal for officers, could trade.

Mr. CLAY. Well, do you think it makes sense to allow executives, in that context, to be able to sell their stock while the company's falling apart, and lock down the employees who are in the 401K? Do you think that should be the rules of engagement, if you will?

Mr. LEGERE. I don't have the data, but maybe it would be important to look. During the blackout period of the 401K, I don't believe any people were trading shares outside of the program, either.

Mr. CLAY. That's one thing we'll appreciate. I want to ask about swaps. And this has been a eye-opener for me, and, I think, for a lot of Americans. There is an old movie called "The Flim-Flam Man," and it starred George C. Scott.

And why he didn't use swaps, I don't know, because to me, this has enormous potential for abuse, where you essentially buy an asset, spread out the cost over many years, with a counterparty and then sell it and take the revenue in 1 year, just has tremendous potential for abuse, it seems to me.

Now, I'm told that in your situation there was substantial swapping with other parties or counterparties, even though there was excess capacity pretty well known in the industry at that time. Tell us, to the extent you can, what economic rationale there was for

those, and tell us, to the extent there was, if you will, simply a transfer by both parties, of a potential stream of revenue to something you book immediately as a stream of revenue?

Mr. LEGERE. If I could start, Congressman, I think the important difference between what you've described and what was taking place here is the notion almost sounds as if you're dealing with people sitting in empty rooms who are walking out, buying something, holding on to it, and then selling it to another.

We've constructed a 101,000 route-mile network that connects 27 countries and over 200 cities in the world. And it was through the process of building and acquiring the routes on this network, which is not just to sell capacity, but to serve enterprise customers advance data requirements. That's the requirement that drove us to looking to capacity that we would require to finish that network.

And when you have 101,000 route-miles of network, you also are a logical place for people who need to buy things from someone, to come to, because you have the broadest reach. And, Dan, if you want to add——

Mr. COHRS. If I could just address the accounting points that you mentioned, Congressman, it is quite often repeated improperly in the newspapers that these transactions generated revenue and spread the costs out over many years. That is simply not true.

As I explained in my opening remarks, an IRU transaction has the revenue recognized over the life of the lease, and the cost is amortized actually over a shorter period. So, in our GAAP accounting, the revenue on a 20-year IRU is only recognized, ratably, over 20 years. It is not recognized up front.

The cost of those assets is depreciated, just like any other asset that we would buy or build, generally over a shorter period, generally 12 to 15 years. And so the amortization of our cost on these transactions is actually much faster than the rate at which we booked the revenue.

The confusion comes because we also reported as a supplemental report, the number we called cash revenue. In addition to the GAAP revenue that I just described, we reported cash revenue because the cash was collected up front, and we felt it was important to our investors and our lenders and the markets as a whole to give both views, the GAAP view, of course, which we were required and which is the proper GAAP accounting, but also the view that more closely corresponded to the cash coming into the company.

I'd just like to say and repeat that it is not true that these transactions generated up-front revenue with costs amortized over a long period of time. It's actually almost the opposite.

Mr. OXLEY. [Presiding.] The gentleman's time has expired.

Mr. CLAY. Thank you.

Mr. OXLEY. Let me thank this panel for your participation. As the subcommittee Chair indicated, the record will remain open for 30 days for written questions from the Members, and they will be forthcoming. Again, gentlemen, we thank you for your participation, and this panel is dismissed.

Chairwoman KELLY. [PRESIDING] I would like to thank the second panel for joining us today. And our second panel is going to discuss the accounting principles involved in the company's filings and disclosures, the state of the industry, and how some of the energy

companies also tread into the telecom world and were caught in the vortex.

For our second panel, we welcome John Morrissey, Deputy Chief Accountant for the Securities and Exchange Commission; Scott Cleland, CEO of the Precursor Group; and a noted telecommunications industry analyst, Will McNamara, Director of Energy Industry Analysis for SCIENTECH, Incorporated.

I want to thank each of you for testifying here before us today, and I welcome you on behalf of the Full Committee. Without objection, your written statements and any attachments that you have, will be made part of the record.

You will each now be recognized for a 5-minute summary of your testimony. Your full written testimony, as I said, will be a part of the record. We begin with you, Mr. Morrissey.

STATEMENT OF JOHN M. MORRISSEY, DEPUTY CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. MORRISSEY. Congresswoman Kelly, Congressman LaFalce, and Members of the subcommittee. I'm John Morrissey, Deputy Chief Accountant at the United States Securities and Exchange Commission. Thank you for the opportunity to testify today on behalf of the Commission concerning several accounting issues affecting the telecommunications industry.

As the subcommittee has requested, my testimony will address the accounting by providers of indefeasible rights of use of telecommunications network capacity, the accounting for non-monetary transactions, including swaps, and the reporting of pro forma financial information. My written testimony addresses those matters in more detail, and I ask that it be included in the record.

As Global Crossing has disclosed, the SEC is investigating certain issues associated with the company's accounting and disclosure practices. The Commission appreciates the subcommittee's recognition of the non-public nature of its investigation. The Commission also asks that, in light of its ongoing investigation, the subcommittee understand our reluctance to address specific issues related to compliance with Federal securities laws at this time. You can be assured that the Commission staff is thoroughly investigating allegations of financial reporting improprieties.

Confidence in our markets begins with the quality and transparency of financial information available to help investors decide whether and when to invest their hard-earned dollars. The goal of the Federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure of all material facts.

Transparency in financial reporting, that is, the extent to which financial information about a company is visible and understandable to investors and other market participants, plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

The SEC's responsibility is to ensure that the financial markets are transparent and hospitable to all investors. Congress wisely ingrained in the Federal securities laws the philosophy that investors have the right to be fully informed of all material factors and to

use markets that are free from fraudulent, deceptive, and manipulative conduct.

Telecommunications service providers often sell access to the networks on the basis of an Indefeasible Right of Use, or an IRU. Accounting for such capacity sales raises a number of issues that can become quite complex.

Perhaps the most important and basic accounting issue is when to recognize revenue from an IRU sale. My written testimony provides more detailed information on some of the considerations that go into this evaluation, and I will not repeat them here. However, I will note that the specific terms of the network capacity agreements between a provider and a purchaser can have a significant impact on how and when to recognize income from such sales under Generally Accepted Accounting Principles.

For example, network capacity purchase agreements that qualify to be accounted for as leases could result in up-front revenue recognition, provided that certain criteria are met. Alternatively, network capacity purchase agreements that are not leases must be accounted for as service contracts, which typically requires that the related revenue be recognize into income over time as the access to the capacity is provided.

Several recent articles in the financial press have focused on the business practices of telecommunications companies swapping network capacity. These articles raise a number of legitimate questions about the accounting for network capacity swap transactions, which is discussed in my written statement.

While I cannot comment on specific companies or specific transactions, I assure you that if any financial reporting improprieties or violations of Federal securities laws have occurred, the Commission staff will not hesitate to seek appropriate remedies to protect investors.

Furthermore, recent press articles have focused on the use of pro forma financial information in Global Crossing's and others' earnings releases. While pro forma financial information can serve useful purposes, the Commission is concerned that pro forma financial information, under certain circumstances, can mislead investors if it obscures GAAP results.

On December 4, 2001, the Commission issued cautionary advice that companies and their advisors should consider when releasing pro forma financial information. The cautionary advice is part of our ongoing commitment to improve the quality, timeliness, and accessibility of publicly available financial information.

At the same time, the Commission is focusing on ways in which our current periodic reporting and disclosure system can be updated to fill the void that pro forma statements may be attempting to fill.

Thank you for the opportunity to appear today. I am happy to try to respond to any questions that the Members of the subcommittee may have.

[The prepared statement of John M. Morrissey can be found on page 132 in the appendix.]

Chairwoman KELLY. I thank you very much, Mr. Morrissey.

Mr. Cleland.

STATEMENT OF SCOTT C. CLELAND, CHIEF EXECUTIVE OFFICER, THE PRECURSOR GROUP

Mr. CLELAND. Yes, thank you for the honor of testifying today, Chairwoman Kelly. I'm Scott Cleland, founder and CEO of the Precursor Group, an independent, research broker/dealer that provides telecom-tech investment research to institutional investors. I will try to provide the subcommittee with a broader, big-picture perspective today.

Global Crossing's bankruptcy is not unique; it's part of a broader telecom spiral, debt spiral in the sector. And we believe that the recession was not the cause of many of these telecom bankruptcies; it was only the trigger.

Nor is the cause what Federal Reserve Chairman Alan Greenspan called irrational exuberance. I surmise that the causes were the rational manipulation of the capital market system and the irrational economics of the telecom-internet sector, which created and burst the NASDAQ market bubble.

I suspect there is some rational manipulation going on here. Global Crossing's bankruptcy is a wakeup call to us all.

First, we must improve our clearly inadequate investment research system that can't even expose a trillion-dollar fib. Investors depend on investment research for an objective assessment of the facts and due diligence on a company. However, they were not informed that the single most important trend buttressing Global Crossing's business model and that of most all the data traffic models, was hugely overstated and inflated for years.

The conventional wisdom, repeated by almost everyone for a few years, was, from 1997 to 2001, that the data traffic growth was exploding; that it was doubling every 3 to 4 months. But that is an 800 to 1600 percent annual growth rate through 1996 to 2001.

Unfortunately, it simply wasn't true. The actual growth rate was closer to 100 to 200 percent. Now, if you can see the chart that we brought with us, you can see then that roughly 14 companies, predicated on this exploding data thesis, that their market capitalization increased during that period by over a trillion dollars. That's the T-world, over a trillion dollars, and then it fell by over a trillion dollars as the bubble burst and the hype on data traffic was exposed.

But more troubling than that is that this is not an isolated incident. It appears that there may be a pattern of misrepresentation in the telecom-internet sector.

In addition to this trillion-dollar data traffic fib, U.S. investors lost almost another trillion dollars of shareholder wealth on the internet dot.com investment thesis, where everybody thought or everybody was told that the virtual economy was purported to obsolete the old economy.

Now, second, I think it's pretty obvious from this that we do not have a well-functioning market. If these kinds of misrepresentations can go largely unchallenged in the system of investor protections, the system simply does not produce what investors need—trustworthy audits and investor research.

Effectively, the Big Five auditors function as a cartel where it's hard for investors to find a pure audit company that would best serve investor interest. Effectively, Wall Street functions as an in-

vestment banking cartel, where it is hard for investors to get objective investment research that's free of investment banking bias, that may be better at discovering the problems behind a Global Crossing.

In response, the Precursor Group, along with Argus Research and Egan-Jones, we're forming the Investor Side Research Association, and our mission is to increase the investor and pensioner trust in the U.S. capital market system through the promotion and use of investment research that is aligned with investor interests.

We're currently recruiting additional members, and recruiting organizations that support our mission, and our website will be www.investorsideresearch.org.

Now, third, we believe we must make our capital market system much less prone to manipulation. Growth or story stocks like Global Crossing have become very prone to manipulation, and, moreover, the options compensation culture that we have created for company management now, can perversely incent the management of publicly-traded companies to engage in very high risk behavior that this hearing is about today.

It's the one-way nature of options that's the problem. It is that they only have something to gain on the way up, but in a down market or if there is a problem, they have nothing to lose on the way down, and, therefore, they can use the balance sheet as a piggy bank, as a way to goose the stock.

So, like a car, we believe that this system is badly out of alignment, which can allow it to dangerously veer off the road. And our capital market system is badly out of alignment, essentially leaving investors and pensioners potentially wounded in the ditch. It's skewed toward company interests over investor interest, and the system is skewed toward equity markets over credit markets.

In conclusion, I'm testifying today to try and bring the overall problem into better perspective. We believe there's no easy solution, however, the Government can improve the inadequate research investment system to prevent future trillion-dollar fibs. It can discourage the rational manipulation of the capital markets by better protecting investor interest, and it can also undo the irrational economics that led to the telecom and the internet debacle. Thank you very much again, Madam Chairwoman, for the opportunity to testify.

[The prepared statement of Scott C. Cleland can be found on page 145 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Cleland.

Mr. McNamara.

STATEMENT OF WILL McNAMARA, DIRECTOR, ENERGY INDUSTRY ANALYSIS, SCIENTECH, INC.

Mr. MCNAMARA. Thank you, Chairwoman Kelly and Members of the subcommittee. I thank you for the opportunity to appear before you today. My name is Will McNamara, and I'm Director of Energy Industry Analysis for Scientech, an energy consulting firm focused on energy trends, both domestically and internationally.

The purpose of my testimony today is to discuss the recent trend of energy companies that may have expanded into the telecom sector through significant investments, and may have incurred finan-

cial or accounting problems as a result of the downturn in the telecom sector.

Deregulation of both the energy and the telecom sectors enabled the convergence between the two. An argument could be made and was often made that it was a strategic move for energy companies and electric utilities to expand into telecom, based on the following conditions:

Most of the companies already had the trenches in which to lay fiber optic cable. In addition, pushing voice and data files seemed similar to electricity distribution.

There were great expectations for the growth of dot.com companies, and energy companies traditionally have low-growth prospects, and many were looking for other revenue-drivers. Companies such as Enron Corporation and Williams Companies led the movement by buying or constructing many miles of fiber optic capacity. However, the prognosis for energy companies that expanded into telecom is virtually the same for the pure-plate telecom companies.

What we are witnessing is that demand was greatly overestimated; there was a glut of capacity or a perceived glut of capacity; there were heavy debt loads for telecom units and diminished opportunities for sales.

To provide you with some specific examples of energy companies that moved into telecom and suffered the consequences, I provide the following data: Enron Corporation, former CEO of Enron, Jeffrey Skilling, had previously anticipated a $450 billion worldwide market for band-width trading by 2005, and specifically evaluated the valuation of Enron's own broad band unit at $35 billion.

However, in the second quarter of 2001, Enron reported a $102 million loss in its broad band unit, and by the third quarter of 2001, although the company had stopped separating telecom earnings, the company also reported that losses had continued. In addition, Enron acknowledged that its sales prospects for the telecom sector had dried up.

Williams Company, based on Tulsa, Oklahoma, had spun off its telecom unit, Williams Communications, but in March of 2002, said it could face a loss due to a stock-backing arrangement between the two companies. Williams Communications has about $5.16 billion in debt, currently.

Houston-based Dynergy, Inc., lost $31 million in telecom during the first 6 months of 2001. The company says it won't make any money from telecom for a year or more.

Butte, Montana, Montana Power, and Touch America, as it is now known, is the extreme example of an electric utility transforming into a pure-plate telecom company. The move has been met with financial losses, a lawsuit from shareholders, and community backlash due to rate increases that occurred as a result of the transformation.

Moreover, expansion into telecom has not been a successful strategy for energy companies thus far, although some companies maintain that their telecom investments will prove financially lucrative in the long term.

The degree of current financial impact on energy companies that moved into telecom depends on the extent of their investment. In terms of recommendations, energy companies will need to manage

their own financial risk exposure to the telecom sector as most are currently doing.

To protect investors and enable analysts to have accurate financial data about energy companies, the SEC is widely working to revise financial disclosure and accounting rules, along with potential legislation supported by this subcommittee.

I thank you for the opportunity to appear before you. I have gone into much greater detail in my written testimony, and I welcome the opportunity to address any of your questions. Thank you.

[The prepared statement of Will McNamara can be found on page 160 in the appendix.]

Chairwoman KELLY. I thank you, Mr. McNamara.

I want to get back to the issue of the pro forma financial statements by the telecommunications companies. Mr. Morrissey, in your testimony you discuss that there is the new SEC guidance on pro forma financial statements. I wonder if you'd be willing to discuss what the SEC is planning to do in the future to address your concerns about those statements?

Mr. MORRISSEY. I'd be happy to. First of all, the Commission is very concerned about the misuse of pro forma financial information. This concern is translated into tangible, substantive action on a number of different fronts:

On one front, we recently issued cautionary advice on the use of pro forma financial information. This cautionary advice acknowledges that pro forma information, when properly presented, can provide very useful and meaningful information to investors to help them understand what's going on.

But it also reminded individuals and preparers that the antifraud provisions of the Federal securities laws apply to a company issuing pro forma financial information. In addition, we offered some guidance in order to help avoid misleading investors in terms of preparation of this pro forma financial information.

For example, we said that they need to clearly disclose the basis of the presentation. They need to not omit material information that is meaningful to investors. They need to do it in plain English, so people can understand what the deviations are from GAAP, and, I think, very importantly, companies need to compare that information to GAAP-reported numbers, so that investors can be able to understand where the numbers come from, and have that basis of comparison.

And I think this has all been very well received within the community, the investment community and investors. Some information I received is that companies have welcomed this because if their desire is to present more meaningful information, to try to explain their results, they also want it to be perceived as being credible. And this is a way for them to comply with these guidelines and give it the type of credibility that, theoretically, they're looking for.

Second, on the other front, the Commission has been very active in also pursuing violations of the securities laws with respect to material misrepresentation. We recently brought a case against Trump Hotels, in which there is evidence to show that there was misleading financial information, pro forma financial information

being disclosed, and we went after them and we prosecuted them and we brought that case.

So I think that one of the things that we've seen is that the new cautionary advice is now out there. It's being digested by preparers of financial information, and I think we're already seeing benefits from that now.

Where do we go from here? We need to, I think, wait and see a little bit to see how the improvement goes.

Chairwoman KELLY. Thank you.

Mr. Cleland.

Mr. CLELAND. Yes, could I add a point? The problem with pro forma is, it tends to be—it can be—not all times—it can be spin. And when it's put out, it is designed to then go to the investor relations department, to the public relations department as their press releases, where they may have had a GAAP accounting loss, however, on a pro forma basis, they're showing an improving financial situation.

And they know that by putting the pro forma first, in advance of the GAAP, that the headline will be, you know, "Company Beats Expectations," or "Company Showing Improving Results." And by baring the GAAP at the end, the perception of the public, through the media and through Wall Street, which loves the pro forma—and they'll talk about the pro forma, pro forma, pro forma—they don't get an accurate picture of what the real financial situation is that can be compared to other companies, because that's what GAAP is all about, is to know, should I invest in Company A, Company B, or in Bond A or Bond B?

You need to have a common language, and that's what GAAP accounting is. And so the trouble is that pro forma contributes to a perception game that can mislead investors.

Chairwoman KELLY. Mr. Cleland, there are statements on the pro forma statements that are caveats. It seems to me that Mr. Morrissey—and, Mr. Morrissey, you may join in answering here—there may be a need for a stronger statement or for a pro forma to carry something that says very clearly, up front—Mr. Baker talked about the Surgeon General's terse warning on every pack of cigarettes. Well, maybe there should be—my question to you really is, should there be a terse warning, large type, up front, on every one of these pro forma statements, so that everybody gets it, and the perception is, this is—what the company is saying, this is not an audited statement.

I know that you do require some things, but perhaps we need to take a look at how that's working. Mr. Cleland, Mr. Morrissey, would you want to jump in there?

Mr. CLELAND. Where I jump in is that the problem isn't necessarily with one individual piece of the system; it's how the system behaves together, in the sense that the pro forma, by itself, might be innocuous, and the way investor relations may decide to put it out, it may be innocuous by itself. But it is the system that comes together, where everybody has an interest to say the good stuff about the stock and not the bad stuff about the stock.

And so what you get is the perception created. And we all know that the average investor reads the headlines and reads the first paragraph, or that's what we take away. We hear the radio an-

nouncement or the TV announcement, which is just the best stuff, and all of the other stuff just tends to fritter away. So, 99 percent of the perception is the good stuff, and you have to go digging for the bad stuff.

Chairwoman KELLY. Mr. Cleland, let me just follow up on that for 1 minute, and then I'd like to have Mr. Morrissey kind of jump in on that original question. But, in recent years, the telecom industry has really just gone right straight up in terms of markets and so forth.

My interest in asking you this question is, whether or not there was any kind of a Government action, any kind of a Government policy that made this an arc rather than a continued curve up? I'm wondering if this was policy or if this was something that was driven by the companies themselves?

Mr. CLELAND. Well, it's a very good question, and when you look at the result on that chart, you see that the NASDAQ, which everybody thought was a bubble and went up, it went up 287 percent. And these data traffic stocks went up 1800 percent, so there is something extraordinary going on in that segment, and that segment helped drive that NASDAQ up 287 percent.

Now, the bubble that we all talk about was driven largely by telcom and tech. There was this culture of what I call rational manipulation of a system. It may not be any one individual, but they all said the same thing and they all knew they all benefited from hyping the traffic growth. That was the essence of it.

But there was also a Government problem in the sense that the Government created a set of irrational economics. Number one, you know, the Government commercialized essentially a not-for-profit peering system, so the entire industry structure of internet data traffic is not profitable.

On top of that, the Government massively subsidized data at the expense of voice, billions of dollars every year. And what it did is, it added more cost to the telecom voice system and subsidized data, so it created this kind of free-lunch atmosphere.

Then you had the Telecom Act come in and said that everybody should build out these new data networks, and the problem was that this is a capital-intensive business where if you add risk, all the people that own the debt freak out and they don't want to necessarily be invested in it. So the Telecom Act essentially took an industry where capital was welcome and changed it into an industry where capital wasn't welcome.

And then the other thing that Government policymakers did is, they added the internet tax moratorium, which gave the perception that the internet was special. Essentially, if we transacted business over the internet, we didn't have to pay a tax, but if I did it over the phone or if we did it in person, the exact same purchase would be taxed, and so we created this unreal tax haven.

So all four of those things, the Government policy tended to inflate the bubble, and the market looked at the Government and the Government was the main cheerleader. So this is a dual problem.

Chairwoman KELLY. Would either Mr. Morrissey or Mr. McNamara like to get in here? Now, Mr. Morrissey, I said I'd come back to you, so let's start with you.

Mr. MORRISSEY. I guess I'd like to respond to your original suggestion and say I think that it has a lot of merit. It's a good idea to have a statement that may say something to the effect that these statements do not represent full financial information in accordance with Generally Accepted Accounting Principles and should be read in conjunction with financial statements prepared in accordance with Generally Accepted Accounting Principles. I think that idea has a lot of merit, and I appreciate the suggestion.

One of the tensions you have, though, in reporting information, is that, we desire to have material information reach the market as quickly as possible. And one of the issues you have is that you may have some financial information that's of interest to investors, but not yet have prepared your financial information, financial statements in their entirety.

So the question is, do you withhold that information until the financial statements are ready, or do you go and do them at different times? And that's just one of the tension issues that needs to be addressed as we try to work through these different types of issues with respect to pro forma earnings releases.

Chairwoman KELLY. Mr. McNamara.

Mr. MCNAMARA. I would add that we spoke earlier about methodologies that companies use for pro forma accounting, and how often they vary from company to company and may not be disclosed to the public. So along with the disclaimer recommendation, which I think has a lot of merit, I think that the methodologies that companies use for their pro forma accounting projections should also be disclosed in the line of greater transparency. Certainly that is something that the SEC appears to be moving toward.

Chairwoman KELLY. Do you want to respond to that, Mr. Morrissey? Are you moving toward that?

Mr. MORRISSEY. As I said, with respect to pro forma, we had this recent initiative. It is something that we're watching very closely. We're hoping to see a significant shift in the market reaction to the issuance of pro forma information, in conjunction with the guidelines that we have established. And we have to watch and see the progress that's being made.

Chairwoman KELLY. I would like now to just kind of go to swaps, the swaps issue. In July of 1999, the FASB mandated that the companies could not recognize all revenue earned from the new swaps in the current year. That was a change.

And they required then that the contract be amortized over its life. How did that affect the telecommunications companies' financial projections? And this is for all of you.

Mr. MORRISSEY. Do you want me to go first? Basically what was occurring within the industry and with an interpretation of the accounting literature was that it was progressing, evolving, and becoming more refined. And the statement that I believe you're referring to added clarification as to what type of lease these IRUs should be accounted under.

And what that statement said is that basically they have to be accounted for under the literature that applies to real estate transactions. Associated with real estate transactions are a whole series of criteria that you have to meet in order to recognize the revenue up front on one of these types of IRU transactions.

And my understanding is that when that statement came out, it effectively presented a significant hurdle that was very difficult to overcome for many of these types of transactions that had been recorded in the past with up-front revenue recognition. So my understanding is that, from an industry perspective, it had a significant impact, and that it reduced companies' ability to recognize the revenue up front.

Chairwoman KELLY. Thank you.

Mr. Cleland.

Mr. CLELAND. You know, the problem here is that you have a set of irrational economics in the industry. You have this extraordinary hype and expectations that were created. When you have, you know, 1800 percent increase in the market capitalization of 14 companies, you've created an unreal circumstance.

Then you have a culture which has a lot riding on keeping that stock up, because the options culture is one way; they want it to have momentum and to go up. And so what it does, it created enormous pressure, and investors wanted that money created. So, investors, the investment bankers, the auditors, the lawyers, everybody, had an interest in making sure that this bubble didn't get burst.

And so in that context of an unreal world and overextended expectations, I think people looked to the accountants and said, you know, how can we, within the rules, make this look the best possible? And what I think is important is, lots of times people can address the letter of the law, but not address the spirit of the law, and they'll say, well, I did this right; I did this right; and I did this right; there isn't anything wrong. When doing the three of those things together, you add them up, and it is a clear, obvious misrepresentation of the circumstance.

So we need to step back and look at these things in context to see whether or not there was rational manipulation or misrepresentation going on.

Chairwoman KELLY. Mr. McNamara.

Mr. MCNAMARA. I would just add that I think Mr. Cleland's assessment is accurate. There is a parallel between the telecom's use of IRUs and the energy industry's use of the mark-to-market technique, although they're vastly different and involve different businesses and different commodities.

What essentially would be the same is that the pressure is to inflate current earnings on the basis of transactions that may not materialize until down the line. And so as changes regarding rules governing pro forma accounting emerge, it would be helpful to look at both industries.

Chairwoman KELLY. Mr. McNamara, you have delivered some really interesting testimony today. Any subsequent figures and facts that you can bring to flesh that out, the subcommittee would appreciate, because I think you've had some very interesting testimony.

I'm going to ask you just a couple of very straightforward questions, and basically I'm concerned that companies over-valued earnings. And I'm concerned that investors really didn't get a clear picture here. And it seems to me your testimony is saying that, and all I want to know is, if my perception is a correct one? And you

can just answer that yes or no, and you can just start down the line and give me a quick answer.

Mr. MCNAMARA. I would say that the answer is yes, but I would say that both pro forma and real-time financial earnings are important, and why not offer both to investors and analysts, and they can choose which one they want to follow.

Chairwoman KELLY. Mr. Cleland.

Mr. CLELAND. I think you can have as quick a disclosure and as complete a disclosure, and then you want to have a system that has people that are looking out for investors, either auditors that are pure audit companies or investor-side research, because we have a systemic problem here where the system is no longer working for investors. That's how Enron, Global Crossing, the bubble, happened. It is that the system got out of alignment and then it always wanted to go up.

And the thing is, markets don't always go up; they have ups and downs; they have corrections and whatever, but this system is out of alignment, and it will continue to veer off into the ditch until you figure out a way to let the free market and competitive use of ideas flourish. Because if somebody would have stood up and said there's a problem with Enron early on, and because they're paid by the system to find those things, or if, you know, if somebody was paid to find those things with Global Crossing and the telecom debacle, you would have identified those things. But the system didn't pay for capital preservation; it paid for stock promotion. It's a problem.

Chairwoman KELLY. Mr. Morrissey.

Mr. MORRISSEY. I guess the way I would answer the question is, at the Securities and Exchange Commission, we fully expect companies to comply with the Federal securities laws and comply with Generally Accepted Accounting Principles, and to reflect transactions based upon their substance.

And that to the extent that mere compliance with the technicalities of the literature does not present a fair picture of what's happening, they have an obligation to disclose what really is going on in management's discussion and analysis, so that investors have a clear understanding of really what is happening.

If that is not occurring, they're going to have a serious problem with my fellow colleagues in the Division of Enforcement, and we expect that from all investors.

Chairwoman KELLY. All right, thank you. I have a few more questions, but I'm going to submit those in writing.

This has been a relatively long hearing. The Chair notes that some Members will have, in all probability, additional questions for this panel, and they will submit them in writing, so without objection, the hearing record is going to remain open for 30 days for the Members to submit written questions to these witnesses and to place their responses in the record.

We thank you very much for your patience in waiting through the first panel, and for your subsequent testimony here. This second panel is excused with our great appreciation for your time.

I want to briefly thank the Members who are here and other Members of this subcommittee who have shown a great deal of interest in this topic, and I also want to thank especially the staff

that we have, my staff, and the staff on the Financial Services Committee. They have been terrific in making this hearing possible, and with that, this hearing is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

A P P E N D I X

March 21, 2002

Opening Statement of Chairwoman Sue W. Kelly

Subcommittee on Oversight and Investigations
Committee on Financial Services Hearing on:
The Effects of the Global Crossing Bankruptcy on Investors, Markets, and Employees

March 21, 2002; 2128 Rayburn

In the interest of ensuring proper committee consideration of H.R. 3763, the Corporate and Auditor Accountability, Responsibility and Transparency Act, known as CAARTA, we are here today to examine the status of the telecommunications industry. We will hear from the executives of the companies, from industry experts, and from an accounting expert at the Securities and Exchange Commission.

Global Crossing's bankruptcy in January marked the fourth largest bankruptcy in the history of the United States. It serves as an ominous warning to the financial and business community and has had far-reaching consequences. While the overall downturn in the telecom industry was a factor in the collapse, the fall of Global Crossing raises serious questions about current accounting practices, disclosure requirements and corporate management.

Just yesterday, we learned that Global did not disclose a complex communications deal several months before the company filed for bankruptcy in January. Experts called the lack of disclosure a serious lapse by management.

An estimated five hundred thousand jobs have been lost in the telecom industry. Global Crossing's bankruptcy resulted in the loss of an estimated 9,000 jobs and has caused real harm to investor confidence. It has had an impact on my home state of New York. State wide, Global Crossing has eliminated hundreds of local jobs and the New York State Pension Fund lost $63 million as a result of the collapse. How did a company that was perceived by all conventional measures as healthy, fall so far, so fast?

By all accounts, Global Crossing was a winner, but now we know that it was actually a financial time-bomb. Did some top executives know that the clock was ticking and time was running out? One thing is certain - we do know that the bomb was tossed right in the lap of employees and investors who didn't have a clue that the company was going under.

The collapse of Global Crossing calls into question how much confidence employees, investors and the public should have in financial information released by companies, particularly pro-forma financial projections.

Since these pro-forma statements are not required to use Generally Accepted Accounting Principles, known as GAAP accounting, a company such as Global Crossing can massage their numbers on these pro forma financial statements, or in other words, these pro-forma statements provide an easy opportunity to 'cook the books.'

In the case of Global Crossing, the company's pro-forma statements may have misinformed investors and employees as to the profitability and performance of the company. In an examination of Global Crossing's filings submitted last spring with the SEC, the company reported an additional $531 million in earnings in the pro-forma statement, pumping up earnings by nearly 50 percent, as the result of controversial swaps activities.

However, the $531 million was not included in the company's GAAP-compliant statement of earnings. Why not? Because under present required disclosure regulations it didn't exist. It wasn't required to exist.

In addition, we need to examine the way in which companies report their swaps of Indefeasible Rights of Use, known as IRU's. It appears that swaps are being used as a quick and easy way to inflate earnings and make a company look more profitable than it really is. Investors deserve accurate information and in some cases they are not getting it. We need to know how the SEC views these IRU's since some have alleged that this accounting practice has mislead investors and the companies' employees as to the true profitability of these corporations.

Other issues raised by the collapse of Global Crossing include corporate governance and responsibility, including blackout periods imposed on employee 401(k) plans. At the highest levels of Global Crossing, top executives were selling stocks and pocketing millions before the company's collapse. Former CEO Gary Winnick sold stock worth $734 million before the company collapsed, while this winter, employees of his company watched their savings, investments, and severance packages disappear.

The purpose of hearing is to take an honest look at the issues surrounding the collapse. The ultimate goal is to protect workers and investors and prevent this from happening in the future through new legislation.

Accounting methods, financial disclosure and transparency, and corporate governance are matters that the full Committee is deliberating upon now. I believe CAARTA provides a comprehensive solution to our concerns and will restore investor and employee confidence in company disclosures.

I would like to note for the record that we invited the President of the Communications Workers of America to testify, however he was unable to join us due to scheduling problems. In addition, we also invited the American Institute of Certified Public Accountants to testify, but they were also unable to accept the invitation.

NO. 198-F | June 1999

Financial Accounting Series

FASB Interpretation No. 43

Real Estate Sales

an interpretation of FASB Statement No. 66

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Paragraph 1 of FASB Statement No. 66, *Accounting for Sales of Real Estate,* states, "This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." This Interpretation clarifies that the phrase *all real estate sales* includes sales of real

estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs.

This Interpretation is effective for all sales of real estate with property improvements or integral equipment entered into after June 30, 1999.

Introduction

1. Paragraph 1 of FASB Statement No. 66, *Accounting for Sales of Real Estate,* states, "this Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." Although Statement 66 states that it is applicable to all sales of real estate, it does not explicitly define real estate or identify the real estate transactions to which it is specifically applicable. As a result, diversity developed in practice with regard to whether transactions involving the sale of real estate with property improvements or integral equipment such as manufacturing facilities, power plants, and refineries are subject to the sales recognition criteria of Statement 66. The FASB was asked to clarify how the phrase *all real estate sales,* as it is used in Statement 66, relates to those transactions.

Interpretation

2. Statement 66 applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms *property improvements* and *integral equipment* as they are used in this Interpretation refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

3. The provisions of Statement 66 do not apply to transactions that involve the following:

a. The sale of only property improvements or integral equipment without a concurrent (or contemplated) sale of the underlying land[1]

[1] Except for sales of property improvements or integral equipment with the concurrent lease (whether explicit or implicit in the transaction) of the underlying land to the buyer. Those transactions should be accounted for in accordance with paragraphs 38 and 39 of Statement 66. In addition, sales of property improvements or integral

equipment subject to an existing lease of the underlying land are also subject to the provisions of Statement 66.

b. The sale of the stock or net assets of a subsidiary or a segment of a business if the assets of that subsidiary or that segment, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate

c. The sale of securities that are accounted for in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[2]

[2] Sales of those types of securities are addressed by FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

4. In the first sentence of paragraph 38 of Statement 66, the phrase *property improvements* is interpreted to include both property improvements and integral improvements (to conform that paragraph to the scope clarification provided by this Interpretation).

Effective Date and Transition

5. The provisions of this Interpretation are effective for all sales of real estate with property improvements or integral equipment entered into after June 30, 1999. For this purpose, a transaction is considered to have been entered into at the date that a written agreement that specifies the principal terms of the sale has been signed by the parties in interest to the transaction.

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Edmund L. Jenkins, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
Gaylen N. Larson
James J. Leisenring
Gerhard G. Mueller

Appendix

Background Information and Basis for Conclusion

Introduction

6. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Interpretation. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

7. In October 1982, the Board extracted the specialized sale and profit recognition principles and practices from the AICPA Industry Accounting Guides, *Accounting for Profit Recognition on Sales of Real Estate* , and *Accounting for Retail Land Sales*, and the AICPA Statements of Position 75-6, *Questions Concerning Profit Recognition on Sales of Real Estate,* and 78-4, *Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate,* and issued them as Statement 66. Statement 66 establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business.

8. Although Statement 66 states that it is applicable to all sales of real estate, the scope of that Statement is not explicitly defined. As a result, diversity developed in practice with regard to identifying which transactions are subject to the sales recognition criteria of Statement 66.

9. In May 1998, the FASB Emerging Issues Task Force asked the Board to clarify the scope of Statement 66 as it relates to sales of real estate with property improvements or integral equipment such as manufacturing facilities, power plants, and refineries. Some had asserted that application of Statement 66 should be relatively narrow (that is, primarily to sales of physical land and any real property whose main value as an asset is as real estate, for example, rental and residential property developments). That approach would have excluded sales of operating facilities such as manufacturing facilities, power plants, and refineries from the scope of Statement 66. Others had asserted that Statement 66 did apply to sales of operating facilities such as operating power plants and manufacturing facilities.

10. On October 13, 1998, the Board issued an Exposure Draft, *Amendment to FASB Statement No. 66, Rescission of FASB Statement No. 75, and Technical Corrections*. The Board received nine letters of comment in response to the Exposure Draft. Generally, respondents were supportive of the Board's efforts to make minor technical corrections to existing accounting literature, but the primary concern expressed in the comment letters related to the proposed clarification of the scope of Statement 66. Based on the comments received, the Board decided to separate the issues dealing with Statement 66 from the other technical

corrections. In February 1999, the Board issued FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections.*

Basis for Conclusions

11. Paragraph 1 of Statement 66 states, "this Statement establishes standards for recognition of profit on *all real estate sales transactions without regard to the nature of the seller's business*" (emphasis added). In addition, paragraphs 38 and 39 of Statement 66 address transactions in which the seller sells *property improvements* and leases the underlying land to the buyer of the improvements. Property improvements are not defined in Statement 66, but they are defined in footnote 2 to paragraph 6 of FASB Statement No. 98, *Accounting for Leases,* as "any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost." The Board questions why some would assert that a transaction involving the sale of a power plant with a concurrent lease of the underlying land would be within the scope of Statement 66 but that the sale of a power plant, including the sale of the underlying land, presumably would not be within the scope of Statement 66.

12. The Board rejected the view that the scope of Statement 66 should be narrow because the Board does not believe that Statement 66 justifies following different profit recognition criteria for the sale of (a) *only* land or land *with* property improvements if the primary value of the property improvements *is from* the underlying land and (b) land *with* property improvements if the primary value of the property improvements *is not from* the underlying land. In addition, although it may be possible (as is done for tax purposes) to separate the value of the underlying land from the value of the property improvements or integral equipment, the Board does not believe that it is appropriate to account for those assets separately. The Board concluded that the focus should be on the physical attributes of the combined asset (that is, the real estate with property improvements or integral equipment) to determine whether the nature of the asset is more like real estate (for example, long-lived, not removable, and secured to the land) than equipment (for example, airplanes, computers, and cars). The Board acknowledges that determining whether something is in substance real estate is a matter of judgment that depends on the relevant facts and circumstances.

13. The Board observed that paragraph 54 of Statement 66 provides a table of typical minimum initial investment requirements for sales of certain real estate properties. One type of real estate property identified in the table is "commercial and industrial property." Although operating facilities such as manufacturing

facilities, power plants, and refineries are not specified, those types of operating facilities meet the description of an *industrial property*. The Appraisal Institute provides the following definition of *industrial property:*

> Land and/or improvements that can be adapted for industrial use; a combination of land, improvements, and machinery integrated into a functioning unit to assemble, process, and manufacture products from raw materials or fabricated parts; factories that render service, e.g., laundries, dry cleaners, storage warehouses, or those that produce natural resources, e.g., oil wells. [*The Dictionary of Real Estate Appraisal,* 1993]

14. As previously stated, the Board believes that the sales recognition criteria of Statement 66 should apply to sales of land and physical structures *attached to* the land that cannot be removed and used separately without incurring significant cost. The Board believes that natural assets such as those that have been *extracted from* the land (for example, oil, gas,[3] coal, and gold) are substantially different and are, thus, not subject to the provisions of Statement 66. Similarly, the Board believes that sales of timber or corn, wheat, or any other harvested crop (that is, anything that will have been detached from the land by the time it reaches the buyer) would not be subject to the provisions of Statement 66. However, the Board views the sale of timberlands or farms (that is, land with trees or crops attached to it) as being similar to the sale of land with property improvements or integral equipment and thus subject to the provisions of Statement 66.

> [3] In accordance with FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies, mineral interests in properties* include fee ownership or a lease, concession, or other interest representing the right to extract oil or gas subject to such terms as may be imposed by the conveyance of that interest. Mineral interests in properties also include royalty interests, production payments payable in oil or gas, and other nonoperating mineral interests in properties operated by others.

15. Statement 98 was issued in May 1988. Among its provisions, that Statement specifies the accounting by a seller-lessee for a sale-leaseback transaction involving real estate, including real estate with integral equipment such as manufacturing facilities, power plants, and office buildings with furniture and fixtures. Statement 98 also addresses sale-leaseback transactions in which the seller-lessee sells only property improvements or integral equipment and leases them back while retaining the underlying land.

16. The purpose of Statement 98 was to clarify that a seller-lessee can report a sale-leaseback involving real estate with property improvements or integral equipment only if the transaction qualifies as a sale under Statement 66. Under Statement 98, sale-leaseback accounting is only appropriate if the transaction is a normal leaseback and if the payment terms and provisions (a) adequately

demonstrate the buyer-lessor's initial and continuing investment in the property (as specified by paragraphs 8–16 of Statement 66) and (b) transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee (as specified by paragraphs 18, 25–39 , and 41–43 of Statement 66).

17. Before Statement 98 was issued, real estate transactions that were essentially the same were reported differently depending on the transaction's structure. In its current deliberations, the Board concluded that Statement 98 implicitly prescribes sales of real estate with manufacturing facilities, power plants, or refineries to be within the scope of Statement 66 and that the scope of Statement 66 should be made explicit in that regard. Assume an entity (the seller-lessee) enters into a sale-leaseback transaction for a manufacturing facility (including the underlying land) that it currently owns. The seller-lessee guarantees the buyer-lessor's investment for an extended period of time. In accordance with Statement 98, the transaction would be accounted for as a financing because of the continuing involvement by the seller-lessee. Accordingly, the manufacturing facility and the land would remain on the seller-lessee's books and the sales proceeds would be reported as a liability. If the seller-lessee sold the manufacturing facility and the underlying land outright but guaranteed the buyer's investment for an extended period of time, the Board questions why some would assert that that transaction would not also be accounted for under Statement 66.

18. Several respondents to the Exposure Draft requested that the Board define real estate and specify whether real estate rights (for example, air, drainage, water, and mineral rights, as well as easements) would be included in that definition. The Board was asked to clarify the scope of Statement 66 because practice differed as to which transactions are subject to its provisions (specifically, manufacturing facilities, power plants, and refineries). The Board concluded that the scope of the project should remain narrow to permit the Board to resolve the primary issue at hand without unnecessary delay.

19. Other respondents expressed concern that the Board was proposing that the scope of Statement 66 be consistent with the scope of Statement 98. Paragraph 6 of Statement 98 states that Statement 98 is applicable to sale-leaseback transactions of only property improvements or integral equipment. Respondents stated that they do not believe that the scope of Statement 66 should be extended to include sales of only property improvements or integral equipment. That is, they do not believe that sales of inventory that will become "integral equipment" of the customer as well as sales of existing equipment that is currently "integral" to the seller but sold separate and apart from the underlying land should be subject to the provisions of Statement 66. For example, the manufacturer of

turbines for electric generating plants (which normally meet the definition of integral equipment — once the turbine is built at the site of the customer's generating plant it normally cannot be removed and used separately without incurring significant costs) should not be subject to the provisions of Statement 66.

20. Statement 98 is applicable to a sale and leaseback of only property improvements or integral equipment when the seller-lessee retains the underlying land because the right to use the property improvements or integral equipment is being leased back to the entity that controls access to the underlying land. The Board did not intend that Statement 66 also be applied to sales of only property improvements or integral equipment without the concurrent (or contemplated) sale of the underlying land.[4] If there is no concurrent (or contemplated) sale or lease of the underlying land, but the property improvements or integral equipment being sold is subject to an existing lease of the underlying land, then that transaction would be subject to the provisions of Statement 66. Furthermore, the Board does not intend for the proposed clarification of the scope of Statement 66 to change the requirements of FASB Statement No. 13, *Accounting for Leases,* with respect to leases involving equipment as well as real estate.

[4] Refer to footnote 1.

21. The Board believes that clarifying that sales of real estate with property improvements or integral equipment are within the scope of Statement 66 is not the same as saying that property improvements are, in and of themselves, real estate. The Board decided to address the diversity in practice with respect to sales transactions involving real estate with property improvements or integral equipment such as manufacturing facilities, power plants, and refineries.

22. Those constituents who believe that sales of operating facilities such as manufacturing facilities, power plants, and refineries should not be subject to the provisions of Statement 66 said that because those types of operating facilities are "businesses" whose operations are not "traditional real estate activities," they are outside the scope of Statement 66. Furthermore, they said that those sales of businesses may include receivables and payables in addition to land and facilities and questioned how Statement 66 would be applied.

23. Statement 66 does not differentiate between *traditional* and *nontraditional* real estate activities. It also does not differentiate between sales of *real estate* and sales of *businesses*. Further, neither *traditional real estate activities* nor *businesses* are currently defined in the accounting literature.

24. The Board believes that whether something is a business should not be a factor in determining whether its sale would be subject to the provisions of

Statement 66. Sales of hotels, motels, marinas, and mobile home parks, which are specifically mentioned in Statement 66 as being within its scope, can also be considered sales of businesses. As stated above, the Board concluded that the attributes of the combined assets being sold (that is, the manufacturing facility, the power plant, or the hotel plus the land, receivables, payables, and so forth) should be considered to determine whether the nature of the assets being sold is like that of real estate and the sale is therefore in substance the sale of real estate.

25. The Board acknowledges that determining whether a transaction is in substance the sale of real estate requires judgment. However, the Board believes that in making that determination, one should consider the nature of the entire real estate component being sold (that is, the land plus the property improvements and integral equipment), and not the land only, in relation to the entire transaction. Further, that determination should not consider whether the operations in which the assets are involved are traditional or nontraditional real estate activities. For example, if a ski resort is sold and the lodge and ski lifts are considered to be affixed to the land (that is, they cannot be removed and used separately without incurring significant cost), then it would appear that the sale is in substance the sale of real estate and that the entire sale transaction would be subject to the provisions of Statement 66. The Board believes that transactions involving the sale of underlying land (or the sale of the property improvements or integral equipment subject to a lease of the underlying land) should not be bifurcated into a real estate component (the sale of the underlying land) and a non-real-estate component (the sale of the lodge and lifts) for purposes of determining profit recognition on the transaction.

26. Paragraph 2 of Statement 66 states:

> Although this Statement applies to all sales of real estate, many of the extensive provisions were developed over several years to deal with complex transactions that are frequently encountered in enterprises that specialize in real estate transactions. . . . Those using this Statement to determine the accounting for relatively simple real estate sales transactions will need to apply only limited portions of the Statement. The general requirements for recognizing all of the profit on a nonretail land sale at the date of sale are set forth in paragraphs 3-5. . . .

Therefore, Statement 66 recognizes that certain of the specific continuing involvement criteria are not applicable to all real estate sale transactions. The Board acknowledged that the extensive provisions of paragraphs 19–43 of Statement 66 may not be applicable to some sale transactions that are in substance the sale of real estate, for example, the sale of real estate with a manufacturing facility. However, the Board concluded that Statement 66 does not provide an exception to the general profit recognition criteria (paragraphs 3–

5 of Statement 66) for such transactions.

27. Paragraph 101 of Statement 66, as amended by Statement 135, includes as examples of real estate sales transactions:

> . . . sales of corporate stock of enterprises with substantial real estate, sales of partnership interests,[33] and sales of time-sharing interests[34] if the sales are in substance sales of real estate; and sales of options to purchase real estate.
>
> [33] An example of a sale of a partnership interest that is in substance a sale of real estate would be an enterprise forming a partnership, arranging for the partnership to acquire the property directly from third parties, and selling an interest in the partnership to investors who then become limited partners.
>
> [34] For purposes of this Statement, a time-sharing interest that is in substance a sale of real estate is the exclusive right to occupy a specified dwelling unit for a designated period each year and represents fee simple ownership of real estate.

28. EITF Issue No. 98-8, "Accounting for Transfers of Investments That Are in Substance Real Estate," addresses whether the sale or transfer of an investment that is in form a financial asset but is in substance real estate should be accounted for in accordance with Statement 66 or Statement 125. Issue 98-8 states the following:

> The Task Force reached a consensus that the sale or transfer of an investment in the form of a financial asset that is in substance real estate should be accounted for in accordance with Statement 66.
>
> . . . The Task Force also observed that a marketable investment in a real estate investment trust (REIT) that is accounted for in accordance with Statement 115 would not be considered an investment that is in substance real estate. Accordingly, the sale or transfer of an ownership interest in a REIT that is accounted for in accordance with Statement 115 should be accounted for in accordance with Statement 125. [Paragraphs 5 and 6.]

29. Several constituents requested that the Board clarify the scope of Statement 66 with respect to sales of securities accounted for under Statement 115. The Board believes that a marketable investment in an entity with substantial real estate (for example, an investment in a REIT) is in substance an investment in real estate. However, the Board concluded that an exception to the provisions of Statement 66 should be provided for the sale or transfer of an investment in a security that is accounted for in accordance with Statement 115, even if that investment is in substance an investment in real estate. The Board concluded that the sale or transfer of an investment that is in substance real estate and is accounted for

under Statement 115 would be subject to the criteria provided in Statement 125, for determining whether a sale has occurred. The Board believes that because securities are generally highly liquid and easily transferable, the guidance provided in Statement 125 is more appropriate than that provided in Statement 66 with respect to sales or transfers of investments in marketable securities, regardless of whether they are in substance real estate. The Board observed that the sale of an investment in a consolidated entity, an investment accounted for under the equity method, or a cost method investment in a nonmarketable security (that is, one that is outside the scope of Statement 115) that is in substance real estate would continue to be subject to the provisions of Statement 66.

Effective Date and Transition

30. The Exposure Draft acknowledged that the proposed clarification of the scope of Statement 66 would require transition for those entities that interpreted the scope of Statement 66 to not include, for example, the sale of an operating facility such as a manufacturing facility, power plant, or refinery, and, therefore, did not consider the criteria of Statement 66 to determine whether sales recognition is appropriate. The Exposure Draft proposed that the effective date and transition for the proposed scope clarification of Statement 66 be for all real estate sales transactions consummated after December 31, 1998. In addition, some Board members expressed concern that during the period between the time the Board decided on the scope clarification of Statement 66 and the proposed effective date, significant real estate sales transactions might be consummated that did not apply the criteria of Statement 66. Therefore, in the Exposure Draft, the Board decided that unless an entity had an established stated policy that certain types of real estate sales transactions are not subject to the provisions of Statement 66, all real estate sales transactions entered into after September 9, 1998 should be accounted for in accordance with the provisions of Statement 66.

31. Several respondents expressed concerns about the proposed transition and asserted that any time the Board adopts a prospective, transaction-based transition approach, transactions can occur prior to the effective date that effectively become grandfathered by the prior rules. Respondents also noted that an entity's prior policy to not apply Statement 66 to sales of operating facilities such as manufacturing facilities, power plants, and refineries may be considered reasonable in the light of the diversity in practice. The Board acknowledged those concerns and decided that this Interpretation should be effective for all sales of real estate with property improvements or integral equipment entered into after June 30, 1999.

EITF ABSTRACTS

Issue No. 00-11

Title: Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13

Dates Discussed: May 17–18, 2000; September 20–21, 2000; January 17–18, 2001; July 19, 2001

References: FASB Statement No. 13, *Accounting for Leases*
FASB Statement No. 66, *Accounting for Sales of Real Estate*
FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*
FASB Interpretation No. 43, *Real Estate Sales*

ISSUE

1. Paragraph 2 of Interpretation 43 states that Statement 66 "applies to all sales of real estate, including real estate with property improvements or integral equipment." Some have interpreted that guidance to mean that integral equipment (as defined in Interpretation 43) should be considered real estate for other accounting evaluations outside the scope of Statement 66, including, for example, lease accounting evaluations. For any lease of real estate to be classified as a sales-type lease by the lessor, paragraph 7(a) of Statement 13 must be met. Paragraph 7(a) of Statement 13 (as amended by Statement 98) states:

> The lease transfers *ownership* of the property to the lessee by the end of the lease term. . .
>
> * This criterion is met in situations in which the lease agreement provides for the transfer of *title* at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title. [Emphasis added.]

2. In the United States, real property (land and buildings) transfers are addressed in state law. Recording a document of transfer in local land records evidences transfer of ownership of real property. Transfers of personal property (tangible, moveable goods) are addressed in Article 2 of the Uniform Commercial Code (U.C.C.). Although Article 2 of the U.C.C. provides a set of guidelines for determining when title to personal property has passed, there is generally no system for recording or registering title. *Fixtures* are a hybrid form of property, defined as personal property that is closely associated with the real property to which it is attached. Transfers of *fixtures* without the concurrent transfer of the

underlying real property may not be subject to either a statutory title registration system or Article 2 of the U.C.C.

3. The issues are:

Issue 1 — Whether integral equipment subject to a lease should be evaluated as real estate under Statement 13

Issue 2 — If integral equipment subject to a lease is evaluated as real estate under Statement 13, how the requirement in paragraph 7(a) of Statement 13 for the transfer of ownership should be evaluated when no statutory title registration system exists for the leased assets.

EITF DISCUSSION

4. The Task Force reached a consensus on Issue 1 that integral equipment subject to a lease should be evaluated as real estate under Statement 13, as amended by Statement 98. Members of the Task Force observed that Statement 98 was intended to conform the requirements of Statement 13 with respect to sales-type leases of real estate to the requirements of Statement 66 with respect to sales of real estate. In order to maintain that conformity, integral equipment should be evaluated as real estate for purposes of Statement 13 (because Interpretation 43 defines integral equipment as real estate for purposes of Statement 66).

5. The Task Force reached a consensus on Issue 2 that for integral equipment or property improvements for which no statutory title registration system exists, the criterion in paragraph 7(a) of Statement 13 (that the lease transfers ownership of the property to the lessee by the end of the lease term) is met in lease agreements that provide that, upon the lessee's performance in accordance with the terms of the lease, the lessor shall execute and deliver to the lessee such documents (including, if applicable, a bill of sale for the equipment) as may be required to release the equipment from the lease and to transfer ownership thereto to the lessee. This criterion is also met in situations in which the lease agreement requires the payment by the lessee of a nominal amount (for example, the minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership. Notwithstanding the foregoing guidance, a provision in a lease agreement that ownership of the leased property is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer of ownership is a *purchase option*. Such a provision would not satisfy criterion 7(a) of Statement 13.

6. The consensuses in this Issue should be applied to (a) leases for which lease inception occurs after July 19, 2001, and (b) leases modified after July 19, 2001, that meet the criteria in paragraph 9 of Statement 13 to be considered as new

agreements. The Task Force reached a consensus that companies should disclose the effect on the balance sheet and the income statement resulting from a change in lease classification under (b), above, for leases that at inception would have been classified differently had the guidance in this Issue been in effect at the inception of the original lease.

STATUS

7. No further EITF discussion is planned.

EITF ABSTRACTS

Issue No. 00-13

Title: Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98

Date Discussed: May 17–18, 2000

References: FASB Statement No. 13, *Accounting for Leases*
FASB Statement No. 28, *Accounting for Sales with Leasebacks*
FASB Statement No. 66, *Accounting for Sales of Real Estate*
FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*
FASB Interpretation No. 43, *Real Estate Sales*

ISSUE

1. With the issuance of Interpretation 43, which concludes that sales of integral equipment are within the scope of Statement 66, determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination now affects whether the detailed guidance in Statement 66 should be applied to a transfer of equipment. Further, the appropriateness of sales-type lease classification by lessors for leases involving equipment is also impacted by the determination of whether the equipment to be leased is "integral equipment." In addition, that determination is important for reaching a conclusion as to whether Statement 98, with its more stringent provisions, applies to a sale-leaseback transaction.

2. Integral equipment is defined in Interpretation 43 as "any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost." The authoritative pronouncements governing the accounting for leasing transactions and sales of real estate do not provide any guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost," and, as a result, there may be diversity in practice with respect to determining what constitutes "integral equipment" for the purpose of applying Statements 13, 66, and 98.

3. This issue is how the determination of whether equipment is integral equipment should be made.

EITF DISCUSSION

4. The Task Force agreed that the phrase "cannot be removed and used separately without incurring significant cost" contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The Task Force reached a consensus that the determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. The Task Force agreed that, at a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship[1] and reinstall the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment.

[1] If there are multiple potential users of the leased equipment, the estimate of the fair value of the equipment as well as the costs to ship and install the equipment should assume that the equipment will be sold to the potential user that would result in the greatest net cash proceeds to the seller (current lessor).

5. When the combined total of both the cost to remove plus the decrease in value (for leasing transactions, the information used to estimate those costs and the decrease in value should be as of lease inception) exceeds 10 percent of the fair value of the equipment (installed) (for leasing transactions, at lease inception), the equipment is integral equipment.

6. Refer to Exhibit 00-13A for an example that illustrates the application of this consensus.

STATUS

7. No further EITF discussion is planned.

Exhibit 00-13A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 00-13

Company A leases equipment to Company B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is $1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is $80,000, which includes

$30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is $85,000. For this example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

In accordance with this consensus, Company A would assess whether or not the production equipment is integral equipment as follows ($80,000 + $85,000) ÷ $1,075,000 = 15.3 percent. Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Oversight and Investigations Subcommittee
The Effects of the Global Crossing Bankruptcy
on Investors, Markets, and Employees
March 21, 2002

Good Morning. I want to take this opportunity to thank the Chairwoman of the Subcommittee on Oversight and Investigations, Congresswoman Sue Kelly, for holding this important and particularly timely hearing.

It seems that each day brings us new revelations about the use or misuse of complex accounting practices that hide the information needed by the markets to assess a company's health. When this happens to a healthy company during a period of growth, the company can work its way through it. But when the company is already experiencing a severe downturn in its business and then has its accounting questioned, as was the case with Global Crossing, it can be devastating.

There are two sets of victims who get burned in this cycle: Investors suddenly receive new and damaging information about the company and then lose confidence in it. And, worse yet, the employees then lose their jobs and their pensions when the business turns bad, and the capital markets freeze because the good news they had about the company was not necessarily true.

While the Enron bankruptcy first brought these issues to our attention, it appears that Global Crossing, which has also declared bankruptcy, and other telecom companies accounted for key activities in a way that raises serious concerns. Employees and investors need to know whether they engaged in swaps of capacity that had a legitimate business purpose or did not, and whether they were accounted for properly or in a way that just pumped up their projected cash flow and stock prices. Global Crossing entered into these capacity swaps with a number of companies, including Qwest, Cable and Wireless, WorldCom, at a time when the entire telecom world was experiencing an excess of capacity. We need to understand how the industry's overall problems intersected with the use of those swaps.

I want to thank the CEO and CFO of Global Crossing and executives of Qwest, WorldCom, and Cable and Wireless for agreeing to appear before us today to explain these issues to the American people.

It is only by investigating these practices that we can help investors to base their decisions upon a company's real financial condition, not just a projection released without an objective opinion by an independent party.

Just as important to my way of thinking is a desire to protect shareholders and employees from the kinds of activities that are often characterized as "sweetheart" deals and might have an adverse impact on shareholder value. Some of these practices include special treatments for loans, bonuses, and pension payouts. We need to discuss the propriety of 401(k) blackout periods, wherein some employees are precluded from selling stock for specified periods of time.

This hearing will be of enormous assistance in assuring that H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002, or CARTA, is successful and effective. In order for our Nation's economy to remain on sound footing and to continue its recovery and anticipated growth, it is vital for the American investor to have access to the most recent, meaningful and accurate information possible. Good corporate governance is necessary for such an environment to exist, and that is one of the things we are seeking to accomplish by the introduction and implementation of the CARTA legislation.

That concludes my comments, and I will now yield to the gentlelady from New York, Mrs. Kelly, for what I anticipate will be a very interesting and illuminating hearing.

####

Statement of the Honorable Wm. Lacy Clay before the Subcommittee on Oversight and Investigations, Thursday, March 21, 2002

Good morning Madam Chairman, members of the subcommittee and witnesses.

The success of our financial markets depends on the free flow of accurate and reliable information. This is particularly important as more and more Americans invest in the stock market and as more and more companies sponsor market-based 401(K) retirement accounts. Therefore, in the wake of the Global Crossing Bankruptcy filing in January, Congress must investigate why the supposed safeguards in the system did not work.

I have seen documents and reports of over-investments, suspect accounting practices and other allegations. However, along with many of my fellow Committee members here today, I will avoid forming any conclusions about the causes of Global Crossing's collapse into bankruptcy until all of the evidence has been presented.

I do have concerns about the damage that is done to the telecom sector of the economy and to the employees of Global Crossing. This failure coupled with several other Chapter 11 filings has severely damaged the confidence that banks and the bond markets have in the industry.

Were any pension laws broken when Global Crossing locked employees out of their 401(K) plans? During a three-week-period in late December and early January, Global Crossing stock prices plummeted while employees were denied the ability to sell. But there are currently no federal laws, which regulate how long -- or indeed when -- such lockdowns can occur.

We must protect employees and their securities for their retirements.

Madame Chairman, I ask unanimous consent to submit my statement to the record.

OPENING STATEMENT

Rep. Stephanie Tubbs Jones

The Effects of the Global Crossing Bankruptcy on Investors, Markets, and Employees

3/21/02

Good Morning, Chairwoman Kelly, Vice Chairman Paul, Ranking Member Gutierrez and Members of this Subcommittee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

In the wake of Global Crossing we have seen first hand the effects of poor corporate governance and financial irresponsibility. The issues have been complicated at best; the misdirection, finger pointing and complexity of the personalities and accounting involved in this situation have made the root issues difficult to parse. However, when the Gordian knot has been tied by the Global's of the world, I think that its best that we get back to basics and move forward to evaluate our position as a nation with regard to corporate responsibility, governance and ethics.

Let me first address those directly responsible for the well being of those least able to protect themselves-shareholders. At a basic level, it is the role of the board of directors of any company to protect and act in the best interest of the shareholders. Protecting shareholders is a task simple enough to speak of but seemingly infinite in its difficulty to perform. Shareholders have no choice but to trust the board as fiduciary agents to act in their best interest and it is because of this dependence that we must carefully evaluate what led to the downfall of Global Crossing's.

Secondly, we must examine the role that Global's corporate auditors had in effecting the company's downward spiral. Is it more than a coincidence that Global Crossing and Enron were both audited by Andersen? Perhaps, but we are sure that both Enron and Global share the same fate in Chapter 11 bankruptcy. The notion of true auditor independence is at issue and specific to this hearing, how big of a factor it was in Global Crossing's demise.

And finally, I would like to acknowledge the employees of Global who have often been overlooked in the media storm surrounding its once proud employer. Over 9,000 people lost their job as a result of the Global bankruptcy, most of which were unaware of the accounting improprieties that may have cost the company its life.

The reach of the Global Crossing debacle into the telecommunications sector was deep. By some estimates, over 500,000 jobs and $2.0 trillion in market capitalization in the sector was lost as a direct result of Global Crossing's bankruptcy. This is reason enough why we must continue to scrutinize what happened to Global Crossing so that it will never happen again.

Mr. Chairman, thank you for your time.

Statement of Representative Louise Slaughter
March 21, 2002
Committee on Financial Services, Subcommittee on Oversight and Investigations
Hearing on the effects of the Global Crossing bankruptcy on investors, markets, and employees

I want to thank Chairwoman Kelly, Ranking Member Gutierrez and Members of this committee for holding this hearing into Global Crossing's bankruptcy.

I appreciate the opportunity to submit my statement for the record. My interest in this hearing stems from the fact that thousands of people in my district have been affected by Global Crossing's bankruptcy filing. Global Crossing's North American headquarters was located in Rochester, New York, and had owned Frontier Communications, the local telephone company which on its own employed 13,000 workers.

As we discuss the effect of Global Crossing's bankruptcy on the marketplace, I would like to emphasize the impact of this bankruptcy on the individual worker. On March 9, I hosted a public forum in Rochester where 250 people came to share their experiences. I would like to quote from an article I received that was written by a former employee which summarizes the general sentiment at the forum: "Many former employees have been economically devastated as a result of corporate greed and the mismanagement of Global Crossing. People have spent their life savings and have had to cash in their deflated (since the stock market plummeted) retirement/401k plans just to survive these last few months after Global Crossing abruptly ceased their promised severance payments. Some (former employees) are now forced to file bankruptcy themselves while others may lose their homes, have had to drastically change their life styles and are barely surviving."

According to press reports, there appears to be striking parallels between the cases of Enron and Global Crossing, including a lack of auditor independence, questionable executive mismanagement, misleading accounting methods, and questions on the accessibility of employees' 401(k) accounts before the bankruptcy filing. And unlike the small shareholders and the company's workers, current and former top executives walked away the winners. This hearing begins the process of Congress asking the tough questions on how this occurred -- where did the system break down and allow this to happen?

Hearings like this one will serve as a wake-up call to both Congress and corporate America that these type of business practices and bankruptcies can be neither sustained nor tolerated. Additionally, current law must change to better protect workers and investors. Across the board, investors are now skittish about relying on auditors' reports and analysts' recommendations. I look forward to listening to the witnesses' views, experiences, and suggestions on how Congress can take effective action.

Before the Subcommittee on Oversight and Investigations of the Committee on Financial Services U.S. House of Representatives

Testimony of
John J. Legere
Chief Executive Officer
and
Dan J. Cohrs, Ph.D.
Executive Vice President and Chief Financial Officer

Global Crossing

March 21, 2002

We are pleased to submit this statement in connection with today's Subcommittee hearing and in response to the March 14, 2002, letter to us from the Committee on Financial Services. Initially, we want to thank the Subcommittee for calling this hearing to take a serious look at the difficult financial issues facing the telecommunications industry, generally, and Global Crossing, in particular. We believe that a thorough, well-considered discussion on these matters is timely and appropriate.

The Committee's letter asked that we address three sets of issues:

(1) First, how Global Crossing, and other companies with fiber optic networks, accounted for relatively contemporaneous purchases and sales of fiber optic capacity from the same counterparty, and the transparency given to public investors of those transactions.

(2) Second, whether the accounting model followed by the telecommunications industry and assumptions respecting its growth served as the trigger for the rolling deflation we have seen in this sector of our economy.

(3) Third, what can the Committee on Financial Services and the Congress of the United States do to ensure that this industry is preserved and that investor confidence can be regained.

In this statement, we will address these topics. If appropriate, we will provide supplemental written testimony.

Before we begin, however, we want to emphasize that although we believe that there are important lessons to be learned from our experience at Global Crossing, we are not just looking back. Although it is important to put to rest all the questions that have been raised, we are also building for the future. Nearly all of our energies are focused on strengthening our Company, and continuing to provide global telecommunications to the world. We have a network that is unparalleled in scope and capability. We have dedicated and loyal employees. We have tens of thousands of customers who depend on us for their national and worldwide communications needs. We simply will not let them down.

We are moving aggressively to execute a turnaround plan that makes good sense. Our network is now complete. We are lowering all of our costs, both capital and operating expenditures. We are continuing to earn recurring service revenues, over $3 billion last year. We intend to emerge from Chapter 11 one way or another, and we hope that we will once again be able to share with you an American success story.

Background

Global Crossing and Its Unique Network

Global Crossing was launched in 1997 and became a publicly traded company in 1998. Since that time, Global Crossing has raised and invested billions of dollars to build the world's most extensive fiber optic network. No other telecommunications company in the world has an owned and controlled infrastructure – consisting of subsea and terrestrial cables, inter- and intra-

metropolitan city networks, and associated equipment and buildings – that is as extensive as that of Global Crossing. A map of the world showing Global Crossing's network is appended to this statement. This network, which is owned and managed by Global Crossing, provides a wide range of services to other carriers, companies large and small and consumers. The Global Crossing network also provides an essential backbone network for other major telecommunication carriers throughout the world that have purchased capacity on it and route large volumes of telecommunications traffic across it. Included in this group are the regional Bell operating companies, many major European carriers and significant Asian carriers.

This unique asset, with its unparalleled infrastructure, is invaluable because it literally connects the world as a global community. Multinational enterprises, across a spectrum of industries, can create, exchange, collaborate, and compete, all with greater ease and security.

The Global Crossing network creates opportunities every day. The network securely and reliably connects over 7,000 financial institutions, carries over $5 trillion in financial transactions per day, and counts as its customers over 85,000 corporations, governments and other organizations. Most recently, and among its many other accomplishments, Global Crossing carried the news feeds for the Olympic Games for NBC in Salt Lake City.

The Effects of a Weakening Economy

As a result of a softening economy and steep declines in demand, opportunities such as these have not come fast enough. With the over $7.2 billion in debt that it took to construct and operate Global's network, given the continued high cost of local access charges from which the incumbent telecommunications companies benefit and with an internal cost structure that could not be cut back fast enough to keep pace with the collapse in demand, Global Crossing had no alternative other than filing for Chapter 11 protection to ensure continued operation of our network while the balance sheet is restructured.

With the benefit of hindsight, we now see that, in 2000, the telecommunications industry experienced the first effects of consolidation as the capital markets closed and access to funding became limited. In the early months of 2001, investor confidence showed signs of weakening, resulting in significant contraction of debt and equity values. Certainly, by the third quarter of last year, the market valuation of nearly every major company in the telecom sector had deflated dramatically, prompted by a tumbling world economy, and the implosion of the dot-com phenomenon.

Ironically, it was at about this time that Global Crossing announced that it had completed its nearly 100,000-mile fiber optic network – a network connecting over 200 of the world's top business centers, designed for a new century of networked computing. In fact, the entire industry, fueled by optimistic market research – which forecasted a society where everyone had access to everything over communications networks – had built out ahead of demand.

At the end of the third quarter of last year, John Legere was recruited from Asia Global Crossing to serve as the Company's CEO. The Company needed to address an overwhelming debt load and design and implement a business model that would enable it to continue and compete. The leadership team immediately eliminated layers of management, implemented dramatic cost reductions, including a reduction in force of more than 20%, and put together a "SWAT" team of strategists to redesign the business and financial model – all by early November 2001.

Despite these immediate and serious measures, it became apparent that the cost of servicing the Company's debt, coupled with a realistic assessment of the market opportunity in the context of a slowing and uncertain economy, required Global Crossing to explore all its options. As a result, the Company accelerated discussions with banks and potential investors. As the pressure of loan obligations increased, and on the advice of financial and legal advisors, it

became clear that the Company's situation called for measures more drastic than originally expected.

Bankruptcy and Potential Investors

Knowing that it had to do the right, if difficult, thing in order to preserve the Company and continue to operate the network on behalf of over 85,000 commercial and carrier customers around the world, Global Crossing prepared for the possibility of a Chapter 11 filing. Concurrently, the Company held negotiations with outside investors, which it pursued intensely. At the end of January, Global Crossing became the fourth largest company in history to declare bankruptcy.

At the same time, Global Crossing signed a letter of intent with Hutchison Whampoa and Singapore Technologies Telemedia for a $750 million cash investment following a successful restructuring. The potential investment, along with the financial restructuring, was designed to strengthen the balance sheet and reduce debt, enabling Global Crossing to build upon its global network and emerge a worldwide leader in networking services.

Since the bankruptcy filing, more than 40 investors have expressed interest in speaking with the Company – investors who the Company hopes will recognize the value of Global Crossing and its potential.

Global Crossing raised and expended billions of dollars to build the world's first and only seamless, global fiber optic network. This network is generating – and will continue to generate – billions of dollars of revenue a year. Unfortunately, a soft economy, difficulties in the telecommunications industry and the huge debt incurred over the past years to build this unique and valuable asset have placed Global Crossing in a "buyer's market." The Company is working very hard to structure a successful reorganization plan in the Chapter 11 proceeding so that it can bring in new investors, continue network operations uninterrupted and realize its

extraordinary potential – and to ensure a future for thousands of employees around the world who have worked very hard to build the business, and who continue to work even through this extremely challenging period to make the business successful.

The Shadow of Enron

Shortly after it announced its plan to restructure, the Company, including its new CEO, came under the public spotlight at a time when other large bankruptcies of a different nature – most notably Enron – had aroused considerable public interest. Some may see *superficial* similarities between Enron and Global Crossing: a collapse in the stock price, questions about accounting practices, executive stock sales, questions about employee investments in 401(k) plans, two highly visible and wealthy chairmen and, of course, Andersen, the independent auditor. Perhaps not surprisingly, the SEC opened an investigation.

Let us be clear: Global Crossing is no Enron. Global Crossing built and owns the world's most advanced fiber optic network, spanning the globe and touching five continents. It is a very real asset, the value and significance of which is indisputable. Global Crossing provides services to 85,000 customers and has billions of dollars in revenues from providing much needed telecommunications services globally.

With respect to the superficial similarities, we will address them one by one.

Accounting Practices: Global Crossing consistently applied accounting policies that it developed in consultation with Andersen. These policies were derived from the applicable accounting literature. The policies and practices common to the industry, to which the Company adhered, were well understood and documented by the financial community and analysts who followed companies in this sector. Samples of analysts' reports discussing such policies and practices have been provided to the Staff of the Subcommittee.

Accounting Practices -- Employee Complaints: Former employees at Enron and Global

Crossing have alleged accounting improprieties. Although the Company cannot comment specifically on these matters as they are currently the subject of litigation, in the case of Global Crossing, following the receipt of a letter from a now-former employee, the Company did engage outside counsel to review the matter, and outside counsel found the allegations to be without merit. The Company's Board of Directors has engaged independent outside counsel and is currently reviewing these allegations.

Executive Stock Sales: Global Crossing's stock price rose rapidly over a very short period of time as the telecom industry expanded. Then, when the industry even more rapidly contracted, the stock price fell – although along a trajectory far less steep than Enron's. At its height, Global Crossing was one of the most heavily traded stocks in the market, in the top ten volume stocks on the New York Stock Exchange on almost a daily basis. The transactions by present and former Company officials are currently the subject of review by the SEC and the Company will be in a position to provide a further report on this subject at a later date. However, it must be added that many other investors profited greatly from Global Crossing stock. Unfortunately – but as is always the case – many investors also lost money because of when they bought or because they chose not to sell.

Governmental Investigations: The SEC and the U.S. Attorney's Office are conducting investigations and the Company is cooperating actively with them to enable their reviews to proceed as expeditiously as possible.

401(k) Issues: Following the purchase and sale of various businesses between late 1999 and June 2001, Global Crossing was left sponsoring three 401(k) plans for various active, retired and former employees. To reduce expenses, enhance service and provide uniform plan features to participants, the Company determined to consolidate the plans under a new record keeper,

Fidelity Investments, effective January 1, 2002, which was the end of the plans' annual reporting and record-keeping cycle.

It is commonplace for administrators to request that such changes be made effective at the beginning of a plan year and to have a "blackout" period during which plan participants are restricted from making changes to their account. The idea is to "freeze" the plan data for a short period so that it can be transferred from the old record keeper to the new one.

In the case of Global Crossing, plan participants were given ample advance notice of the blackout period. The blackout for changing investment allocations began on December 14, 2001, and ended on January 18, 2002. All participants were first advised of that year-end blackout by an announcement mailed by Fidelity on October 2, 2001, which was followed by an internal email to U.S. employees on October 11, 2001. As the blackout drew near, a transaction brochure was mailed on December 4 to each plan participant specifying key blackout dates, followed by an internal email notice sent on December 11, 2001, again reminding employees of the blackout commencement date of December 14, 2001.

Significantly, more than two months elapsed between the Company's revised earnings announcement of October 4, 2001 and the blackout. During those ten weeks, participants remained free to re-allocate their investments. This contrasts with the situation involving Enron, where the accounting charges that caused Enron shares to plummet were announced *during* the blackout period itself.

Global Crossing's shares lost just $.13 a share during the blackout period, falling from $.67 a share on December 14 to $.54 a share on January 18, 2002. By contrast, in the 10 weeks preceding the start of the blackout, Global Crossing shares fell 65%, from $2.09 on October 3 to $.73 on December 13. Of course, the stock had steadily dropped from a 2001 high of $25.87 during the 11 months preceding the blackout.

Industry Woes: The Roles of Accounting Methods and Federal Telecommunications Policy

Both Global Crossing and Enron are audited by Andersen. As one of only five global accounting firms, Andersen necessarily audits a significant percentage of the companies whose operations are global. Like Enron, Global Crossing also made selected use of Andersen's well-regarded consulting practice. This is not at all unusual.

We do not believe that issues relating to accounting methods or procedures for sales of capacity in the form of Indefeasible Rights of Use, or IRUs, or the application of accounting principles to specific transactions, played a significant role in the current financial troubles confronting our industry. To begin with, the sale and acquisition of capacity via IRUs is an essential part of creating efficient networks. Transactions involving IRUs are legitimate and important to both buyers and sellers of capacity, and have been used for many years in the industry.

A number of our sales of IRUs were contemporaneous with purchases from our customers. Contrary to some popular misimpressions, during our Company's history, these contemporaneous transactions were not common: there were fewer than two dozen in 2000 and 2001. These transactions were entirely lawful, were reported in a manner in accordance with applicable accounting principles and were fully disclosed. Neither these transactions nor our accounting for them have anything to do with the telecommunication industry's – or our Company's – difficulties. Illustrating this point, many carriers that do not sell IRUs to any significant extent are also beset by today's financial woes. Moreover, most of our Company's revenues were derived *not* from sales of IRUs, let alone contemporaneous transactions, but from services.

The Committee has asked whether federal telecommunications policies played any meaningful role as a trigger to the industry's problems. Naturally, our company, like others, was

born of deregulation and the competitive environment for telecommunications networks and services, both in this country and elsewhere. We applaud our Nation's trade negotiators, who have helped to open up so many foreign markets, where we can now land cables and provide services directly. These opportunities were attractive to us.

The federal government can play an ongoing role, however, in stimulating broadband infrastructure investment and creating an environment to encourage consumer demand for these services. Heightened consumer demand for bandwidth intensive services, coupled with infrastructure development at the local level, will create a more robust telecommunications market. Global Crossing and our carrier customers will compete vigorously to provide capacity and services to satisfy this demand.

Once broadband services are rolled out in meaningful numbers to every home in America, consumers will want to send and receive more data across our national telecommunications networks, to watch movies, download music and exchange information on an unprecedented scale. Congress, the FCC and the Administration are taking steps to encourage broadband deployment. We very much welcome those measures and hope that they can be accelerated. Conversely, to the extent that the government or others are taking actions that have the effect of impeding the delivery of new networks and services to the home, or are not moving rapidly enough on this front, there is a very significant risk that the installed capacity of Global Crossing and others may continue to not be used to its fullest potential.

IRUs and Contemporaneous Sales of Capacity

There has been considerable interest in the telecom industry's treatment of IRUs. In short, an IRU is a mechanism that allows a carrier to expand the scope of its network by purchasing a large block of capacity on another carrier's network, thereby creating enormous cost efficiencies for the industry and, by extension, for customers and end users around the

world. The ability to buy – as well as build – capacity is critically important to Global Crossing and other carriers. For some carriers in some markets, buying capacity may be the most efficient way of building out or extending a network.

What is an IRU?

The terminology on this subject requires some explanation. IRUs have been used for many decades to sell capacity on carrier networks. An IRU itself is merely a right that a carrier conveys, typically by means of a long-term lease, to a fixed amount of communications capacity for a defined period of time. The capacity may be in the form of an identified physical asset – such as a specific strand of fiber optic cable or a specified wavelength on a strand – or capacity on one or more parts of a carrier's network. For example, one carrier might purchase an IRU giving it the right to use a wavelength for a certain number of years, or might purchase the right to use 2 fibers on one cable in Global Crossing's global network for 20 years.

Carriers purchase IRUs to fill gaps in their own networks, to ensure that sufficient capacity is available on crowded routes to meet peak demand and projected future demand, and to provide diverse or redundant transmission paths to enhance the efficiency of their networks and to ensure continued services in the event of an outage. These long-term IRUs also enable carriers to obtain capacity, to plan and equip their networks for periods of time, while avoiding the capital expense required to build all or part of their networks. The sale of IRUs to carriers has always been and continues to be an important part of Global Crossing's business model as well as that of other major telecom carriers. In recent years, however, the Company has greatly increased its revenues from the sale of telecommunication services to carriers and business enterprises.

Accounting for IRUs

When a carrier, such as Global Crossing, sells an IRU via a lease, it generally is paid up

front, in a single cash payment. As with most leasing activity, however, the proper accounting for transactions involving IRUs is not a simple matter. Leases of IRUs generally fall into one of two categories: sales-type leases and operating leases. To simplify greatly, in a sales-type lease, the ownership of the fiber optic capacity (e.g., a defined unit of capacity or a fiber optic strand or a wavelength on a fiber optic strand) that is leased ultimately may change hands and belong to the purchaser. If the terms and conditions of the lease are not consistent with those required by the accounting standards for a sales-type lease, then the lease will be treated as an operating lease. Where the lease is an "operating lease," ownership of the capacity stays with the seller.

The GAAP principles applicable to accounting for these two types of leases differ. Again simplifying greatly, although **both** leases typically involve a single up-front cash payment, only the revenue received on a sales-type lease may be recognized entirely in the year in which it is received. The revenue from an operating lease must be recognized over the life of the lease (e.g., on a 20-year operating lease, only 1/20th of the total revenue may be recognized in that first year, even though all of the cash was received in year one, and the remaining 19/20ths is deferred and is only recognized in 1/20th increments per year over the life of the lease).

Generally speaking, in response to changes in the applicable accounting rules as well as in our business model, after about mid-1999, Global Crossing was required to account for the majority of its IRU leases in which it sold capacity to other carriers as operating leases. Accordingly, Global Crossing recognized as GAAP revenue **only** the first increment of lease revenue in the year in which payment was received. It deferred the remainder of lease revenue – the far greater percentage of what it received from the purchase – over the succeeding years of the lease. We understand that not all telecom carriers may have treated the leases that they sold as operating leases. As noted earlier, based on their industry reports, the analysts who frequently wrote about Global Crossing and other carriers seemed to fully understand the manner in which

the Company accounted for its lease revenue.

Disclosure Terminology

As indicated, these same financial analysts, along with various banks and other lenders, realized that Global Crossing generally did not record the up-front cash payments from sales of IRUs as GAAP revenue in the period in which they were received (and disclosed such revenue when it was recognized). As a result, Global Crossing also disclosed in its press releases and filings the cash portion of lease revenue that was deferred and, therefore, not recognized as current-year GAAP revenue in the Company's financial statements. The reason for this was to give the financial community a better sense of the cash flows, including cash spent on capital expenditures, that Global Crossing was actually experiencing in a given period, as these amounts were highly relevant to the Company's ability to service its debt load and build out its network, among other things.

To respond to this need on the part of the financial community, Global Crossing employed the term "Cash Revenue." Cash Revenue includes all of Global Crossing's GAAP revenue (e.g., the revenue Global Crossing receives each period from the sale of telecommunications services) plus the cash portion of the change in its GAAP deferred revenue (e.g., the totality of the IRU cash payments received by the Company during the period) for a particular reporting period (as well as other items that are not important in this context). The precise meaning of the term Cash Revenue, how it was derived and the fact that it was neither a GAAP term nor GAAP revenue, were fully disclosed in every press release and periodic filing where the term was used. A related concept, which again was not a GAAP reporting term, "Adjusted EBITDA," was also used; the definition, components and non-GAAP nature of this term were also fully disclosed. Adjusted EBITDA is a concept that Global Crossing's lenders use in their loan covenants with the Company. Our releases and filings reconciled Cash Revenue

and Adjusted EBITDA with GAAP numbers.

In short, although there has been some confusion as a result of inaccurate reporting by the media, Global Crossing accounted for the revenue it received from IRU leases in accordance with GAAP. Although the cash payments for such leases were typically received in a single up-front payment, the Company recorded as GAAP revenue only a fraction of such payments when received, deferring the far larger remainder over the life of the lease. The Company did advise the public and, in particular, the financial community that needed to know such information, as to the total amount of cash it received from such leases through the use of the term Cash Revenue, which was always reported concurrently with the much smaller GAAP revenue number.

Contemporaneous Sales of Capacity

No one disputes that the sale of IRUs is a legitimate and appropriate business for telecommunications companies. However, questions have been raised with respect to business motives when two companies sell each other IRUs at approximately the same time. The applicable and generally accepted accounting model permits the seller of an IRU to record the revenue it receives as current revenue (an income statement item) or deferred revenue (a balance sheet item). The cost of purchasing an IRU is properly treated as a capital expense and is disclosed in the purchaser's statements of cash flows. There is now a debate as to whether the disclosures concerning these transactions may in some fashion have misled the market.

To promote transparency, Global Crossing disclosed these transactions in the Company's press releases and periodic filings in a manner that is accurate, complete and clear, and which discusses their business purpose. Thus, for instance, in the press release for the second quarter of 2001, dated August 1, 2001, Global Crossing stated that:

> Cash Revenue from the sale of capacity in the form of IRU's was $567 million for the quarter, an increase of 38% from the second quarter of 2000 and flat sequentially.

> Included in this amount, and in Recurring Adjusted EBITDA, was *$345 million received from significant carrier customers who signed contracts during the quarter* to purchase $381 million of capacity on the Global Crossing Network, and to whom Global Crossing made substantial cash commitments during the quarter (see "Network and Capital Plan" below).
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> **Network and Capital Plan**
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> During the quarter, *Global Crossing entered into several agreements with various carrier customers for the purchase or lease of capacity* and co-location space. The transactions were implemented in order to acquire cost-effective local network expansions; to provide for cost-effective alternatives to new construction in certain markets in which the Company anticipates shortages of capacity; and to provide additional levels of physical diversity in the network as the Company implements its global mesh architecture. *The new cash commitments totaled approximately $358 million.*

(emphasis added).

As noted, Global Crossing entered into a relatively small number of transactions – compared to all of its capacity sales to carriers – in which it sold IRUs or other capacity or services to a company from which it purchased capacity or services at approximately the same time. Given the recent allegations, the Company's Board is currently examining these transactions with independent counsel and auditors, including their business justification as well as the manner in which revenue and expenses were recorded and disclosed.

Global Crossing and the Future

Global Crossing was created by visionaries who saw a need in the marketplace for a high capacity global network. The founders of the Company successfully raised substantial amounts of capital, which was essential both because of the huge companies (such as AT&T) against which Global Crossing would have to compete and the staggering costs associated with virtually encircling the planet with fiber optic cable. Based on the power of this business idea, the capital was raised quickly, and construction was completed in record time.

Global Crossing is very much a real company, with real tangible assets and a real vision. The Company's assets are its customers, its employees and its network, which is the most advanced, most secure fiber optic network in the world, and which reaches the top 200 cities in 27 countries. The size and security of the network has attracted some of the world's most important companies, financial institutions and governments as customers, and the network is utilized as a backbone network by other major telecommunications carriers throughout the world.

The Company has continued to win business this year, even after its Chapter 11 filing. That Global Crossing, even in this economic climate, has investors ready to sign on and infuse cash validates the vision of Global Crossing's founders. Unlike other companies without substantial hard assets or the ability to deliver much-needed services, Global Crossing has intellectual, creative and physical capital – despite the fact that its financial capital is restrained until the economy improves and demand increases once again.

Pending Legislative Proposals

Finally, we are aware that the Committee has before it various legislative proposals regarding auditing accountability, including H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002." In response to the Committee's request, though not necessarily grounded in the Global Crossing experience, we have three observations and suggestions in connection with these proposals: (1) outside directors need to be fully informed with respect to the nature and scope of non-auditing services provided by a company's auditors; (2) auditors should institute a partner review policy with respect to all significant accounting judgments; and (3) the SEC needs to act, proactively and decisively, when an industry is experiencing revolutionary change at a pace that outstrips the ability of industry and private-sector standard setters to develop appropriate accounting standards in a timely

fashion.

Outside Director Assessment of Non-Auditing Services

One lesson to be learned from many of the spectacular business failures of the past several years is that outside directors of publicly traded companies must be equipped with sufficient information to enable them to assess whether the company's independent auditor is truly independent and, therefore, capable of requiring that corrective action be taken when needed with respect to a company's internal controls or accounting practices. Clearly, the auditor will not be truly independent in this sense unless it is fully prepared, if necessary, to refuse to certify a company's financial statements under GAAP. To be in a position to assess auditor independence, the outside directors must have an intimate familiarity with the nature and scope of the non-auditing services provided by the auditor. The outside directors must be presented with information concerning the non-auditing services that the auditor proposes to render **before** they are rendered and these directors must then make a disinterested determination as to whether the cost, nature or scope of such services will compromise the independence of the auditors. This kind of evaluative involvement by the directors should prove more useful, and would certainly be more flexible and adaptable in rapidly changing industries, than a proscriptive approach, in which identified practices are simply prohibited.

Second Partner Review of Accounting Judgments

Another lesson from the recent past is that it can be difficult for the principal partner on an audit engagement to consistently exercise independent, unbiased judgment in difficult or novel areas with respect to that partner's significant audit clients. The reasons for this run the gamut from not wishing to endanger a relationship that produces pecuniary benefit, to being too close to the matters in question to be able to think critically, to not being able to deal at arm's length with company accounting professionals with whom the audit partner has developed a

close working relationship over a substantial period of time. One potential solution for this problem is to require the involvement of at least one additional partner from a geographically distant office of the audit firm, who will receive no pecuniary benefit and who has no professional or other relationship with the finance or accounting personnel at the company in question. The province of this review partner would be to review, both critically and before any certification is provided, and perhaps anonymously (at least vis-a-vis the engagement partner), each significant accounting judgment made in connection with the audit of the company's financial statements. The concurrence of this review partner would be required in connection with the judgments made as to each matter reviewed. This internal check would thus insert the judgment of a comparatively disinterested auditor into the audit process, without unduly lengthening the time required to complete the audit process.

The SEC Must Speak

The last decade has witnessed the emergence and growth of many new industries that present industry-specific accounting and disclosure issues. At the same time, other industries which have existed for decades have, like the telecommunications industry, experienced precipitous transformational changes. Our industry includes both new and old members, and its transformation, like that of other technology-driven industries, has been and continues to be dramatic. When the emergence or transformation of new and existing industries occurs quickly and is revolutionary, there is often the risk that the private sector standard setters will face uncertainty as they attempt to adapt existing accounting standards and principles to new practices, involving new products or services. As a result, the accounting profession may not be able to reach a considered consensus on which principles govern, or even which model applies, as quickly as companies require in order to report their earnings.

In these circumstances, appropriate regulatory bodies must play an **early** role in helping

the industry to define and, if necessary, develop, the appropriate accounting standards. The alternative is for a patchwork of disparate accounting treatments, with varying degrees of transparency, to develop on a company-by-company basis, due in part to the presence of different auditing firms in that industry. Although there are accounting standards in place that can accommodate slower, more evolutionary changes within industries, there is no mechanism for requiring the federal agency charged with enforcement of laws relating to the adequacy of disclosure – the SEC – to take prompt, decisive and industry-wide action when circumstances, such as those in the telecommunications industry, so warrant.

We believe that a collective effort and shared commitment – among all those who have participated in a system of expectations, substantial growth and, regrettably, tremendous disappointment and loss – is essential. We call for cooperation from industry analysts, investment banks, financial analysts, accounting firms, elected officials and the media.

In closing, we wish to thank the Subcommittee for this opportunity to share our views and for your efforts to lay the benchmark for reforms.

Responses to Questions for Global Crossing Submitted by Congresswoman Sue W. Kelly Hearing on Effects of the Global Crossing Bankruptcy On Investors, Markets, and Employees

If your network should fail, where would your customers go for continued service?

In the unlikely event that Global Crossing were to cease some or all of its operations as a result of the bankruptcy proceeding, the Company would endeavor to give as much notice as possible to our customers, we would comply with all regulatory requirements regarding termination of service, and we would work closely with our customers to effect an orderly transition of services.

With respect to a technical failure, Global Crossing's network has been designed with redundancy and diversity in the transport layer as well as in the switched voice, data, and IP layers. Should a failure happen in a network element or because of a fiber cut, customers who have purchased protected service will be automatically restored within milliseconds. Customers who have elected to purchase services that are unprotected would be restored in accordance with their service level agreements with Global Crossing. The Company has committed to make its best efforts to attempt to restore unprotected customer circuits by utilizing any unused capacity available on the network to reroute the circuit for restoration purposes. Customers who purchase unprotected bandwidth on the Company's network do so with the understanding that a single failure in a network element or a fiber cut will jeopardize the service. Customers are advised that a contingency plan to reroute their service or to provide a secondary transmission path for restoration, redundancy, or physical route diversity is their responsibility.

In the event of a catastrophic failure in the network, such as a flood, fire or some other event that destroys a portion of the network and disrupts service for an extended period of time, the Company's engineering and operations personnel are committed to working with the customer to restore service using an alternative carrier to provide temporary service while making necessary repairs to the network. The Company will then work with the customer to transition the service back to the Global Crossing network when it is once again operational.

What are the results, if any, of your independent review of your practice of selling capacity on your network to a customer and then turning around and buying a similar amount of capacity on that customer's network?

From its very inception, Global Crossing purchased as well as sold network capacity as it built its unprecedented global fiber optic network. Purchases of capacity had various objectives, including quickly and economically extending the network into certain

additional markets and supplementing revenues, adding redundancy to the network in order to make it more reliable and more efficient, or adding capacity on existing routes to relieve forecast shortages. Most of these transactions were "one-way" in that there were no concurrent purchases and sales between Global Crossing and its customers. In some cases, purchases and sales with the same customer occurred in close proximity. When the volume of these concurrent transactions became significant, in early 2001, Global Crossing opted to disclose the existence and the size of the transactions. It is important to understand that usually there were very significant differences – in types, amounts, location and portability – between what Global Crossing sold and what it purchased. Global Crossing had a documented business purpose for what it purchased and charged what it estimated to be market prices for what it sold. Furthermore, these sales and purchases were separately documented and, usually, the subject of separate negotiations. Given the differences between what was purchased and what was sold, and the business purposes underlying the transactions, Global Crossing did not simply sell capacity and then "turn around" and buy a similar amount of capacity on its customer's network.

In accounting for these transactions, Global Crossing followed the advice of its independent auditor in applying the authoritative accounting literature applicable to the sales of telecommunications capacity generally and to concurrent transactions in particular. Presently, the Company is reviewing these transactions with outside counsel. In addition, a special independent committee of the Company's Board of Directors retained outside counsel to conduct a review of the Company's accounting for these transactions. Due to resignations from the Board and that committee, and the recent appointment of three new directors to that committee, that review is not yet concluded. Pending the outcome of these reviews, we are ready and willing to undertake any interim action recommended as a consequence of these investigations and approved by our Board of Directors.

Did any members of the Global Crossing leadership team ever personally meet with employees in an attempt to encourage them to buy shares of Global Crossing?

In looking back over the period from January 2001 to the present, neither the leadership team nor Board members Messrs. Winnick and Cook recall ever meeting with employees in an attempt to encourage them to buy shares of Global Crossing. A review of available transcripts and videotapes from employee meetings during this period confirms this. Global Crossing management has held and continues to hold frequent meetings and conference calls with employees. The goal of these meetings and calls is to motivate employees in their jobs and keep the lines of communication open throughout the organization. The goal is not and has never been to encourage employee share purchases. For example, during Mr. Legere's first employee conference call as CEO of Global Crossing in October 2001, he stated that he personally intended to purchase

shares in the Company. As a newcomer with no equity stake in Global Crossing, his statement was intended to show his personal belief in and support for the Company.

From December 14th of 2001 until January 18th of 2002, more than 8,000 Global Crossing employees were not permitted to sell shares from their retirement plans. On January 28th Global Crossing declared bankruptcy. While a 401 K lockdown is legal, how do you explain the timing of this particular lockdown?

The "lockdown" or "blackout" period between December14, 2001 and January 18, 2002 was related to a long-planned consolidation of 401(k) plans at Global Crossing under a new plan administrator (Fidelity Investments), and was wholly unrelated to the financial challenges that were then facing the company.

It is normal industry practice for plan administrators to restrict activity by 401(k) plan participants during periods of major changes, such as transitioning to a new administrator. That is because massive data transfers must take place and complex computer software must be customized, implemented and tested before the service provider can be certain that the system will function smoothly.

The timing of the blackout period for Global Crossing's 401(k) plan was designed around the end of the calendar year because that was the end of the accounting year for the plans. Changing administrators at year-end allows the service provider to "freeze" data to facilitate its transfer. As the new service provider, Fidelity determined when to start and end the blackout period, which was driven by its need to ensure that enough time preceded and followed the close of the year to allow a smooth transition.

Participants in Global Crossing's 401(k) plans were given substantial advance notice of the blackout period. An initial announcement of the change and anticipated blackout period was sent by Fidelity on October 2, 2001 to all participants by mail, and a follow-up announcement was e-mailed to North American employees (excluding Canada) on October 21, 2001. A Transition Brochure was then mailed to each plan participant on December 4, 2001, which listed the key dates regarding the period during which no transactions in 401(k) accounts would be processed. Finally, on December 11, 2001, employees were reminded through a "Flash" e-mail notice that the blackout would begin on December 14, 2001.

It is important to understand that the Global Crossing situation is fundamentally different from that which raised concerns at Enron. In the case of Enron, the company announced the news about its charges and accounting irregularities after the blackout period had begun, and the stock fell precipitously during the blackout period. In the case of Global Crossing, the stock price had substantially deteriorated long before the blackout period had begun — from trading in the low $30s in the fall of 2000, to $2.06 on October 2, 2001, to $0.73 on October 4 after the third quarter results were released (and,

coincidently, two days after the first notice to participants of the anticipated year-end blackout period was mailed). At the time the blackout began, the stock was trading at $0.67 and declined only slightly more to $0.54 by the end of the blackout period, which ended two weeks before the company's Chapter 11 filing. The timing of the blackout period thus was not related to the loss in value suffered by 401(k) participants as a result of their Global Crossing holdings.

Global Crossing has had five CEO's in as many years. Are you concerned by this high turn over in leadership? Have you formed an opinion as to the reasons for such a high turnover in such a significant position of responsibility and authority?

We recognize that management stability can be beneficial to any company and we will strive to achieve this in the future. However, the past leadership changes at Global Crossing must be viewed in the context in which they were made. Over a very short time period, Global Crossing grew rapidly and repeatedly transformed itself. The Company's evolution proceeded through many phases, from its birth, through a period of subsea construction, eventually leading to acquisitions and expansive growth. Ultimately, Global Crossing became one of the world's preeminent providers of telecommunications capacity and services, to both carriers and end users. Over the last year, as the telecommunications climate changed, the Company has had to accommodate itself to far more limited resources, has adopted a focused business plan, and has now gone into Chapter 11. With each of these phases in the Company's history, the skills needed to lead Global Crossing also changed. Although some companies might see these sorts of transformations over a period of forty years, at Global Crossing they took place in just four. It is not altogether surprising, therefore, that Global Crossing's leadership changed rapidly as well.

Mr. Legere, how do you plan to deal with the issues of licenses and the regulatory approval that you will require in order to effect a transfer of ownership or restructuring deal? How also will you deal with any current government contracts or others that you may currently be bidding?

The Company has continued to comply with all licensing and other regulatory requirements of the Federal Communications Commission and other relevant government agencies while in bankruptcy. The Communications Act and the rules and regulations of the FCC require prior approval for any assignments of the Company's licenses or authorizations, or any transfer of control of the Company. In emerging from bankruptcy, the Company will comply with these requirements and, accordingly, the FCC and other relevant government agencies will be able to review and approve the qualifications of any proposed assignee or transferee.

With respect to any current government contracts, Global Crossing will continue to honor and support all of those obligations. With respect to current and future

government contracts, the Company has had discussions with representatives of the United States Government, including the Department of Defense and the Department of Justice (FBI), regarding any national security or law enforcement concerns that might be raised about a transfer of control of Global Crossing. The Company will continue to work with the Government regarding these matters as Global Crossing emerges from bankruptcy.

Mr. Legere, please tell us your reasons for stepping down as head of your Asian unit in January and also why you felt the need to also resign from its board in February?

Because the Asia Global Crossing Board decided it needed a full time CEO and I believed it was necessary for me at this critical time to concentrate my efforts on Global Crossing, the Asia Global Crossing Board decided that I should be removed as CEO of Asia Global Crossing. In order to further focus on Global Crossing, I resigned from the Asia Global Crossing Board. The time lag between my leaving AGC as CEO and then resigning from the Board represented nothing more than the time needed to take care of the mechanics.

Global Crossing required employees to stay for five years before selling stock that they held in their 401(k) pension plan. When the stock plunged, however, younger workers saw their pensions go down with their company. Why shouldn't Congress require publicly traded companies to allow the average employee to sell their shares more easily?

As you correctly observed, it is legal, as well as commonplace, for sponsors of 401(k) plans to restrain participants from trading company stock contributed by the employer to the accounts of plan participants. In Global Crossing's case, it required participants to hold on to the stock contributed by the company to their 401(k) account for a period of five years following the date of contribution. That type of "lockup" requirement was not unusual in terms of length; in fact, it was a feature of Rochester Telephone's 401(k) plan at the time that enterprise was merged with Global Crossing.

It is important to note that the lockup provision applies only to stock that was contributed by Global Crossing as a matching contribution (Global Crossing matched employees contributions up to 6% of their compensation). Thus, to the extent that the employee decided to use his or her own contributions to purchase Global Crossing stock, the employee was free to sell his or her holdings at any time.

Whether Congress should or should not further regulate or eliminate lockup provisions in 401(k) plans is a matter of legislative policy. In making a judgment whether to legislate restrictions on such provisions, Congress should weigh the advantages that favor allowing some period of lockup. From an employer's standpoint, it is advantageous to be able to issue stock to employees while restricting trading to some degree in order to

promote price stability and prevent dilution in the market. Moreover, employers generally find it desirable to encourage employees to invest in company stock, both to provide an incentive to be productive and to maintain a block of stock in the hands of those most interested in supporting management objectives.

Although Global Crossing did determine to eliminate entirely its lockup provisions for 401(k) participants as part of the consolidation of its 401(k) plans effective January 1, 2002, we nevertheless recognize that such provisions can benefit employees by maximizing employer contributions. Lockup provisions can serve to motivate employers to be more generous in matching participant contributions than they might otherwise be. If the company contributions were required to be made in stock that could immediately be traded in the market, employers might offer a lower match or none at all, thereby depriving employees of substantial assets over the life of their career. That is why we believe the Department of Labor, in its recent legislative initiatives, has not recommended complete elimination of such lockup provisions, but has instead suggested a maximum holding period of three to five years.

One further observation: depending on how they are designed, lockup provisions may have a greater impact on more senior employees, rather than younger employees. The more time an employee has with a company, the more likely the employee is to have a greater amount invested in contributions matched by company stock. Thus, lifting the lockup gradually or completely, may be an appropriate way to minimize risk to participants and maximize generous matching contributions by employers.

Global Crossing and Asia Global Crossing at one time shared both board members and key senior executives. Such links have caused many investors to be concerned as to whether and how they could be fairly represented. Do you agree or disagree with the appropriateness of this arrangement and the controversy surrounding it?

Prior to its initial public offering, the predecessor companies to Asia Global Crossing Ltd. had been owned as a joint venture between Global Crossing Ltd., Microsoft Corporation, and Softbank Corporation. After the initial public offering of Asia Global Crossing shares, Global Crossing had a 56.9 percent ownership interest in Asia Global Crossing and Microsoft Corporation and Softbank Corporation each had a 15.4 percent ownership interest in Asia Global Crossing. The remaining 11.8 percent of Asia Global Crossing was owned by the public and other strategic investors. The relationships between Asia Global Crossing, Global Crossing, Microsoft Corporation, and Softbank Corporation were disclosed to investors in connection with the initial public offering on October 12, 2000. Asia Global Crossing's registration statement included extensive discussions concerning the principal shareholders of the Company, including their voting rights arrangements, and the relationship between Global Crossing and Asia Global Crossing. Similar disclosures subsequently were made in other public filings of Asia Global Crossing, including its annual report for 2000 on SEC Form 10-K. In public

filings, the two companies also disclosed that the membership of their Boards of Directors overlapped significantly.

Ownership and director arrangements such as those described between Global Crossing and Asia Global Crossing in their public filings often exist in the case of affiliated companies. It is common and perfectly appropriate to have overlapping directorates and to share employees in order to realize economies that can result from the affiliation of distinct entities. In fact, we understand that government authorities have looked at such arrangements in other contexts and found them to be entirely acceptable. We believe the way in which Global Crossing and Asia Global Crossing have dealt with those arrangements has been proper.

More recently, as issues have arisen regarding the relationship between the shareholders and creditors of Global Crossing, on the one hand, and Asia Global Crossing, on the other, steps have been taken to reduce the extent of the overlaps on the boards and in management.

Mr. Legere, please explain your business relationship with the Blackstone Group? Please also explain to the Committee, how, as recently reported, that you failed to disclose what appears to be a particularly complex communications capacity swap with a Blackstone affiliate in the months before your declared bankruptcy?

In November 2001, Global Crossing retained The Blackstone Group L.P. to advise it in connection with its restructuring effort. At that time, the Global Crossing executives and the Blackstone Group executives who were working on the restructuring were unaware of the business relationship that was the subject of a recent New York Times *article. A conflicts check by the companies had not uncovered that relationship. It was through the* New York Times *article that the executives became aware that there was a pre-existing relationship between Global Crossing and Blackstone.*

More particularly, the transactions reported in the New York Times *article involved contracts with Centennial Communications Corp. The Centennial contracts were specifically disclosed in the Company's first quarter earnings release for 2001, long before Global Crossing had any business relationship with Blackstone. In these transactions, Centennial contracted with Global Crossing to purchase a substantial amount of capacity as the anchor tenant on a subsea system to be built in the Caribbean by Global Crossing. Global Crossing also agreed to purchase various telecommunications services and products from Centennial. In June 2001, Global Crossing and Centennial modified the value of the commitments made under the original March 2001 agreements. In December 2001, the parties restructured their agreements to reduce the amount of commitments of both parties.*

Investment funds managed by Blackstone hold an approximate 29.7% equity interest in Centennial. In addition, two Blackstone representatives were members of the nine-member Board of Directors of Centennial. Jack Scanlon, who was a member of the Board of Directors of Centennial, is a member of the Board of Directors and Vice Chairman of Asia Global Crossing Ltd., in which, as noted above, Global Crossing has a significant equity stake.

Global Crossing and Blackstone have since filed statements with the Bankruptcy Court fully disclosing the relationship between the companies and their respective affiliates. Blackstone has stated to the Bankruptcy Court that none of its professionals handling its relationship with Global Crossing have had or will in the future have conversations with the Company's management concerning Centennial; have been or will in the future be involved in any aspects of Global Crossing's agreements with Centennial; or are responsible for managing the Centennial investment. We continue to believe that Blackstone does not have any business relationship with Global Crossing that would preclude it from acting as an advisor to Global Crossing or from fully carrying out its professional obligations to Global Crossing.

Please also explain how senior Global Grossing executives continued to receive severance benefits while low ranking employees lost theirs completely.

On the date that the Company commenced its bankruptcy proceedings, all severance benefits ceased for all employees, including executives, who left the Company prior to that date. As required by bankruptcy law, those with unpaid severance benefits hold claims as unsecured creditors of the Company.

It has been alleged that the $750 million offer made for your assets would only allow for creditors receiving four cents on every dollar. What can your shareholders and employees expect to derive from such an agreement?

The $750 million bid by Hutchison Whampoa Ltd. and Singapore Technologies Telemedia Pte. Ltd. for Global Crossing assets is but one of the many bids that Global Crossing anticipates will be made for its assets; that bid specifies that no value will be preserved for the current shareholders. At the time the Company filed for bankruptcy, we anticipated that other potential bidders would emerge and that the bankruptcy process would ensure that every bid would be fully and fairly evaluated with a view to maximizing the value of the Company. As anticipated, approximately 60 parties have expressed interest in some or all of the Company's assets. We understand that the Bankruptcy Court currently has imposed a June 20 deadline for the submission of bids by interested parties. The Bankruptcy Court is scheduled to consider those bids and the potential disposition of Global Crossing assets in July.

The Bankruptcy Court overseeing the bidding process ultimately will decide which, if any, of the bids is most beneficial to the bankrupt estate. Although the Bankruptcy Court could reject all of the bids and allow Global Crossing to continue as an independent operation, if the Court determines that one or more of the bids should be accepted, we understand that the Bankruptcy Judge will allocate the proceeds from a sale of assets among its creditors in the manner that is required by the Federal bankruptcy laws. Unfortunately, given the priority of recovery mandated by the bankruptcy laws, there is seldom any recovery for the shareholders at the conclusion of bankruptcy proceedings. Please be assured that, consistent with obligations to our creditors in the bankruptcy proceeding, we are working to preserve as many jobs as possible at Global Crossing.

It has been alleged that Arthur Andersen signed off on many transactions due at least in part to pressure brought by Executive Vice President of Finance Joseph Perrone. Mr. Perrone, interestingly served originally as the chief audit officer at Arthur Andersen on the Global Crossing account. Please comment on this most serious allegation?

Mr. Perrone resigned from Andersen on April 27, 2000 and joined Global Crossing in May 2000. While he was at Andersen, he had been in charge of the media and communications practice in Andersen's New York office. Prior to the commencement of his employment by the Company, the following steps were taken:

- *Severing of all financial interests between Mr. Perrone and Andersen. Mr. Perrone's capital account, retirement benefits and all other financial obligations to or from Andersen were settled in cash prior to the commencement of his employment by the Company.*
- *A review of previous audit work by an independent partner at Andersen.*
- *A review to ensure that the Andersen team that would conduct all audit work for the future was independent of any influence from Mr. Perrone.*

Andersen assigned Mark Fagan, a telecommunications audit partner, to be responsible for the first quarter 2000 review of the Company. Since then, Mr. Fagan has been responsible for all of the quarterly and annual audits of the Company. Neither Mr. Fagan, the practice director nor the concurring partner of Andersen reported to Mr. Perrone in any capacity during his tenure at Andersen with respect to significant accounting policies relating to the Company and their accounting for specific transactions. Finally, Mr. Perrone's independence was discussed by Andersen with the Chairman of the Company's Audit Committee and, later, with the entire Audit Committee.

Andersen undertook separate and independent review of the accounting for the Company's concurrent sales and purchases of capacity to and from carrier-customers as part of its quarterly review of the Company's books. In the course of these reviews, Global Crossing and Mr. Perrone accorded Mr. Fagan and his colleagues full access to these materials and any other materials they required to complete the audit. Mr. Fagan and the Andersen team also had unrestricted access to the management team at Global Crossing as well as to the Audit Committee. Each meeting of the Audit Committee included an executive session that excluded Mr. Perrone and other members of management (although the executive session included the Vice President of Internal Audit). These sessions afforded ample opportunity for Andersen to express privately with the Audit Committee any concerns they had over independence or other issues.

In addition, these transactions were reviewed with the Chairman of the Board's Audit Committee. The audits of the Company's books prepared by Andersen also were reviewed with the Audit Committee. At no time did Mr. Perrone ever apply any pressure on or seek to influence Andersen regarding the Company's accounting for any transactions. Indeed, with respect to establishing accounting policies and with regard to several of the most significant transactions, Mr. Perrone and his colleagues specifically solicited the views of Andersen regarding the appropriate accounting.

The February 21 *Wall Street Journal* reported that Global Crossing moved up its last pay date by a week so that executives and others still employed could get paid before declaring bankruptcy on Jan. 28. Was that the real reason? Why did Global move the date?

The Company issued employees' semi-monthly and bi-weekly paychecks early. Employees were paid on January 23, 2002 for payments originally scheduled for January 31, 2002 and February 1, 2002. This early salary payment was made after consulting with counsel and based on our understanding that early salary payments are a common practice used to manage cash in the bankruptcy process. This early salary payment did not result in any additional payments to Global Crossing employees or executives, but merely helped to ensure that there would be no delay in salary payments to Global Crossing employees, regardless of level, as a result of the bankruptcy filing. Since the commencement of the bankruptcy proceedings, payrolls are being processed in accordance with the regular schedules.

There have been reports of severance and buyout checks bouncing, leaving former employees gasping for some economic security. Can you assure everyone who lost their job at Global that the checks promised to them will eventually be paid? Are you willing to forego some of your own benefits to stand behind Global's promise to pay those checks?

Bankruptcy law precludes the Company from making payments to employees who were terminated prior to the commencement of the bankruptcy proceedings. When Global Crossing filed its bankruptcy petition, our former employees became unsecured creditors in the bankruptcy. Bankruptcy laws dictate the relative priority of all creditor claims. These priorities generally range from administrative claims like taxes to secured creditor claims, to unsecured creditor claims, to preferred shareholder claims and to common shareholder claims. I sincerely wish that the Company could pay all of its former employees in full, but the bankruptcy laws do not allow the Company to do so. Moreover, foregoing some or even all of my compensation would in no way amount to a meaningful payment to those who hold claims against Global Crossing.

APR 1 3 2002

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April 15, 2002

The Hon. Sue W. Kelly, Chairwoman
Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives
1127 Longworth House Office Building
Washington, D.C. 20515

Global Crossing Ltd.

Dear Ms. Chairwoman:

We are counsel to Global Crossing Ltd. (the "Company") and to John Legere and Dan Cohrs, who appeared before the Subcommittee on Oversight and Investigations on March 21, 2002.

I am writing to clarify a statement in the written submission of Messrs. Legere and Cohrs to the Subcommittee. In the context of discussing a letter regarding accounting practices that the Company received from a former employee, the written submission states at page seven that "the Company did engage outside counsel to review the matter, and outside counsel found the allegations to be without merit." That clause should have said that "the Company did conduct a review of the matter and consulted with outside counsel, and the Company concluded that the allegations were without merit."

Although we have not seen a copy of the transcript of the hearing, to the extent that any statements were made concerning the Company's review of the allegations by the former employee, those statements too should reflect that above clarification.

Please do not hesitate to contact me if you have any questions about this matter.

Very truly yours,

Ralph C. Ferrara

By Hand

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Testimony

of

Afshin Mohebbi
President and Chief Operating Officer
Qwest Communications International Inc.

Before

The Committee on Financial Services

March 20, 2002

My name is Afshin Mohebbi and I am President and Chief Operating Officer of Qwest Communications International Inc. I want to thank you for inviting us to appear today at your hearing on the effects of the Global Crossing bankruptcy.

Permit me to tell you a little about Qwest. Qwest is a local telephone company with 25 million customers. We provide local telephone service in a 14-state area throughout the West. We have 60 thousand employees and annual revenues of more than $19 billion. About eighty percent of our revenues and more than 90 percent of our profits come from our local phone service. We also provide data and long-distance services to businesses in 27 cities outside the 14-state local service area. And, we are the nation's fourth-largest long-distance company.

Six of the country's 10 fastest-growing states have Qwest as their local phone company. Qwest completes 240 million phone calls and carries 600 million e-mails daily. In addition, we have about a half-million high-speed Internet service customers; a million wireless customers; a large Yellow Pages business; and a product line that ranges from the most basic telephone service to the most sophisticated Internet and data technologies available.

As described below, Qwest has a state of the art worldwide fiber optic network in the United States, Asia and Latin America and, through its related company KPNQwest, in Europe. In addition to its fiber optic network, Qwest has sixteen web hosting centers that safeguard the critical data of banks, corporations, health care providers and government agencies among others. Qwest does business with 60 percent of the Fortune 1,000 companies.

Qwest developed its 190,000 mile domestic and international fiber optical network mainly to service multinational business customers. Qwest's optical network is among the most advanced in the world. More than 4.2 billion megabits of traffic travel across the network at any given time.

Qwest's strategy in building its domestic network was to provide facilities for our own use as well as constructing facilities for sale. Conduit, fiber and capacity sales have paid for substantial portions of the cost of building our US network.

As we completed our domestic network, we began to expand overseas. We made decisions whether to build or buy these international facilities based upon analyses of time and cost. We purchased facilities to connect our network to Europe, Asia, and Latin America.

It was in this context that we entered into IRU transactions with Global Crossing and others. The IRUs Qwest sold to Global Crossing were principally on domestic routes we built to sell. The IRUs Qwest purchased from Global Crossing enabled us quickly and cost-efficiently to build out our network internationally to locations that we could not otherwise serve.

An IRU is an Indefeasible Right of Use, which is the exclusive right to use a specified amount of capacity or fiber for a specified period of time, usually 20 years or more. An "indefeasible right" is one that cannot be revoked or voided. IRUs are for specific point-to-point assets. IRUs are not services and are generally asset sales. Once sold, they belong to the customer and cannot be moved without the consent of the customer. An IRU allows the purchaser to carry voice, data, and video traffic on that specific fiber or channel.

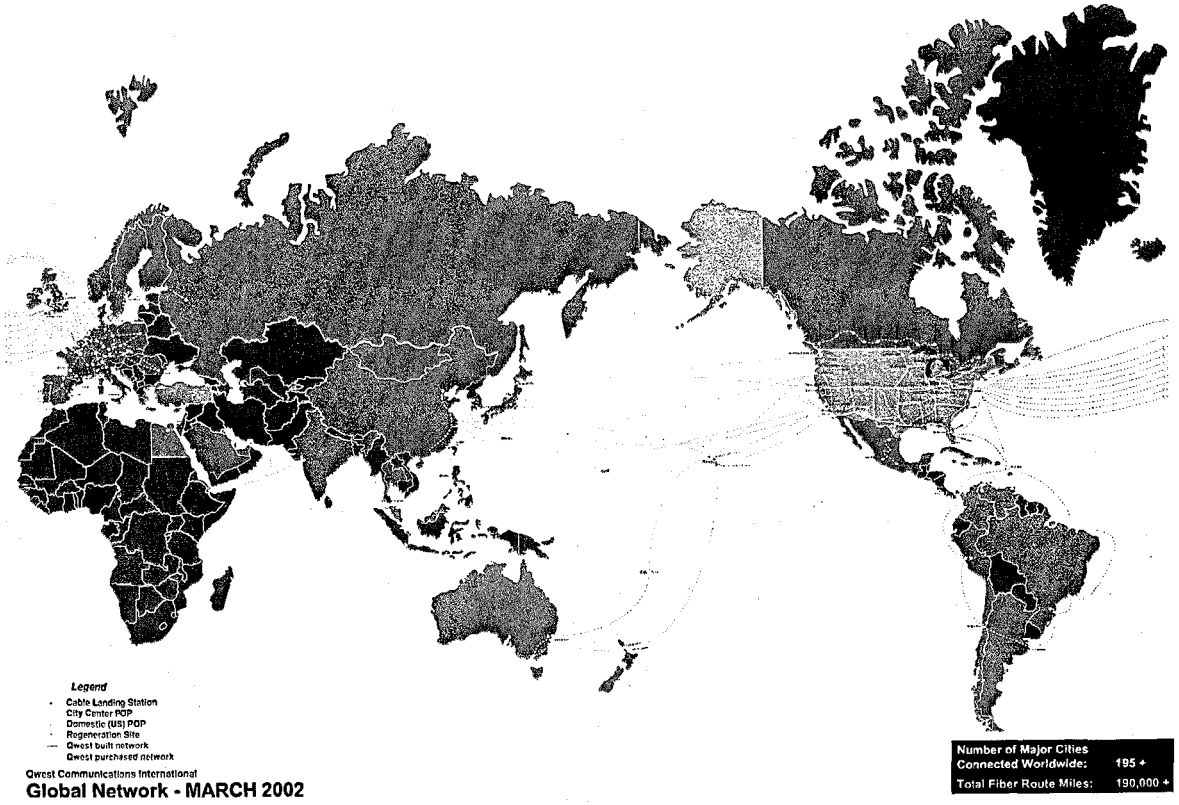
In some cases, Qwest enters into two transactions that occur at the same time: one to sell IRUs to companies and a second to acquire optical capacity from such companies. The agreements for the sale of such optical capacity are separate legal agreements that are enforceable regardless of whether the other company performs under the separate purchase contract.

In accounting for the purchase and sales of IRUs, Qwest complies with generally accepted accounting principles (GAAP). Qwest's auditors review our IRU transactions in the context of reviewing our financial statement each quarter. When Qwest sells IRUs the customer receives the exclusive right to a specific asset, and the risks and rewards of ownership pass to the buyer. Under the relevant accounting rules, Qwest recognizes revenue when Qwest delivers the asset, the buyer accepts it, and Qwest receives adequate consideration. Where the purchase and sale transactions occurred at the same time, Qwest applied the more restrictive rules for revenue recognition on what the accountants call "nonmonetary transactions." The revenues attributable to IRU sales that occurred at the same time as purchase of an IRU in 2000 and 2001 were approximately 2 percent and 3.5 percent of total reported revenues, respectively.

Qwest publicly disclosed the network expansion plans and the nature, size, and accounting treatment of the IRU transactions undertaken to further that strategic objective. In various press releases and filings with the Securities and Exchange Commission, Qwest made appropriate disclosure of the existing of the IRU transactions and the way Qwest accounted for them.

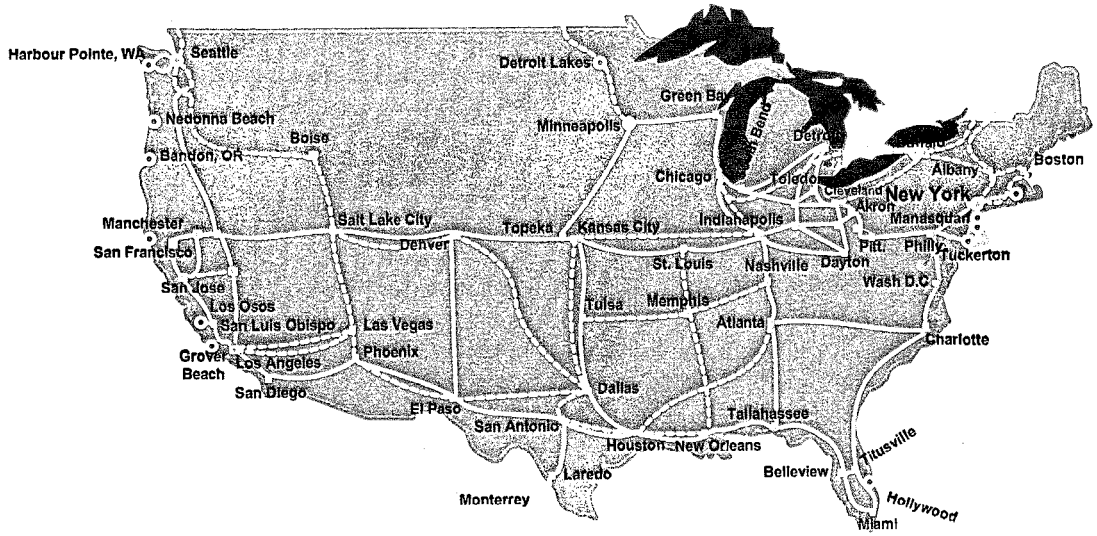
In conclusion, as part of our business strategy to build a worldwide fiber optic network, we bought and sold IRUs. When appropriate and in compliance with GAAP, we recognized revenue – as well as cost – from these transactions when we entered into them. And although IRUs were not a material component of our revenues in the last two years, we publicly disclosed them and how we accounted for them.

We are proud of the state of the art network we have built and the service it enables us to provide, and I will be glad to try and answer any questions you may wish to ask me.



Qwest Communications International

Global Network - MARCH 2002

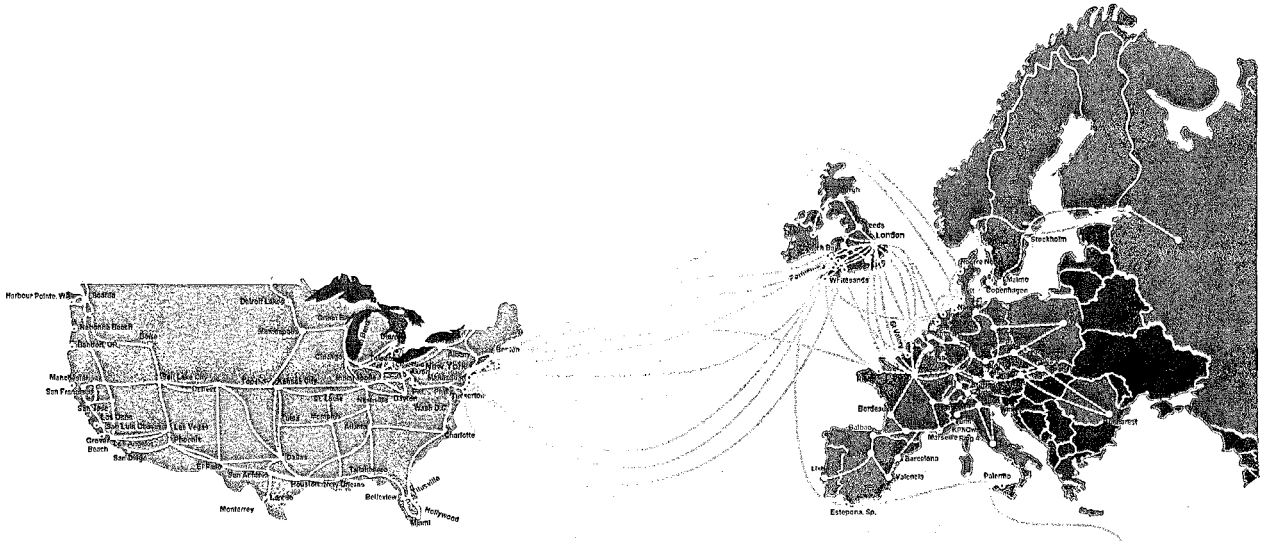


Legend

- Cable Landing Station
- City Center POP
- Domestic (US) POP
- Regeneration Site
- Qwest built network
- Qwest purchased network

Qwest Communications International

United States Network - MARCH 2002



Legend

- Cable Landing Station
- City Center POP
- Domestic (US) POP
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Qwest Communications International

United States / Europe Network - MARCH 2002

Qwest
1801 California Street, Suite 5200
Denver, Colorado 80202

April 24, 2002

The Honorable Sue W. Kelly
Committee on Financial Services
Subcommittee on Oversight and Investigations
United Stated House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Kelly:

I write as requested to respond to the questions posed by you, sent by letter dated April 8, 2002 from Hugh Nathaniel Halpern to me. Under separate cover, as Mr. Halpern instructed, my Washington office has today delivered the corrections to the portions of the transcript of the proceedings sent to me.

Based on information made available to me, the responses to your questions are as follows:

Q: Are you in agreement with statements from various analysts that the value of your company would not be as low as it currently stands, had it not been for the bankruptcy of Global Crossing?

A: **No. We have experienced difficulties in achieving results that would lead to a higher valuation for a number of reasons. As we have stated publicly, most recently in our investor call of April 18, 2002, our results have been adversely impacted by pressures on the entire telecommunications sector as well as a continuing economic downturn in our local service region. The bankruptcy of Global Crossing may have been a symptom of the ailing industry, but it was only one.**

Indeed, the entire industry, as the Committee knows, is under pressure not only because of accounting concerns, but, more fundamentally, because of broader economic conditions, over capacity in portions of the industry, and a number of bankruptcies.

Q: What did your CEO, Mr. Nacchio mean when he said that "Qwest was a victim of Enronitis that has opened a new era of corporate McCarthyism?"

A: **That statement, a quotation of an article that originally appeared in the March 11, 2002 edition of *TheStreet*.com, is a purported paraphrase of Mr. Nacchio. It both mistates what he said, and leaves out the context in which he said it.**

At an industry conference in March, Mr. Nacchio explained that much of the recent drop in value in the telecommunications sector has been a function of structural economic changes, that such changes are not unexpected, and that, in time, the industry will recover. It was in this context that he stated the following: "[The current economic situation] is not unexpected in terms of the way telecom generally leads and lags out of a recession or a downturn. I think clearly we've got this Enronitis that breeds greater suspicion of sector [sic] in individual companies. A little bit of corporate McCarthyism. But we'll all work through that and I think the industry is poised to move with the economy."

Mr. Nacchio does not believe — nor did he state — that governmental inquiry into accounting practices is an improper use of government authority. However, in this post-Enron era, some appear to immediately conclude that any drop in value in the telecommunications sector must be attributed to (or is a reflection of) something improper. Such conclusions are unreasonable and unfair.

Q: In Mr. Legere's testimony, he said that the IRU's did not play a significant role in Global Crossing's problems. In your opinion, have the revelations about the cash flow presentations of a number of telecom companies led to a loss of confidence by investors?

A: **I do not know specifically what did or did not contribute to Global Crossing's problems. As for the telecom sector generally, I think the atmosphere of anxiety that now exists regarding accounting practices probably has affected investor confidence. However, the question of investor confidence, I believe, is also affected by other aspects concerning the telecommunications sector, including the large number of bankruptcies. Most importantly, however, as I noted before, investors are doubtlessly (and understandably) responding to the softness in the economy that directly affects this sector.**

Q: Does Qwest believe that the change in treatment of revenue earned from IRUs mandated by the FASB in 1999 was fairly and carefully considered and took into account the realities of your business? Did it come at a bad time for your business?

A: **I assume that you are asking about the issuance of Interpretation No. 43 ("FIN 43") of the Financial Standards Accounting Board ("FASB"). FIN 43 was not specifically concerned with IRUs; rather, FIN 43 clarified the definition of "all real estate sales" as that phrase had been used in FASB Statement 66, which governs the "Accounting of Real Estate Sales."**

In pertinent part, FIN 43 provided that Statement 66 applied to "all sales of real estate, including real estate with property improvements or integral equipment. The terms *property improvements* and *integral equipment* as they are used in [FIN 43] refer[red] to any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring a significant cost." (FIN 43 ¶ 2; emphasis in original)

While FIN 43 was not specifically concerned with IRUs, based on the analysis of Qwest and its independent outside auditors, from the effective date of FIN 43 we have treated

IRUs of dark fiber and capacity as sales of integral equipment and applied FAS 66 and 98 in assessing whether sales type lease accounting is appropriate for these IRU transactions.

I do not believe that the issuance of FIN 43 came at a bad time for Qwest's business. It did not necessarily change the treatment of revenue from IRU transactions; rather, it only required that the more stringent requirements of FAS 66 and 98 be applied to determine if sales-type lease treatment is appropriate. Because these more stringent requirements were generally met in IRU transactions after the issuance of FIN 43, the change had little or no effect on our business.

Q: Has any aspect of the Enron matter led to changes in your accounting policies or relationship with your corporate auditor?

A: **Given the general concerns that have been expressed publicly related to the recent indictment of Arthur Andersen and the discussions about the future of that company, Qwest's Board of Directors has been reviewing the engagement of Arthur Andersen. Our Board makes the final determination regarding our independent auditor. They have made no changes at this time. Qwest has determined that it will not use Arthur Andersen to perform any new consulting work for it.**

On April 15, KPMG LLP announced that it has entered into a non-binding letter of intent to acquire a number of Arthur Andersen offices, including the Denver practice, which has served as Qwest's auditor since 1999. Qwest will be looking into this development and evaluating it in terms of its own engagement.

Q: In December, the SEC issued cautionary advice about preparing pro forma financial statements. How has that guidance changed how you go about preparing and presenting pro forma statements?

A: **This guidance did not change Qwest's preparation and presentation of its earnings releases. Qwest's current earnings release format, which was adopted months before the Commission's December advice, already met the standards set forth by the Commission in its December 4, 2001 Release regarding pro forma earnings. In particular, even prior to the December release by the Commission, Qwest's earning releases explained how Qwest's pro forma results differed from its results calculated in accordance with GAAP, and described the amount of these differences.**

Q: Shouldn't the SEC take steps to require a more consistent presentation of cash flow estimates on pro forma statements within the telecom industry?

A: **Clear and reasonable guidance from the SEC concerning consistent presentation of pro forma results certainly would be acceptable.**

Q: Are there particular proposals that have been discussed in Congress to resolve accounting and disclosure issues that most concern you?

A: **Qwest recognizes the importance of the oversight of corporate governance as outlined by legislation introduced by the Chairman of the House Financial Services Committee, Mr. Oxley, and cosponsored by Oversight and Investigations Subcommittee Chairwoman Kelly and a number of other members on the House Financial Service Committee.**

H.R. 3763 is aimed at better protecting individual investors by improving the accuracy and reliability of corporate disclosures made to the public. The legislation is also aimed at strengthening the enforcement ability of the Securities and Exchange Commission. Qwest supports both goals.

There have been numerous bills introduced in 2002 regarding accounting and auditing rules and public disclosure. Qwest continues to study those many other proposals.

Q: Global Crossing and Asia Global Crossing at one time shared both board members and key executives. Such links have caused many investors to be concerned as to whether and how they could be fairly represented. Do you agree or disagree with the appropriateness of this arrangement and the controversy surrounding it?

A: **Qwest is not sufficiently familiar with the internal corporate structure of Global Crossing or its affiliates to opine on the propriety of its actions that may have affected investors or the controversy surrounding such actions.**

Q: We know that Global Crossing recently employed a black-out period on 401(k) plans. Has Qwest ever employed such a black-out?

A: **Restriction periods are routine and implemented whenever plan changes or system updates are needed. These plan changes are beneficial to participants and we strive to implement them over a weekend or other periods when the markets are closed or expected to be quiet. Restrictions in which system providers are changed or plans are merged, as in the second instance outlined below, require more time to transfer and reconcile all participant records.**

Recently our plans had two planned restriction periods: One when the investment options were enhanced; and a second when two 401(k) plans were combined.

The first began at 4:00 PM on Friday, July 6, 2001 (Friday) and ended at 9:00 AM the following Monday. The entire period occurred during the time the New York Stock Exchange was closed. Participants were notified of the restriction in advance, during the week of June 18. This action resulted in a new set of investment choices for participants.

The second restriction period came in conjunction with our efforts to integrate US WEST and the pre-merger Qwest. In late 2001, Qwest merged the two separate 401(k) plans that resulted from the merger of the two companies. As part of the merger of the two plans, from 4:00 PM December 21, 2001 through mid-day Saturday, January 19, 2002, 18 business days, employees who had been members of the pre-merger Qwest plan — including all senior pre-merger Qwest executives — could not re-direct payroll contributions, initiate fund transfers, take new loans or take withdrawals. Employees who had been members of the US WEST 401(k) plan had similar limitations from 4:00 PM on Friday, January 18 until mid-day Saturday, January 19.

The limited restriction applied equally to all personnel, regardless of rank or position, and no senior executive sold Qwest stock, of any kind, during that restriction period. The purpose of the action was to offer one consistent 401(k) plan to all employees and to reduce costs associated with maintaining two 401(k) plans. All participants received notice of the merger as early as June 2001, and, in September 2001, of the dates of the proposed restricted period. Notice was provided again in November and mid-December.

Q: Has Qwest seen the need to institute rules that would disallow senior executives from selling stock during a 401(k) black-out?

A: **Whatever the actions of other companies, Qwest does not believe that such rules are necessary for the black-out initiated by Qwest. The restriction period was limited; all affected employees were treated equally; and there were no non-plan stock sale restrictions on any employee.**

Q: Has Qwest ever considered instituting or implementing a coordinated set of rules that would treat all employees equally during such a black-out period?

A: **All employees were treated equally during the limited restriction period.**

Q: Qwest spokesman, Mr. Michael Tarpey, stated during a February 7th, 2002 interview that between 1998 and 2001, Qwest "bought and sold several hundred million dollars of specific capacity amounts, which were not undefined amounts with Global Crossing, and paid and collected cash in each deal, completed both sides of any given swap in the same quarter and followed GAAP accounting rules when recording the deals."

a) Do you agree with Mr. Tarpey's summary of those transactions with Global Crossing?

A: **Contemporaneous transactions with Global Crossing did not occur until 2000 and continuing into 2001. At that time, when Global and several other companies had begun to build out international routes which Qwest wanted, Qwest sold approximately $ 313 million over two years to Global in contemporaneous transactions in which Qwest**

acquired capacity in East Asia, trans-Pacific routes, and Latin America at far less cost than would have been involved if we had built our own global network. The total cost of these purchases from Global in 2000-2001 was approximately $440 million. In 2001 and 2000, total recognized revenue on optical capacity asset sales was only 5.1% and 2.8%, respectively, of the Company's total revenues, and Global Crossing transactions represented only a fraction of that.

b) How did Qwest account for these lucrative sales?

A: **As an initial matter, I respectfully disagree with the assumption that these sales were "lucrative". They constituted only a fraction of Qwest's overall revenue and in terms of margins were not the highest margin part of Qwest's business.**

As for accounting: In contemporaneous transactions — in which Qwest sells and buys optical capacity from the same third party in the same time period — the agreements for the sale of the capacity are separate legal agreements that are enforceable regardless of performance under the purchase contract. It is Qwest's policy that prior to recognizing revenue on these sales transactions, it obtains acceptance of the delivered route from the buyer and generally receives all or a significant portion (at least 25%) of the sales proceeds in cash. Qwest has the ability to retain the cash received regardless of the buyer's performance under the purchase contract. Therefore, Qwest believes these are legally enforceable, cash transactions.

Also, Qwest generally applies the more restrictive "nonmonetary" transaction accounting guidance to these contemporaneous transactions. This guidance is contained in Accounting Principles Board ("APB") Opinion No. 29, "Accounting for Nonmonetary Transactions" and EITF Issue 01-02, "Interpretations of APB Opinion No. 29." Applying these standards, exchanges of Qwest optical capacity held for sale in the ordinary course of business for the counterparty's optical capacity to be used in Qwest's operations are recorded at fair value. Otherwise, the exchanges are recorded at the lower of historical cost or fair value. Qwest recognizes revenue based on fair value for these contemporaneous transactions principally based on the following factors: (1) whether the assets exchanged are dissimilar (assets held for sale in the ordinary course of business for assets to be used to provide telecommunication services), (2) whether fair value can be determined within reasonable limits and (3) whether, from an accounting perspective, the earnings process is complete.

c) What companies were involved and what was the value of each swap?

A: **In addition to contemporaneous IRU transactions with Global Crossing (in 2000 and 2001) and Asia Global Crossing (in 2001), Qwest entered into contemporaneous IRU transactions during 1999-2001 as follows:**

1999	360 Networks (aka Worldwide Fiber, Inc.), ACSI (E.Spire), Digital Teleport, Inc., Electric Lightwave, Inc., Enron Communications, ICG Telecom Group, Inc., Primus Telecommunications, Inc., Verio Incorporated
2000	Broadband Office, Cable and Wireless Global Network Ltd., Enron Broadband Services, ICG Equipment, Inc., KPN Qwest Carrier Services, Metro Fiber Network Services, Inc., Network Plus, Inc., Nextlink Communications, Inc., Pathnet Telecommunications, Singapore Telecommunications Ltd., Worldwide Fiber Networks, Inc. (360 Fiber)
2001	Adelphia Business Solutions, AEP Communications LLC (C3 Communications), Cable and Wireless, China Netcom Corporation, Enron Broadband Services, Flag Asia, Metromedia Fiber Network, Network Plus, Inc., New World Telephone, OnFiber Communications, PF.NET Construction Corporation, Singapore Telecommunications Ltd., BCE Nexxia Inc., Teleglobe, TyCom Networks, Winstar Wireless, XO Michigan

In 2001, 2000 and 1999, respectively, Qwest recognized revenues from these sales in aggregate amounts that accounted for 5.1%, 2.8% and (approximately) 4.5% of its total revenues.

d) Why did Qwest not announce the value of these transactions in company press releases?

A: **Qwest typically issues press releases (1) when it determines that disclosure of a particular transaction or event is required by the securities laws (either because it is required to be disclosed on Form 8-K or otherwise) and (2) occasionally to announce transactions or events that may be of particular strategic importance, including where the parties to a transaction have agreed to a mutual press release, or of interest to investors or other third parties, irrespective of the dollar value or impact associated with those transactions or events. Any releases of Qwest's optical capacity transactions would have fallen into one of these two categories. The only announcement of a transaction with Global Crossing was in 1998. Since this was a release under (2) above, no value was provided.**

e) Why was this not shown in the 2001 10-Q [sic] along with the other IRUs shown in exhibits 10-15 through 10-17?

A: **Exhibits 10.15 to 10.17 to Form 10-K for the year ended December 31, 2000 are Qwest's original agreements with Frontier, WorldCom and GTE for the sale of dark fiber, dating, respectively to 1996, 1996 and 1997. These agreements constituted a key source of funding for the initial build-out of Qwest's network and transferred a significant portion of the network that was to be constructed. Accordingly, these agreements were disclosed starting in 1997 with Qwest's registration statement in connection with its initial public offering. Unlike the Frontier, WorldCom and GTE transactions, the sales**

and purchases of capacity to and from Global Crossing were entered into in the ordinary course of business and did not otherwise qualify as "material contracts". Qwest follows the requirements of Item 601(b)(10) of Regulation S-K in determining whether contracts are required to be filed as exhibits to its filings. As such, the agreements with Global Crossing were not included as exhibits to the interim or annual reports for the year ended December 31, 2000.

Q: How does your company define the "legitimate business purpose" behind individual IRU capacity swaps?

A: **Qwest engaged in its optical capacity purchases and sales, whether or not occurring in the same quarter, for legitimate business purposes in order to efficiently, quickly and at low cost deliver global broadband telecommunications services.**

Over the last five years, Qwest has grown from a domestic wholesaler provider of telecommunications with 200 miles of network facilities in the Western U.S. to a global provider of broadband communications services with more than 190,000 miles of network facilities around the world.

The purchase and sale of IRUs has been a core business strategy for Qwest in building our network. We decided early in the process of building that network, that it was less expensive and significantly faster to buy international and certain domestic routes than to build them on our own. Simply stated: we wanted to be able to service our customers first, with maximum availability, and to compete on price.

At the same time, when Qwest first built its domestic network, it was part of its business plan to install a substantial quantity of fiber for sale to other carriers. Those sales of fiber financed a significant portion of Qwest's costs in building other parts of its network, particularly the international portion. Thus, sales of fiber and capacity assisted us in buying capacity for our needs.

I appreciate the opportunity to have testified before the Committee and to respond to your questions.

Respectfully submitted,

Afshin Mohebbi

STATEMENT OF
MICHAEL H. SALSBURY
EXECUTIVE VICE PRESIDENT & GENERAL COUNSEL
WORLDCOM, INC.
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
MARCH 21, 2002

My name is Michael Salsbury, and I am the General Counsel of WorldCom, Inc.

The questions and issues that the Subcommittee seeks to address in this hearing – how accounting standards and federal policies may have contributed to the problems experienced by Global Crossing and the industry – are valid and important.

The competitive sectors of the telecommunications industry have experienced difficult times recently, primarily as a result of the failure of the Federal Communications Commission (FCC) and the Department of Justice (DOJ) to engage in timely and effective enforcement actions. Accounting issues also have contributed to the problems experienced by some companies. The Subcommittee is correct to be considering both federal policies and accounting issues at this hearing.

About WorldCom

Before specifically addressing questions posed by the Subcommittee in its invitation to testify, it may be of benefit to Members to have some background information about WorldCom.

WorldCom is a global telecommunications company with operations in more than 65 countries. In 2001, WorldCom had revenues of $35.2 billion and net income of $1.4 billion. Our global workforce of 85,000 employees is dedicated to developing and delivering a broad range of data and voice services to more than 20 million enterprise and consumer customers around the world.

WorldCom is a facilities-based carrier. In the last three years alone, WorldCom has invested more than $23 billion in its network. Today, WorldCom owns the world's most extensive and modern end-to-end data and voice communications network. We have wholly-owned facilities throughout North America, Latin America, Europe, the Middle East, Africa and the Asia-Pacific region, as well as ownership in private and consortium undersea cables.

By leveraging the strengths of its operating units – the WorldCom Group and the MCI Group -- WorldCom, Inc. continues to expand its market leadership in data, internet and international services, the growth drivers of the telecommunications industry:

- The WorldCom Group comprises the company's data, internet, managed and hosted solutions, international, and voice services for enterprise customers worldwide. WorldCom is the largest carrier of internet backbone traffic in the world. Also, WorldCom last year surpassed AT&T as the world's largest carrier of international traffic.
- The MCI Group comprises WorldCom's long distance and local consumer voice, wireless messaging, and wholesale private line and dial-up internet access businesses.

WorldCom's Accounting Practices with respect to IRUs

The Subcommittee's March 14, 2002 letter asked if WorldCom has engaged in "swap" transactions of indefeasible rights of use (IRUs) with Global Crossing and other carriers and, if so, how the value of these transactions was reported.

There has been a lot of press recently about "swap" transactions whereby carriers record revenue from "selling" capacity that is not likely to be used in return for a "purchase" of capacity that is not used and is capitalized rather than expensed. WorldCom does not participate in such transactions. WorldCom sells IRUs and occasionally purchases them where needed, but in all cases accounts for them appropriately.

An IRU is the right to exclusive use of a specified amount of capacity on a specific network facility for a specific term, generally the useful life of the facility. IRUs often are described as a "condominium-like" right. Prior to mid-1999, the general practice in the industry was to treat IRU sales like the sale of a condominium – the sales revenue was recognized in full when the transaction became effective and the appropriate fixed asset account was reduced by the cost of the facilities covered by the IRU. During June 1999, FASB Interpretation No. 43 was issued which, WorldCom was advised, effectively concluded that IRU sales generally should be treated as operating lease transactions with recurring revenue recorded ratably over the life of the IRU. During 2001, in accordance with FIN 43, WorldCom recorded recurring revenues of approximately $23 million (out of total revenues of $35.2 billion) from the sale of IRUs.

Although WorldCom is a facilities-based carrier, occasionally WorldCom does purchase IRUs from other carriers where we have a need, that is, in areas where WorldCom either does not have network or where our available network capacity is fully utilized. In those situations, WorldCom treats the purchase of an IRU just as it would a sale, that is, prior to mid-1999 WorldCom capitalized the cost of the IRU when it became operational and, after mid-1999 WorldCom expensed the cost of the IRU ratably over its term.

During December 2001, WorldCom entered into two IRU transactions with Asia Global Crossing (AGC). WorldCom purchased needed capacity on AGC's East Asia Crossing cable and AGC purchased capacity on WorldCom's Australia-Japan cable. Each transaction was for $20 million over a 10-year term. Because neither lease has yet become operational, WorldCom has not yet recognized either transaction on its P&L. As each IRU becomes operational, WorldCom will recognize approximately $0.5 million per quarter in revenue and expense over a 10-year period.

Unless otherwise disclosed by carriers, investors should expect that IRU transactions will be recognized by companies pursuant to accounting standards in effect at the time of the transactions.

Factors Contributing to the Industry's Problems

The Subcommittee also asked to what extent the following factors served as a "trigger" for industry problems:

- Use of unique accounting standards and the issue of pro forma revenue projections.
  WorldCom does not use unique accounting standards and does not issue pro forma revenue projections. As many companies do, WorldCom issues pro forma profit/loss statements to show the effect of acquisitions or of revenue from consolidated entities. WorldCom believes such statements assist investors in understanding the impact of certain transactions.

- Invalid assumptions about the growth of capacity, leading to excessive debt levels.
  It has become fashionable recently to blame the large number of failures in the competitive sectors of the telecommunications industry on bad planning. These claims – which generally emanate from the monopoly sectors of the industry and their pundits, but occasionally also from regulators – suggest that new entrants invested too much in new facilities and mis-forecast the demand for telecom services. There may well have been invalid assumptions by new entrants, but they related more to the expectation that federal regulators would fairly and vigorously enforce the telecommunications and antitrust laws than to assumptions about consumer demand. By repeatedly favoring monopoly interests and undermining competition, these regulators increased the costs for new entrants, which led directly to higher prices and lower consumer demand for local telephone services and high-speed data services such as DSL.

- Federal telecommunications industry policies.
  Congress established the right pro-competition policy direction in the historic Telecommunications Act of 1996. The Act was intended to open the Bell companies' local monopolies to vigorous competition – in particular to competition among the Bell companies themselves. The active involvement of federal and state regulators was a *sine qua non* in achieving the Act's goals. As noted, shareholders of competitive telecommunications providers and equipment manufacturers invested

billions of dollars in reliance that the law would be implemented and enforced as intended.

Instead, incumbent monopolies have successfully sabotaged the Act and federal enforcement efforts have been wholly ineffective:

- The Bell companies almost immediately embarked on a litigation strategy to frustrate and delay implementation of the Act. Six years after enactment of the Telecom Act, for example, we still do not have certainty over the prices Bell companies must charge for leasing unbundled facilities to competitors.

- The DOJ under Joel Klein consistently allowed the Bell companies to consolidate and expand their monopoly power through merger rather than to compete against each other as intended by the Telecom Act.

- The FCC under Bill Kennard and Michael Powell consistently has adopted policies that favored the interests of monopoly providers over competitive providers and failed to enforce existing policies designed to promote competition. When competitive DSL providers attempted to bring high-speed broadband services to residential and business markets, the FCC failed to enforce requirements that Bell companies unbundle their networks as required by the Act. When experience has showed that the only effective means to start competition in local telephone service is via UNE-Platform, or UNE-P, as permitted by the Act, the FCC responded by questioning whether UNE-P should be eliminated. Most recently, the FCC has proposed the development of rules that would lead to an effective duopoly of Bell companies and cable monopolies in the provision of high-speed data services, including internet access, to consumers. If adopted, this policy can only lead to higher prices, fewer competitive providers to buy from telecom manufacturers, and fewer choices for consumers.

The impact of these actions is apparent in the market capitalizations of a partial list of network and competitive local exchange companies (CLECs) over the last year:

	Market Cap (Mil.)		
	3/31/01	3/19/02	
Network Providers			
Broadwing Inc	$ 7,575	$ 1,662	
Flag Telecom Holdings Ltd	3,017	38	
Global Crossing Ltd	31,996	96	
Level 3 Communications	38,630	1,398	
Metromedia Fiber Network	26,327	54	
Williams Comm'n Group	24,049	79	
	$131,594	$ 3,327	-97%

CLECs	Market Cap (Mil.) 3/31/01	3/19/02	
Adelphia Bus. Solutions	$ 4,288	$ 3	
Allegiance Telecom	8,718	348	
Caprock Communications*	1,639	0	
Covad Communications	7,232	354	
Focal Communications	3,411	24	
ICG Communications	1,756	3	
Northpoint Communications	3,026	21	
McLeodUSA Inc	16,270	113	
Mpower Holding Corp	2,538	3	
RCN Corp	4,371	136	
Rhythms Netconnections	2,840	0	
Teligent Inc	3,696	0	
Time Warner Telecom	8,365	342	
US LEC Corp	1,094	80	
Winstar Communications	5,325	0	
XO Communications	16,901	23	
	$91,470	$ 1,450	-98%

These investor losses, and the associated job loss, did not result solely or even significantly from accounting issues. Nor were all these entrepreneurs poor planners.

WorldCom's Views on H.R. 3763

WorldCom is in the process of reviewing H.R. 3763 and would be pleased to offer its views to the Subcommittee when that review is completed.

Conclusion

The current problems in the competitive sectors of the telecommunications industry were not caused primarily or even significantly by accounting issues or assumptions about capacity utilization. Rather, those problems resulted directly from the unrelenting efforts of the Bell companies to retain their monopoly power and the fundamental failure of the FCC and the DOJ to properly and effectively implement and enforce the law.

In WorldCom's view, those failures have destroyed far more market capitalization and robbed far more value from shareholders' investments than any accounting issues.

Thank you.

Responses to
Questions for WorldCom, Inc.
Submitted by Congressman Sue W. Kelly
Hearing on Effects of the Global Crossing Bankruptcy
On Investors, Markets, and Employees

1. You commented during the recent hearing that you never engaged in "swap" transactions of indefeasible rights of use (IRUs) with Global Crossing, rather your transactions in fact took place with Asia Global Crossing. Is it not a fact that Asia Global Crossing at the time of your transactions in December 2001 was 59% owned by Global Crossing?

   Answer: Mr. Salsbury's testimony described two IRU transactions between WorldCom and Asia Global Crossing that were executed during December 2001. Asia Global Crossing is a publicly-traded company. We do not know Global Crossing's ownership interest in Asia Global Crossing, although press reports indicate it is greater than 50%. WorldCom had a legitimate business interest for engaging in these transactions and, as explained in Mr. Salsbury's testimony, does not consider them to be "swaps" as characterized by the media.

2. Has the recent publicity surrounding Enron and issues over related party involvement in company transactions, lack of auditor independence, and the payment of millions to the same firm that both audits and consults, led to any changes in your accounting policies or in your relationship with your corporate auditor?

   Answer: No.

3. In December, the Securities and Exchange Commission (SEC) issued cautionary advice about preparing pro forma financial statements. Has that guidance changed how you prepare and present pro forma statements?

   Answer: No.

4. Should the SEC take steps to require a more consistent presentation of cash flow estimates on pro forma statements within the telecom industry?

   Answer: WorldCom does not use cash flow estimates on pro forma statements.

5. Are you aware of any particular proposals that have been discussed in Congress to resolve accounting and disclosure issues that concern you?

   Answer: No.

6. It has been widely reported that WorldCom has made more than $340 million in loans to your Chief Executive Officer, Mr. Ebbers. How do you explain the below market rates for these loans since they take millions of dollars away from your stockholders? After all, hasn't the value of your stock dropped more than 40% since January of this year?

   Answer: The interest rates charged to Mr. Ebbers are equal to WorldCom's incremental cost of borrowing money, so there is no loss to WorldCom shareholders. During 2002, WorldCom's stock price has declined from $14.39 on January 2 to a closing price of $3.41 on April 23. The decline in stock price was caused by a number of factors, but negative publicity surrounding the loan to Mr. Ebbers likely contributed.

7. Can you state with any degree of certainty that Mr. Ebbers will indeed not be forgiven these enormous loans in the same manner Mr. Legere's loans were forgiven by Asia Global Crossing?

   Answer: Mr. Ebbers has taken steps to collateralize the loans from WorldCom. It is the expectation of both WorldCom and Mr. Ebbers that these loans will be repaid.

8. Are you in agreement with statements from various analysts that the value of your company would not be as low as it is today if not for the bankruptcy of Global Crossing?

   Answer: Investor uncertainty resulting from the bankruptcies of Global Crossing and other telecom companies as reflected in Mr. Salsbury's testimony was a contributing factor in the decline in stock values in the telecom sector, including WorldCom's.

9. A class action lawsuit in 2000 charged, among other things that WorldCom intentionally delayed taking a $685 million pre tax charge. It has also been alleged that uncollectible debts were sometimes retained as assets. Please provide your comments on these allegations.

   Answer: The lawsuit was dismissed with prejudice on March 29, 2000. The allegations are untrue.

10. The same lawsuit also claims that Mr. Ebbers, your CEO, personally supervised large write-offs in order to protect the value of stock that he personally bought on credit. Is there any truth to this allegation?

Answer: No.

11. How does your company define the "legitimate business purpose" behind individual IRU swaps?

Answer: As set forth in Mr. Salsbury's testimony, WorldCom does not engage in capacity "swaps" as that term has been used by the media. WorldCom does occasionally obtain IRU capacity from other carriers where needed and does occasionally sell IRU capacity upon request. WorldCom's IRU purchases are based upon the need for low cost network capacity. The legitimate business purpose is to increase the overall utilization of the network and to reduce capital expenditures. IRU transactions are not a significant part of WorldCom's business.

WRITTEN STATEMENT OF ANDREW McGRATH
CABLE & WIRELESS PLC
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
March 21, 2002

Good morning Chairwoman Kelly, Congressman Gutierrez, and members of the Subcommittee.

My name is Andrew McGrath. I am President of Cable & Wireless' Service Providers division. Cable & Wireless is a global provider of telecommunications services headquartered in the United Kingdom. Cable & Wireless, with annual revenues of $11 billion, provides services ranging from local telephone service to Internet backbone and web-hosting services in more than 70 countries. Cable & Wireless has been in business for over one hundred years. It is well-financed and has no net debt. We are proud to have a substantial presence in the United States, where we provide IP and data services and solutions to business customers.

I have been with Cable & Wireless since 1991 and currently head the global group within Cable & Wireless that provides a broad range of services to carriers, ISPs, and content owners. I hold an engineering degree from Surrey University and an MBA from London Business School. I have been invited to appear today to address the Subcommittee's inquiry regarding telecommunications capacity transactions typically called indefeasible rights of use or "IRUs."

The nature of the telecommunications industry makes it essential for carriers to contract with each other to provide services to their respective customers. It is not always cost effective for a carrier to build all aspects of its global network for its own exclusive use. It has been a long-established industry practice for carriers to interconnect with other carriers and to purchase network capacity from other carriers, either through leases or IRUs. Cable & Wireless has undertaken IRU purchases for the purpose of obtaining the network capacity necessary to support its customer requirements. Our internal governance policies are designed to ensure that, in each case, our acquisition of capacity serves a legitimate commercial need.

Cable & Wireless has also sold network capacity to other carriers. These IRU sales are a very small part of Cable & Wireless' business. At their peak, in the year ending March 31, 2001, such sales accounted for less than 5 percent of Cable & Wireless' revenues, and have since declined as carriers largely completed their network build-out programs.

In building its global network, Cable & Wireless has purchased capacity from several operators. A small proportion of these transactions has been with Global Crossing. As always, the network capacity we obtained through these transactions served specific commercial needs.

Cable & Wireless states its accounts in accordance with Generally Accepted Accounting Principles ("GAAP") as adopted in the United Kingdom, as it must do as a U.K. public limited company. As an additional disclosure, Cable & Wireless separately reports the amount of its IRU sales. Our accounting policies with regard to the treatment of such transactions are disclosed as part of our financial statements and are readily available to the public.

Because Cable & Wireless ADRs (American Depositary Receipts) trade on the New York Stock Exchange, it also discloses its financial results in SEC Form 20-F. For these purposes, Cable & Wireless states its results, including IRU transactions, in accordance with U.S. GAAP. A reconciliation of the net income under U.K. GAAP with that under U.S. GAAP is disclosed as part of our financial statements and is also readily available to the public.

Thank you for the opportunity to appear today. I welcome any questions from the members of the Subcommittee.

Cable & Wireless plc's Response to Questions
Submitted by Congresswoman Sue W. Kelly
Hearing on Effects of the Global Crossing Bankruptcy
On Investors, Markets, and Employees
House Subcommittee on Oversight and Investigations
Committee on Financial Services

Question 1:

We know that Global Crossing recently employed a black-out period on 401(k) plans. Has Cable & Wireless ever employed such a black-out?

Answer:

Cable & Wireless' 401(k) plan does not provide for the purchase or investment in shares (or ADRs) of Cable and Wireless plc. Nor does Cable & Wireless use shares (or ADRs) as matching contributions. Accordingly, Cable & Wireless has not applied a black-out period to its 401(k) plan. Cable & Wireless does, however, observe London Stock Exchange ("LSE") rules requiring a closed period prior to earnings releases, during which all directors, executive officers and employees are prohibited from trading in Cable & Wireless securities.

Question 2:

Has Cable and Wireless instituted rules that would disallow senior executives from selling stock during a 401(k) black-out period?

Answer:

For the reasons stated in response to Question 1, Cable & Wireless has not applied a black out period to its 401(k) plan. As noted above, the closed period that Cable & Wireless observes under LSE rules applies to directors and executive officers.

Question 3:

The Corporate and Auditor Accountability, Responsibility and Transparency Act includes a ban on insider trading during 401(k) black-out periods. Would your company have problems with that initiative?

Answer:

Cable & Wireless currently operates under effectively similar restrictions under LSE rules. Therefore, such a ban on insider trading should not raise an issue for Cable & Wireless.

Question 4:

Do you believe that the change in the treatment of revenue earned from IRUs mandated by the FASB in 1999 was fairly and carefully considered and took into account the realities of your business? Did the change come at a bad time for your business?

Answer:

As a UK company, with a primary listing on the LSE, we report primarily under United Kingdom GAAP. Accordingly, we did not form a view on the 1999 change in treatment of IRU revenue as mandated by the FASB.

Question 5:

Has the Enron matter led to changes in your accounting policies or your relationship with your corporate auditor?

Answer:

The Enron matter has not caused Cable & Wireless to change its accounting policies or its relationship with KPMG, our corporate auditor.

Question 6:

In December, the SEC issued cautionary advice about preparing pro forma financial statements. How has that guidance changed how you are preparing pro forma statements?

Answer:

The SEC's "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases" (December 4, 2001) provided a public warning on the use by public companies and other registrants of "pro forma" financial information in earnings releases. It raised particular concerns about the "presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP."

During the Subcommittee's March 21, 2002 hearing, Congresswoman Kelly asked the participants about the use of "pro forma" financial statements by their respective companies. Andrew McGrath, President, Service Providers of Cable & Wireless, understood Congresswoman Kelly's question to focus on certain types of "pro forma" financial statements similar to the ones about which the SEC provided cautionary advice. As Mr. McGrath testified, Cable & Wireless has not used "pro forma" financial statements in this context, namely for SEC reporting, including Form 20-F, or in earnings releases or other public statements.

The SEC distinguished its cautionary advice on the use of "pro forma" financial statements in these contexts from what it called the "useful" implementation of "pro forma" financial information by companies when it is designed "to focus investors' attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations." The SEC added that "accurate interpretations of results and summaries of GAAP financial statements taken as a whole can be quite useful to investors." Cable & Wireless has made limited use of "pro forma" financial information in presentations to analysts and investors for this purpose, namely, to explain the impact of pending acquisitions and dispositions.

Question 7:

Are there particular proposals that have been discussed in Congress to resolve accounting and disclosure issues that most concern you?

Answer:

Because Cable & Wireless reports primarily under UK GAAP, Cable & Wireless has not formed an opinion with regard to the proposals currently being discussed in Congress.

Question 8:

How does your company define the "legitimate business purpose" behind individual IRU capacity swaps?

Answer:

Cable & Wireless enters into transactions with a "legitimate business purpose," which means that the transaction taken as a whole meets Cable & Wireless' business objectives, including the enhancement of shareholder value.

As Mr. McGrath stated in his testimony before the Subcommittee, the nature of the telecommunications industry requires carriers to contract with each other to provide services to their respective customers. It is not always cost-effective for a carrier to build all aspects of its global network for its own exclusive use. It has been a long-established industry practice for carriers to interconnect with other carriers and to purchase network capacity from other carriers, either through leases or Indefeasible Rights of Use ("IRUs").

Cable & Wireless purchases capacity from another carrier when that carrier has been found to be the most suitable provider of the capacity required to service customers' needs. That purchase is negotiated on an arm's length basis in the best interests of Cable & Wireless. IRU purchases are undertaken when internal approval criteria have been met. IRU transactions are accounted for as revenue when the risks and rewards of the ownership of the capacity is transferred to the purchaser.

TESTIMONY OF

JOHN M. MORRISSEY, DEPUTY CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
TELECOMMUNICATIONS ACCOUNTING ISSUES

BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 21, 2002

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
JOHN M. MORRISSEY
DEPUTY CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

TELECOMMUNICATIONS ACCOUNTING ISSUES

Before the Subcommittee on Oversight and Investigations
Committee on Financial Services
March 21, 2002

Chairwoman Kelly, Ranking Member Gutierrez 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 concerning several accounting issues affecting the telecommunications industry. As the Subcommittee has requested, my testimony will address: 1) the accounting by providers of telecommunications capacity for the sale of an indefeasible right of use ("IRU") of such capacity, 2) the accounting for nonmonetary transactions, including "swaps," and 3) the reporting of pro-forma financial information.

Global Crossing Ltd. has disclosed that the SEC is investigating certain issues associated with Global Crossing's accounting and disclosure practices. Any further information relating to such an investigation would be nonpublic and, accordingly, my statement will be confined to the public record.[1]

[1] The information contained in this statement concerning Global Crossing's accounting practices is based upon publicly available information.

Transparent Financial Reporting Protects the Financial Markets

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting, that is, the extent to which financial information about a company is available and understandable to investors and other market participants, plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

Transparency enables investors, creditors, and market participants to evaluate the financial condition of an entity. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness and to take early corrective actions, when necessary, to address deterioration in the financial condition of companies. Therefore, it is critical that all public companies provide an understandable, comprehensive and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then investors and other users of the information are less likely to be surprised by unknown transactions or events.

Investors and creditors expect clear, reliable, consistent, comparable, and transparent reporting of events. Accounting standards provide a framework that is intended to present financial information in a way that facilitates informed judgments. For financial statements to provide the information that investors and other decision-makers require, meaningful and consistent accounting standards and comparable practices are necessary.

Recent press articles have raised questions about the transparency of the accounting and disclosure practices followed by Global Crossing. In light of these articles, I would like to review the accounting by providers of telecommunications capacity for an IRU of such capacity, the accounting for nonmonetary transactions, including "swaps," and the reporting of pro-forma financial information.

Telecommunications Capacity Purchase and Sale Agreements

The expansion of fiber optic communications increased the frequency of transactions involving the "sale" of network capacity. The granting of an indefeasible right to use such network capacity is often referred to as an "IRU." Pursuant to an IRU, an entity purchasing network capacity has the exclusive right to use a specified amount of capacity for a period of time.

Accounting by the purchaser of network capacity pursuant to an IRU has not raised significant accounting issues. An entity purchasing capacity would typically record the amount paid for the capacity as an asset,[2] and amortize that asset by charges against income over the period of benefit, which would normally be the term of the capacity agreement.

For the provider of the capacity, the fundamental accounting issue related to an IRU is when to recognize revenue. That determination can be quite complex but can be boiled down to two basic questions: Is the IRU a lease or is it a service contract? And, if it is a lease, what kind of lease is it - a sales-type lease, for which revenue is recognized up-front, or an operating lease, for which revenue is recognized over time? Please allow me to elaborate on the details:

[2] Depending on the nature of the capacity purchase agreement, the purchaser would possibly record either a fixed asset, such as property, plant, and equipment, or a prepaid expense.

Step 1—Service contract or lease?

As I previously stated, the first step in determining when to recognize revenue is to evaluate whether the contract between the provider and purchaser of the capacity is an arrangement for the provision of a service or a lease. Although service contracts may have attributes similar to those embodied in leases, the accounting results may be dramatically different for service transactions than for leases.

Accounting for service contracts: Under generally accepted accounting principles ("GAAP"),[3] revenues associated with long-term service contracts are generally recognized over time as performance occurs. The accounting guidance as to when to recognize revenue for service contracts is limited, but can be primarily attributed to the conceptual framework of the FASB and a paper published by the FASB on accounting for service contracts. The SEC staff communicated its views on various issues related to revenue recognition for service contracts in Staff Accounting Bulletin No. 101.[4]

Accounting for leases: FASB Statement of Financial Accounting Standards ("SFAS") No. 13, *Accounting for Leases*, and the related interpretations of this standard, provide the relevant GAAP for lease accounting, including the definition of a lease. This accounting literature defines a lease as an agreement conveying the right to use property, plant or equipment for a period of time, and specifically excludes agreements that are contracts for **services** that do not transfer the right to use property, plant or equipment.

To the extent that a network capacity contract conveys to the purchaser the right to use specific identifiable assets[5] for a period of time, providers of this capacity have concluded

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[3] 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 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 ("FASB").

[4] See Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, December 3, 1999.

[5] For example, a specific fiber or wavelength of light within a fiber-optic cable network, along with the conduit through which that cable passes, the land on which the conduit rests, and a specific component of the telecommunications equipment at each end of the cable necessary to transmit data over the network, would represent specific identifiable assets.

that such a contract meets the definition of a lease. If the network capacity contract does not convey to the purchaser the right to use specific identifiable assets, the contract would be viewed as an arrangement for the provision of services, and revenue would be recognized over the period of the contract as the services (the access to the network capacity) are provided.

Step 2—It is a lease, but what kind of lease?

For capacity contracts that meet the definition of a lease, the next significant accounting consideration is the determination of the appropriate lease classification. In a network capacity contract or arrangement that meets the definition of a lease, the capacity provider is the lessor, and the capacity purchaser is the lessee. From the lessor's perspective, there are two general types of leases – sales-type leases and operating leases.

Sales-type leases: In a sales-type lease, which gives rise to manufacturer's profit, the lessor records the fair value of the leased assets as revenue upon inception of the lease. The cost (or carrying amount) of the leased assets is charged against income in the same period that the "sale" is recognized. Sales-type lease accounting reflects in the financial statements of the lessor a sale or financing when substantially all of the benefits and risks incident to the ownership of the leased property have been transferred to the lessee.

Operating leases: Alternatively, in an operating lease, the lessor continues to record the leased assets on its balance sheet, subject to the lessor's normal depreciation policies. The minimum lease payments are recorded as rental revenue by the lessor over the lease term, typically on a straight-line basis. Operating lease accounting is similar to service contract accounting.

For a network capacity transaction to be appropriately classified and accounted for as a sales-type lease, certain specific criteria must be met. Otherwise, the transaction must be classified and accounted for as an operating lease. Further complicating the issue, these criteria differ depending on whether the leased asset is considered equipment or real

estate. Under SFAS No. 13, and the related interpretations of this standard, a lease of real estate must transfer title in the leased assets to the lessee in order to be classified and accounted for as a sales-type lease by the lessor. Equipment leases need not transfer title in the leased assets to the lessor in order to be classified and accounted for as sales-type leases.

Real estate or equipment: The FASB issued Interpretation No. ("FIN") 43 in June 1999 which was effective for transactions entered into after June 30, 1999.[6] FIN 43 provides interpretive guidance on the definition of real estate for accounting evaluations. This guidance, along with additional interpretive guidance provided by the FASB's Emerging Issues Task Force ("EITF"),[7] has the general effect of rendering the assets subject to telecommunications capacity agreements as real estate for accounting purposes. When the interpretation in FIN 43 and the related EITF guidance became effective, many telecommunications capacity sellers concluded that they were unable to meet the title transfer requirement for the assets subject to the IRU and, therefore, were required to account for subsequent capacity sale transactions as operating leases. Prior to FIN 43, the assets subject to telecommunications capacity agreements were generally viewed as equipment, and frequently, providers of capacity accounted for these agreements as sales-type leases.

Industry Practice

In addition to these changes in the accounting rules, as the industry evolved, many capacity providers changed their service offerings to permit more flexibility than was previously available in fixed, point-to-point capacity sales. Because these more recent service offerings typically do not grant the purchaser of such services the right to use specific identifiable assets for a period of time, these arrangements fail to meet the fundamental conditions for being treated as leases, and instead are considered executory

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[6] See FIN 43, *Real Estate Sales, an Interpretation of FASB Statement No. 66.*

[7] See EITF Issue No. 00-11, *Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13*, and EITF Issue No. 00-13, *Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98.*

contracts (that is, contracts for the provision of services, which are specifically excluded from the lease accounting literature). Therefore, the sales-type lease accounting model may not be appropriate for more recent capacity contracts.

In administering the federal securities laws, the Commission staff has reviewed public filings of telecommunications network capacity providers and suggested that certain disclosures be made so that the accounting policies of telecommunications capacity providers are transparent to investors. In addition, the Commission staff has worked closely with the private sector accounting standards-setting organizations to identify issues related to the accounting for telecommunications capacity purchase agreements, and to resolve those issues in a manner that is in the best interests of investors. Two accounting issues have been addressed and resolved by the EITF that primarily relate to IRU accounting.[8] Other issues on the EITF's current agenda could have an impact on the industry's accounting practices.[9]

Accounting for Nonmonetary Transactions

Several recent articles in the financial press have focused on the business practices of telecommunications companies "swapping" network capacity.[10] Many of these articles suggest that the companies entering into these transactions may have inappropriately inflated their operating results by recognizing revenue for the network capacity sold, and recording long-term fixed assets for the capacity purchased. While I cannot comment on specific transactions, my testimony seeks to provide an overview of the accounting literature that addresses the accounting for exchanges of nonmonetary assets.

In general, GAAP requires that the accounting for the exchange of nonmonetary assets be based on the fair value of the asset received or given up, whichever is more reliably

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[8] See footnote 7.

[9] See EITF Issue No. 01-08, *Determining Whether an Arrangement is a Lease*, EITF Issue No. 01-04, *Accounting for Sales of Fractional Interests in Equipment*, and EITF Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*.

[10] See, for example, "Optical Illusion? Accounting Questions Swirl Around Pioneer In the Telecom World," *The Wall Street Journal*, February 13, 2002, and, "Losing a Grip on the Fiber Optic Swap," *The New York Times*, February 18, 2002.

determinable.[11] One of the exceptions to this general principle is an asset exchange that does not represent the culmination of the earnings process. For example, an exchange of an asset held for sale in the ordinary course of business (such as inventory) for an asset to be sold in the same line of business. Furthermore, the exchange of a productive asset not held for sale for a similar productive asset also is not viewed as the culmination of the earnings process. These types of nonmonetary exchange transactions are required to be accounted for based upon the recorded amount, or book value, of the asset relinquished.

The simultaneous exchange of nonmonetary assets along with equal amounts of cash consideration between the parties to an exchange would raise significant "substance" over "form" questions. When cash consideration is exchanged between the parties to a transaction concurrently with an asset exchange, questions may arise as to the substance or business purpose of the transaction structure, and whether that structure has an economic purpose or is designed solely to remove the transaction from the scope of the accounting literature governing nonmonetary asset exchanges.

In these situations, a careful analysis of the specific facts and circumstances surrounding the transaction would have to be made. To the extent that the "check swapping" between the parties lacks economic substance, such a practice should not alter the accounting for such exchange transactions. In other words, the accounting rules for nonmonetary asset exchanges should be followed. These rules require that certain conditions be met in order for the transaction to be accounted for at fair value.

In order to conclude that a network capacity swap transaction should appropriately be accounted for as revenue and a capital expenditure at fair value, a company entering into such a transaction would have to reach the conclusion that: 1) the network capacity received in the exchange will not be sold in the same line of business as the network capacity given up in the exchange, 2) the network capacity received in the exchange is a productive asset that is dissimilar to the network capacity given up, and 3) the fair values

[11] Accounting Principles Board (the predecessor to FASB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, provides relevant guidance on the accounting for these types of transactions.

of the assets exchanged are determinable within reasonable limits. Capacity swap transactions likely include complex terms that would require a diligent analysis and professional judgment to determine the proper accounting treatment.

Companies that engage in material nonmonetary transactions during a reporting period are required, under GAAP, to disclose, in the footnotes to the financial statements, the nature of the transactions, the basis of accounting for the assets transferred (that is, fair value or book value), and gains or losses recognized. GAAP also requires that information about all investing and financing activities of an enterprise that affect recognized assets or liabilities but that do not result in cash receipts or payments, such as nonmonetary asset exchanges, be disclosed in the footnotes to the financial statements.

Furthermore, the Commission's rules require registrants to include in their public filings a section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").[12] In MD&A, registrants are required to discuss the known trends, demands, events, commitments and uncertainties that are reasonably likely to materially affect a registrant's liquidity, capital resources, and results of operations. To the extent that nonmonetary exchange transactions have a significant impact on a registrant's liquidity, capital resources, or results of operations, disclosure of these transactions in MD&A would be required.

Pro-forma Financial Information

Recent press articles have also focused on Global Crossing's use of "pro forma" financial information in its earnings releases. "Pro forma," in this context, generally refers to the presentation of earnings and results of operations on the basis of methodologies other than GAAP.

"Pro forma" financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly

[12] See Regulation S-K, 17 CFR, Item 303.

or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations. There is no federal securities law prohibition preventing public companies from publishing interpretations of their financial results or publishing summaries of GAAP financial statements.

Nonetheless, the Commission is concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.

The Commission has cautioned companies and alerted investors to the potential uncertainties of "pro forma" financial information. Most recently, on December 4, 2001, the Commission issued cautionary advice that companies and their advisors should consider when releasing "pro forma" financial information.[13] Among other things, this release reminded companies and their advisers that:

> First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information. Recently, the Commission concluded its first pro forma financial reporting case ever, regarding the issuance of a misleading earnings release by the Trump Hotel and Casino Resorts, Inc.[14] This action demonstrated the Commission's commitment to address the dangers of "pro forma" financials.

[13] See Financial Reporting Release No. 59.
[14] See Accounting and Auditing Enforcement Release No. 1499.

Second, a presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP, raises particular concerns. Such a statement misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this "pro forma" financial information without an indication of the principles that underlie its presentation. To inform investors fully, companies need to describe accurately the controlling principles. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

Third, companies must pay attention to the materiality of the information that is omitted from a "pro forma" presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a "pro forma" presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

Fourth, public companies should consider and follow the recommendations regarding pro forma earnings releases jointly developed by the Financial Executives International and the National Investors Relations Institute before determining whether to issue "pro forma" results, and before deciding how to structure a proposed "pro forma" statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company

in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

With appropriate disclosure, accurate interpretations and summaries of GAAP financial statements benefit investors. Our cautionary advice is part of our ongoing commitment to improve the quality, timeliness, and accessibility of publicly available financial information. At the same time, the Commission is focusing on ways in which our current periodic reporting and disclosure system can be updated to fill the void that "pro forma" statements may be attempting to fill.[15]

Conclusion

Many of the accounting issues surrounding the accounting for telecommunications capacity contracts are complex, and I have provided only a brief summary of some of the more significant issues. We very much appreciate your prompt action and interest in the current issues that impact financial reporting and our capital markets. You can be assured that the SEC staff takes very seriously allegations of financial reporting improprieties by public companies. Furthermore, in our oversight capacity, the SEC staff will continue to monitor developments in the accounting practices of the telecommunications industry, and provide recommendations for issues that need to be addressed by the accounting standards-setting organizations.

[15] See Testimony of Harvey L. Pitt, Chairman of the U.S. Securities and Exchange Commission, Concerning H.R. 3763, the "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002," Before the House Committee on Financial Services (March 20, 2002), explaining the Commission's disclosure initiatives.

Written Testimony of
Scott C. Cleland
Chairman and CEO
The Precursor Group®

"Global Crossing's Bankruptcy:
A Window Into a Broken System of Protecting Investors"

Before the House Committee on Financial Services
Subcommittee on Oversight and Investigations

Hearing on

"The Effects of the Global Crossing Bankruptcy on
Investors, Financial Markets, and Employees"

Thursday, March 21, 2002

I. Introduction

Mr. Chairman, thank you for the honor of testifying before your Subcommittee and for the Subcommittee's interest in the perspective of an *independent investment research broker-dealer*.

My testimony includes:

- An explanation of the Precursor Group® perspective
- Introduction and outline of my remarks
- Broader lessons learned from Global Crossing bankruptcy
- Conclusion

II. Precursor Group® Perspective

I am Scott Cleland, founder and CEO of the Precursor Group®, an independent research broker-dealer, which provides investment research to institutional investors. My partner, Bill Whyman, and I founded the Precursor Group® very intentionally as an *independent* firm in order to better serve our investor clients' interests and not to serve companies' interests or investment banking interests. We have learned that the investment research marketplace is thirsting for trust, and our business is trying to quench a part of that thirst.

Our business is simple. We work for institutional investors; they pay us research commissions on their trading to the extent that we help improve their investment performance.

- If our research helps investors identify opportunities or avoid pitfalls, we get paid in directed trading commissions.
- If our research does not help investors, we do not get paid.
- We have a market-driven, merit-based business model.

We are unusual in that we are a pure research firm in a business dominated by integrated full-service brokerage firms that bundle investment banking, trading and research. **We are exclusively an investors' broker-dealer**, akin to a buyer's broker in real estate. We are not the traditional sellers' or company broker-dealer, which tries to represent *both* companies' and investors' interests.

We have done our best to align our financial interests with investors' interests. We are very serious about avoiding conflicts of interest, actual and *perceived*, so we:

- Do no investment banking for companies;
- Do not manage money or own a stake in any companies;
- Do not allow Precursor Group® researchers to trade individual stocks – as a condition of employment (which exceeds NASD rules); and
- Do not trade securities for proprietary gain.
- We get paid through agency trading commissions, which is the primary payment mechanism that institutional investors use to pay for investment research.

We are a pure research firm because we do not believe one firm can well serve different masters at the same time: investors *and* companies. We strongly believe true independence yields better research.

III. Introduction and Outline of Remarks

I don't believe Global Crossing, the fourth largest bankruptcy in history, is unique. It is a wake up call to Government overseers of broad and troublesome patterns in the capital markets system and in the telecom/Internet marketplace.

- The recession did not cause Global Crossing to go bankrupt, and it was not what **Federal Reserve Chairman Alan Greenspan calls "irrational exuberance."**
    - **I surmise that it was more likely "rational manipulation" of the capital markets system by many for private gain; and**
    - **"irrational economics" of the telecom/Internet sector, which largely created the NASDAQ bubble that burst.**

The country has a much bigger problem than most may appreciate.

- The capital markets system that was designed to protect investors now may be being "rationally manipulated" by company interests.
- There's a serious "telecom debt spiral" going on that has Government policies based on irrational economics at the root of the problem.

Arguably these problems are at the heart of the economy's problems.

- Post-Enron, how do we restore investor trust in the U.S. capital markets system so investors again will entrust their capital with companies so the economy can grow and create jobs?
- How do we stop telecom, a key sector to the economy's growth and productivity, from being a long-term drag on the economy?

Telecom is in crisis.

- While Global Crossing's bankruptcy is getting a hearing, don't forget there have been over thirty more bankruptcies (like Teligent, Winstar, McLeod, ICG, PSINet, 360 Networks, and others.)
- The deflationary trends that helped take these companies down are now doing their work on XO, Metromedia, Williams, Level 3, Qwest, Sprint, WorldCom, and others.
    - While these companies are currently solvent, they are in what Precursor calls the "insolvency zone."
    - This means that investors are legitimately concerned that these companies may not be able to outgrow their cost of capital long-term.
    - Global Crossing and many other telecom companies were built with heavy debt assuming high growth; now that growth has slowed and projected demand has disappointed -- the math doesn't work.

This is no trifling matter. *The Wall Street Journal* recently reported that since 1996, telecom companies have borrowed more than $1.5 trillion from banks and issued over $600 billion in bonds. It is instructive to recall that the Savings and Loan debt crisis in late 1980s cost taxpayers over $200 billion to remedy.

IV. What broader lessons can we learn from Global Crossing's bankruptcy?

(A) We must improve our very inadequate investment research system.

(1) The investment research system can't even expose "trillion dollar fibs."

The "Trillion Dollar Fib!" Investors, who depend on investment research for an objective assessment of the facts and due diligence, were not informed that **the single most important trend buttressing Global Crossing's business model, and that of all the other data growth stocks, was, and had been, hugely overstated and inflated for years!**

- The conventional wisdom, repeated by almost everyone in the industry from 1997-2001, was that data traffic growth was doubling every three to four months—an extraordinary 800-1600 percent annual growth rate from 1996 through 2001.
  - Unfortunately, it simply was not true.
  - The actual growth rate had been closer to a 100-200% annual rate since 1997.
    - We believe the Precursor Group was the first investment researcher to challenge this exploding data traffic thesis in our February 5, 2001 research piece, "Datatopia – Why Data Transport Growth Stories May Disappoint," which used data from AT&T Labs. (See attachment).
- **Nonetheless, this exploding data traffic growth thesis was the core selling point for some of the hottest stocks the market has ever known.**
- **This gross misrepresentation of demand for data traffic fueled roughly a trillion dollars worth of stock appreciation from 1996 to 2000 that has since cratered.**
  - See the chart on the next page for the stock appreciation of the data traffic carrier models and their equipment suppliers.
  - Given that most institutional investors were unaware data traffic growth had slowed dramatically, Precursor believes that this repeated factual misrepresentation of exploding traffic demand could have contributed to inflating these companies stock.

It appears that there may be a **pattern of misrepresentation** in the telecom/Internet sector.

- In addition to this trillion-dollar data traffic investment thesis disaster, U.S. investors and pensioners lost roughly another trillion dollars of shareholder wealth on the Internet dot.com investment thesis where the new virtual economy was purported to obsolete the old economy.
- And investors have lost more than $50 billion dollars buying into the competitive Telecom Act investment thesis that has resulted in over thirty bankruptcies so far.

Was this merely "irrational exuberance" in the stock market? Or could there have been some "rational manipulation?"

All of these telecom-related investment theses were pushed by the investment research system, blessed by auditors, and completely missed by Government, and the mainstream and financial media.

- How many more trillion-dollar investment debacles need to occur before the inadequacies in our system of producing investment research get addressed?

(2) We must figure out how to get the system to pay for investor protection, not just pay promotion of stock prices.

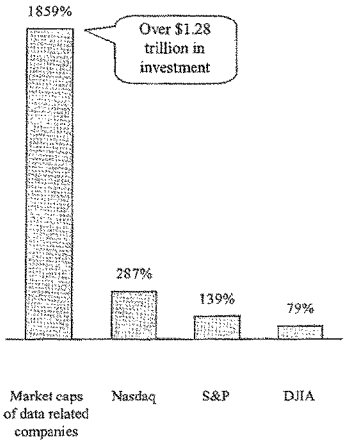
"The Trillion Dollar Fib" of Data Traffic Growth

(Market Capitalization of Data Related Companies, $Billions)

	1/1/96	1/1/00	3/18/02
Data Carriers			
Global Crossing	0	22	0
Level 3 Communications	0	28	1
PSINet	0	5	0
Qwest (excludes US West in 1996)	0	38	15
Williams Communications Group	0	11	0
WorldCom (excludes MCI in 1996)	14	151	21
Data Equipment Providers			
Ciena	0	8	3
Cisco Systems	42	369	121
Corning	2	32	8
JDS Uniphase	0	52	7
Juniper Networks	0	106	4
Lucent	0	230	16
Nortel Networks	11	278	15
Sycamore	0	22	1
Total Market Capitalization	**$69 billion**	**$1.352 *trillion***	**$212 billion**
Market Indices			
Dow Jones Industrial Average	5117.12	9181.43	10577.75
Nasdaq Composite	1052.13	4069.31	1877.06
S&P 500	615.93	1469.25	1165.39

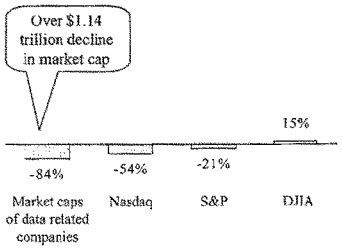
Bubble Rises with Data Growth Prospects . . .

% increase 1996 – 2000



"Irrational Economics" Help Burst Data Bubble

% decrease 2000 – today



Sources: Nasdaq; NYSE; Company reports; Precursor analysis

Better audits? The current system now makes it hard for a large public company to instill trust in its financial representation, because for all practical purposes, it cannot hire a top-tier auditor that does not have trust-eroding conflicts of interest that have been so painfully exposed by the Enron-Arthur Anderson scandal.

- **Unfortunately, the current public audit system appears to be heavily tilted toward what is best for auditors and companies rather than what is best for investors to entrust their capital with companies.**
    - It appears that the current system does not value producing non-conflicted audits that instill investor trust.
- If investors don't trust an audit to fairly represent the financial condition of a firm, the audit is more than worthless; it's all cost with no benefit.

Better Research? The current system also makes it hard to use investment research that is free of investment banking company bias that may be better at discovering the problems behind a Global Crossing. Investment banking is the proverbial "900-pound gorilla" that dominates the production of almost all investment research.

- The overwhelming funding source for investment research is directed trading commissions, which by regulation can only be collected by broker-dealers.
    - Regulation also requires that all broker-dealers must be licensed to do the complexities of investment banking even if they do no investment banking; this is a regulatory barrier to entry for pure research firms.
    - Competitive bond rating firms face similar regulatory barriers to entry that ill serve investors.
    - Moreover, the lack of transparency of commingled commissions for investment banking, trading and research mean that investment banking tends to rule the roost undermining the research function. (See our earlier testimony before the Subcommittee on Capital Markets June 14, 2001 at www.precursorgroup.com.)

- **InvestorSide Research:** To help correct this misalignment of research interests in the system, the Precursor Group, Argus Research and Eagan Jones are forming the InvestorSide Research Association.
    - **Its mission will be to "increase investor and pensioner trust in the U.S. capital markets system through the promotion and use of investment research that is financially aligned with investor interests."**
    - We are currently recruiting additional members without investment banking conflicts and also recruiting organizations and individuals who support this mission to join the Association's Advisory Board.
    - Our website will be www.investorsideresearch.org.

(B) We must make our capital markets system much less prone to "rational manipulation."

(1) Our capital markets system has become much more prone to manipulation.

The old adage, "an ounce of prevention is worth a pound of cure," is especially applicable here. Arguably, the current reported SEC enforcement investigations of Global Crossing, Qwest, and WorldCom may not have been necessary if the system's first line of defense in protecting investors—auditing and research—were not so inadequate.

Over the last decade, I believe the system of investor protections that were designed into the system have largely been hijacked or watered down by highly sophisticated company interests. It is alarming the extent to which the system, originally designed to instill investor trust in the capital markets system, now is geared primarily to promote company interests. **Precursor believes there is a clear bias in the system to promote company interests over protecting investor interests.** For example:

- **Auditing:** Virtually all of the largest publicly traded companies are audited by the Big Five accounting firms, which like Arthur Anderson, all have deep consulting business ties to the companies they are supposed to police for the public.
    - Given that roughly half of the revenues and the lion's share of profits of the Big Five come from non-audit consulting, the business of the Big Five arguably is skewed to serving the private interests of companies more than the public interests of investors.

- **Research:** We estimate that investment banking driven investment research firms have over 95% market share of the investment research market.
    - This means that the financial interests that are driving the investment research system are overwhelmingly skewed to promoting company interests over protecting investor interests.
    - There is little counter-balancing research force in the marketplace representing investors interests, which has become painfully obvious in the wake of Enron, the Dot.com bubble, and the data traffic trillion dollar fib.

- **Lawyers:** Lawyers ethical obligation of reporting misrepresentation, or fraud, runs only to management that controls their pay, not to the Board of Directors that represent shareholders.
    - This effectively prevents another line of investor protection from occurring.
    - It seems like common sense that the Board, which is responsible to public shareholders, should be informed if the company's legal counsel has suspicions of wrongdoing that could materially affect investor interests.

- **Investor/public relations:** Companies have become highly sophisticated in accentuating the positive and playing down the negatives.
    - Reportedly almost half of the Fortune 500 now use "pro-forma" reporting of financial results.
    - Much of pro-forma reporting is essentially the company's made-up accounting that excludes whatever pesky information could undermine a company's outlook.
    - The investor/public relations operations of companies then emphasize the pro-forma characterization of the company and divert focus from GAAP accounting results that enable an investor to compare a company to all other investments.

- **Media:** The public's perception of companies is often driven by how the media characterizes them.
    - The companies understand this and actively manage their investor and public relations.
    - To the extent that the media gives headline or story prominence to pro-forma reporting or emphasizes Wall Street "expectations" versus actual GAAP financial performance, the media is unwittingly complicit in the system of misrepresenting the financial state of companies to the investing public.

(2) Growth or "story stocks" have become the most prone to manipulation.

The management of growth companies has learned from market experience that their stock price is more dependent on the *perception* than the reality of future growth. **This means that the price of a growth stock is all about what a company can convince the market that it can do in the future. It is all about "the story."** The best storytellers have the hottest stocks. Or in other words, the tallest tale, that the market can believe wins.

- There are legitimate growth stories that actually deliver—Microsoft and Intel being the most prominent.
- Unfortunately there have been many more growth stories like Global Crossing that have not delivered, as the slew of telecom bankruptcies and the $4 trillion NASDAQ 2000 crash can attest to.

What can make growth stocks so prone to manipulation is the tremendous pressure to make current financial performance conform to aggressive forward leaning expectations. This pressure, in addition to the options culture that will be discussed later, can encourage management to employ many available "tricks of the trade" to manage this dilemma.

Since the "future story" often has no financial results to speak of, companies and Wall Street have come up with creative ways to try to validate business models before they show actual earnings.

- Dot.coms were valued on audience *potential* and "hits."
- Data carriers were valued on *potential* data traffic growth; and
- Competitive telecom companies (CLECs) were valued on buildings built-out.

The problem is it is so much easier to tell a story and get the system to buy it than it is to actually deliver profit growth in the market place. Thus, in the capital markets system today, it <u>may perversely be easier to manufacture "stock currency money" to make acquisitions and buy profits, than it is to make real money and profits on one's own</u>.

(3) The options-compensation culture encourages high-risk behavior which when mixed with the capital-intensive telecom sector, is a recipe for the "telecom debt spiral" the sector is in today.

Contrary to conventional wisdom, compensating company management primarily with stock options does not completely align management's interests with shareholders as much as paying them in actual stock would. Options are just that—an option to benefit on the upside without the same risk on the downside. The options culture encourages growth and high-risk behavior.

- In the entrepreneurial, risk-embracing tech sector, the options culture can work exceedingly well.
- **However, in sectors with lower risk tolerances like telecom, which is a hugely capital-intensive infrastructure business that absolutely depends on long-term debt financing to make the business model sustainable, an options culture can encourage the disastrously inappropriate aggressive growth behavior that we have recently seen in telecom.**

In no way am I saying that company management should not be rewarded handsomely commensurate with the financial performance of their firm. What I am saying is that options only fully align management's interests with shareholders in a growth environment with an appreciating stock.

- **In a slower growth environment like today, management's dependence on option compensation can encourage management to do "whatever it takes" to re-inflate their stock – even if it risks the company's capital preservation or survival.**
- Moreover, it may not be management's capital at risk, but rather shareholders' capital. In a tough environment, shareholders are more interested in having management preserve capital than rolling the dice for a big stock-inflating score.
- **An options culture can encourage management to view the balance sheet as a piggy bank to fund stock growth increases with debt.**
    - In telecom, overextending or wasting a balance sheet can prove disastrous, just ask Global Crossing, AT&T, McLeod, Teligent, Winstar, etc.

The one-way upside nature of options can perversely incent the management of publicly traded companies to engage in the high-risk behavior that this hearing is about today.

- **There are many stock-enhancing "tricks of the trade" that management can permissibly engage in, sometimes with the help of outside advisors, investment bankers, research analysts, accounting consultants, and lawyers etc., to lift their stock price.**
- Some of these "tricks of the trade" are:
    - Hiding debt off-balance-sheet in special purpose entities (alleged of Enron);
    - Increasing revenue recognition short-term through fiber capacity swaps (alleged of Global Crossing, Enron and others), and equipment/services swaps (alleged of Qwest);
    - Increasing revenue recognition short-term with 200% equipment vendor-financing (alleged of many equipment companies);
    - Writing off costs to improve forward-looking results (alleged of WorldCom and many others);
    - Writing off over $50 billion in goodwill and saying it doesn't matter (alleged of JDS Uniphase);
    - Continuing to book revenues from former customers (alleged of Winstar);
    - Backdating revenues to maintain the expected revenue growth trajectory (alleged of MicroStrategy);
    - Creating tracking stocks to supposedly "unlock shareholder value" (WorldCom and Sprint);
    - Buying a company solely to acquire revenues to avoid a debt triggering convenant (alleged of Level 3);
    - Selling an asset to avoid a debt triggering covenant (alleged of Sprint);
    - Managing earnings estimates (alleged of Cisco and many others);
    - Allowing supportive analysts to see more financial detail than non-supportive analysts (alleged of WorldCom);
    - Promoting pro-forma financial performance rather than actual GAAP results (alleged of many companies);
    - Declaring that the company has "no visibility" about future demand while simultaneously expressing confidence about eventually returning to 30% plus growth (alleged of Cisco);
    - And the list can go on and on.

(C) "Irrational Economics:" Government telecom and Internet policies that artificially stimulated supply and demand are at the root of the current "telecom debt spiral."

Government policies have powerfully subsidized and encouraged demand for data and the supply of data facilities.

- A large part of the current market problem with data-related business models is that Government policies fostered what Precursor calls a "datatopian" environment that lacks real world economics, which requires profits and return on investment.
- Government data policies have created an uneconomic data house of cards where costs were very high and revenues could not keep up with them.
- **The data marketplace, as constructed by Government, is unprofitable and it's contributing to the telecom debt spiral.**

First, the U.S. Department of Defense effectively created the Internet in 1969 as a commune system where each research lab that connected to the Internet data system paid for its own connection. This was a Government and research communications system, not a market.

- In 1991, the Government endorsed the commercialization of the Internet through the National Science Foundation.
- The Government effectively commercialized a "not-for-profit" system where each computer owner paid for its connection, but no one commercially supported the maintenance of the overall system.
- This not-for-profit system evolved into the current "peering" commercial system where similar carriers peer on negotiated terms.
    - This system offers little potential for pricing power to generate profits.
    - Consequently by June 2000, UUNET, the leading carrier of data traffic in the country with roughly one-third-market share, said they were unprofitable.

Second, to promote computer innovation, the FCC has had a policy since the late 1960's that **favored the use of data communications over voice**; this "enhanced service provider" (ESP) exemption exempted data traffic from the access charges voice traffic paid to maintain the overall system and universal phone service.

- This conferred roughly a 40% cost implicit arbitrage advantage for data over voice.
    - In practical terms, this implicit Government subsidy of data over voice enabled Internet Service Providers (ISPs) to charge roughly $20 a month rather than roughly $40 a month, because ISP's did not have to pay the same amount for the use of the network as voice users did.
    - **This multi-billion dollar annual implicit Government subsidy encouraged the exploding amount of data traffic being carried, which in turn increased the cost dramatically of maintaining the Public Switched Telecommunications Network (PSTN).**
        - While the PSTN voice system was designed for three-minute average phone calls, the average length of time for a data call was many multiples of the system's voice design.
        - FCC's data subsidy policies enabled flat rate ISP pricing in the U.S., which encouraged heavy use, or "surfing," that would not occur if people paid per minute.
        - This subsidized, or "free lunch," policy helped fuel the dot.com bubble, because it was so cheap to stay online.
        - This flat rate policy also was unique to the U.S. during the bubble; all other countries kept per-minute data use models to enable their carriers to recover the cost.
            - Consequently, other nations online use and growth lagged the U.S. dramatically.

Third, in 1996, Congress passed the Telecom Act which changed U.S. communications policy from endorsing monopolies, which promote universal phone service, to promoting competition and deregulation, which lowers prices for consumers and spurs innovation. The FCC aggressively promoted U.S. competition policies around the world.

- **Without the new competition policy in the U.S. and around the world, and without the Government's active assistance in securing interconnection in the U.S. and around the world, Global Crossing and other data carriers could not have existed or raised public capital.**
- **With the Government as the data industry's effective champion** against monopoly incumbents and intransigent Governments, the Government provided cover and "official" validation of the investment bankers and companies "growth stories."
    - **Investors lost billions of dollars by trusting that the Government knew what it was doing and believing the data growth stories told by the companies and effectively "supported" by Government policymakers.**
- The fundamental economic problem with the 1996 Telecom Act is that it took a highly capital-intensive infrastructure industry and introduced massive competitive and technological risk and increased price regulation without a clear realistic way for the companies to make a sustainable profit or return on investment.

Fourth, Congress also passed the Internet Tax Moratorium in 1998, creating a special no tax zone for economic activity that happened to occur over data rather than over the phone, in person or in a physical location.

- **This only added Government endorsement to the "datatopian" economics of the Internet and that there was indeed a "free lunch" where dot.coms and data traffic companies could generate multi-billion market capitalizations without any profits and with long shot business models.**

Finally, current Government telecom/data competition policies are massively deflationary; they are unwittingly, but very effectively, anti-profit, anti-growth, and anti-job creation.

- The Telecom Act and regulatory implementation has adopted competition as an end in itself when it is really just a means to an end.
- The market has figured out that the Telecom Act and its implementation has been an unmitigated disaster, but the Government sure has not.
- The Government is continuing to pursue competition even when it is economically irrational, deflating economic growth, destroying jobs and shareholder wealth, and ill serving consumers.

V. Conclusion

Global Crossing is telecom's Enron. It exposes a deeper pattern of problems and highlights that Enron was not an isolated incident.

- Global Crossing won't be the last bankruptcy in this sector. Many more bankruptcies lurk in the "insolvency zone."
- Many more investors, pensioners and employees will lose much more wealth because the system so poorly protects their interests.

We submit this testimony to help bring the overall problem into better perspective. There are no easy "silver bullet" solutions, however, the Government can:

- Improve the inadequate investment research system to prevent future trillion dollar fibs;

- Discourage the "rational manipulation" of the capital markets by protecting investor interests; and
- Undo the irrational economics the led to the telecom and Internet.

The system of protecting investors and pensioners is much more susceptible to manipulation than most appreciate and it needs substantial bolstering. It won't get fixed without comprehensive market reform.

Thank you again Madame Chairwoman for the honor to testify before your Subcommittee on this important topic.

Attachments

Precursor Research

"Datatopia" – Why Data Transport Growth Stories May Disappoint, February 5, 2001
Telecom's Debt Spiral, February 5, 2002
Why Telecom is Decoupling From Overall Economic Growth, March 6, 2002

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Scott C. Cleland
February 5, 2001

"Datatopia"—Why Data Transport Growth Stories May Disappoint

(Part Six in a Reexamining Telecom-Internet Investment Themes Series)

Summary: Precursor is skeptical about the market's expectations for continued data networking revenue hyper-growth. **Precursor questions expectations for sustained hyper-growth in Cisco's data carrier business over the next few years as well as hyper-growth prospects for data carriers and fiber optic players.** *Precursor sees these businesses as fast revenue growers, but believes that hyper revenue growth expectations stretch credulity.* Precursor believes the **last 3-5 years of data networking were more an aberration than an accurate indicator of the future**. Too many investors appear to still be relying on the growth trajectory of past data networking financial trends as a strong indicator of the future growth trajectory. Past momentum *can be* an outstanding future indicator *unless* there is **discontinuous change** — which is precisely what Precursor believes is happening in the data sector. Many investors have to see "the whites of the eyes" of bad numbers before "pulling the trigger." By then, it can be too late. Precursor further cautions investors that the foundation of the data story is unlikely to be able to support the weight of hyper revenue growth expectations.

Why Data Past is a Poor Indicator of Data Future: **(1) Discontinuous change:** It's unlikely the next 3-5 years will experience anything like the Internet/dot-com mania and subsequent flame-out. It's unlikely the second half of U.S. households will go online as quickly as the first half did in the last five years. It's unlikely there will be a repeat of investment banking "gold rush" triggered by the 1996 Telecom Act, which over-funded dozens of CLECs and data carriers. **(2) More momentum than propulsion:** Rockets need fuel and oxygen to keep accelerating or maintain speed. The data "growth rocket" of the last 3-5 years also needs the constant "fuel" of ongoing demand and economic growth and the "oxygen" of plentiful capital. Precursor suggests data growth is currently more momentum than propulsion given that the economy and capital expenditures are slowing, the telecom sector is over-leveraged, and access to capital has become difficult. **(3) Broadband Can't Grow Like Dial-up:** (A) Dial-up prices are half of broadband prices. (B) Dial-up requires minimal installation cost, time, and hassle; broadband installation is an expensive, time-consuming hassle for consumers and businesses. (C) The local telcos' network upgrade cost for dial-up data service on voice lines is minimal because it requires little network modification; broadband (DSL and cable) requires expensive network reengineering. Many under-appreciate the very different impacts dial-up and broadband have on last mile networks; **dial-up is easy and relatively cheap while broadband is hard and costly**.

Data Revenue Growth Expectation's on Weak Foundation: ***(1) Data traffic growth is actually slower than the hype:*** Much like the popular myth that "voice will be free," **hyper data traffic growth appears to be over-hyped as well.** Conventional wisdom still believes data traffic doubles every 90 to 120 days. While this may have been true for a brief, anomalous period in the mid-1990s, industry studies estimate that in reality, data traffic doubles roughly once a year (Coffman and Odlyzko). **This implies a ~100% annual data growth rate — which is substantial by any measure, but is significantly lower than the 800% to 1600% implied by the popular "doubling every three to four months" myth.** Hyped traffic growth rates obviously would increase expectations for more frequent equipment upgrades than the slower rates industry studies suggest. **(2) Highly distorted artificial market:** Hyper revenue growth depends on an efficient marketplace where prices and costs are based in reality. Precursor reiterates that few appreciate that the data market is not the "free market" that most imagine, but more similar to the proverbial "free lunch." Investors should not forget that the *original* data industry model was created as an academic, **NOT-FOR-PROFIT model**. (Pre 1991, NSF, the Internet overseer, had a no-commercial-use policy.) Each computer user paid only for their link to the rest of the network, and no mechanism was necessary to arbitrate recovery of asymmetric costs generated by others — because it wasn't organized around a profit motive. So more than most appreciate, the old not-for-profit structure lives on through "peering," where companies negotiate how they interconnect to each other's networks. Unfortunately the "peering" structure depends on carriers being true "peers." If not peers, the arrangement can require uneconomic (unprofitable) cooperation and does not provide much pricing leverage. (UUNET, the one company that has some pricing power, is under the watchful eye of the DOJ antitrust Division.) Free markets inherently are driven by economic self-interest; the Internet model was organized to serve the collective interest. **(3) Poor Industry Business Model:** Hyper revenue growth results from a robust business model. (A) By government policy design over the last 30 years, the Internet/data model disproportionately benefited the "information service" companies that ride on the networks at the expense of the "telecom service" carrier. Interconnection and nondiscriminatory access requirements limit carriers' market leverage in order to benefit users. (B) Packet networks strategically forfeit control of the network to users. Control of the network's functionality and how it's used can represent substantial business and price leverage. As @Home's CEO famously said: "no one wants to be a dumb pipe." (C) The current data networking model also encourages uneconomic behavior: e.g. Napster's file sharing creates enormous costs that are not borne by those generating the costs, because "the Internet is supposed to be free." * * * * *

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Scott C. Cleland
February 5, 2002

Telecom's Debt Spiral

Summary: Precursor advises **relatively more under-weighting of the telecom sector** as "Enron-itis" fears exacerbate an already bad debt and overcapacity imbalance. The fundamental health of this **sector is likely to get worse before it gets better.** Precursor **now advises wholesale avoidance of the competitive telecom segment and the equipment players, especially the data and optical segment**. The relatively reliable positive cash flow of Verizon, SBC, and Bell South may only be a relatively safe haven in this very risky sector. The combination of: the sector's anemic growth outlook, the cannibalizing competitive mega-trends of wireless substitution, voice to data migration, Bell entry into long distance combined with local competition, and the bubble-induced excesses in debt and over-capacity, all create a powerful wealth destroying dynamic. **Telecom's "debt spiral" has gotten so bad** that even the relatively strongest players who are still able to raise significant capital (VZ, SBC, and BLS) don't want to assume any more liabilities or business risk. Consequently, **Precursor is reversing its long held view that consolidation can help improve the sector from excess capacity and debt any time soon.** This is no longer a growth, but a preservation of capital, sector dynamic. Precursor now **no longer believes that Qwest or Sprint shareholders can expect much of a takeover premium**, if they are lucky enough to be merged with SBC and Verizon at all. **Without expectations of robust growth in this debt-ridden, risky, high fixed cost, increasingly competitive sector, the math of many business models simply does not work.** More bankruptcies lurk.

Telecom's Debt Spiral: **(A) "Enron-itis" has infected telecom.** Two more Andersen-audited, debt-heavy, forward-leaning companies, Global Crossing and McLeod, just declared bankruptcy. Five more are now drawing suspicion by association: WorldCom, Qwest, Level 3, Allegiance, and XO. The market apparently has realized that heavy debt does not mix well with an anemic growth outlook. Falling equity values can lead to debt-rating downgrades, which weakens already tenuous business models and further scares investors away. **(B) Market's no longer giving telecom the benefit of the doubt.** The market's post-9/11 momentum rally effectively winked at telecom's real growth prospects. However, so many high profile and hard-to-ignore bankruptcies have the market worried about its "backside" as well as its upside. It's hard to "visualize" equity growth through a fixed-income solvency lens. Flipping from anticipating beta and growth to anticipating bankruptcies contributes to a downward dynamic. **(C) Competitive telecoms must have growth expectations for their math to add up.** Without growth, there's less stock currency to borrow against or grow by acquisition, no takeover premium for investors, and no way to stay ahead of the debt man. Heavy debt plus no growth equals negative real growth. **(D) The debt overhang prevents the work-off of the huge over-capacity in the market.** No company wants to take on more debt in order to cull the over-capacity in the system. And, bankruptcy does not necessarily eliminate over-supply; it only resurrects it on competitive steroids. The competitive dynamic of high fixed costs forces players to chase incremental revenue by slashing prices to just above variable costs, which are far below average fixed costs. This can create a vicious dynamic like that continually experienced by the steel industry, where over-capacity never gets worked out, prices get slashed, and investors get left holding the bag. **(E) Imploding fundamentals create business risk contagion for all involved in telecom transport business.** (1) While the tectonic network shift from voice to data traffic was long-touted to be a good thing, "data-toplan" pricing makes data traffic so dramatically less profitable than voice traffic that profitability can't be made up on volume. (2) The mega-trend of wireless substitution for wire-line minutes effectively transfers huge shareholder wealth to consumers. It increases net costs in the system while reducing net revenues—a highly deflationary dynamic. (3) Bell entry into long distance combined with local competition has a similarly deflationary dynamic: the system's net costs surge with massive regulatory intervention and inefficiency, while net revenues plummet with competition and the FCC's deflationary UNE-P and TELRIC resale rates. **(F) Surviving today can mean disinvesting in tomorrow.** Like a rapidly dropping hot air balloon demands its occupants throw anything big overboard, competitive carriers need to make big cost cuts; the prime candidates are more capital expenditures and people.

Few Forces Able to Pull Telecom Out of Its Debt Spiral? (A) Even when the economy emerges from this telecom-tech induced recession, the telecom-tech sector will remain decoupled from the performance of the rest of the economy, because telecom-tech has gone from "economic propeller to growth anchor." Telecom will not only lag the recovery, but also serve as one of the leading drags on the rest of the economy for *at least* the next year. (B) Apparently, the market does not see any credible new "killer apps" or any big steeply-increasing demand curves out there as online access, wireless, and computer growth rates are maturing. Video file sharing is one of the few potential major demand catalysts out there. (C) And material de-regulation relief from the FCC is likely still quarters away, or even longer, from the states. Policymakers throughout the Government remain largely oblivious to both the magnitude and economic implications of the telecom-tech meltdown and the destructive role government competition policy has played in helping precipitate this market debacle. * * * * *

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Scott C. Cleland
March 6, 2002

Why Telecom is **Decoupling** From Overall Economic Growth

Summary: Precursor advises investors to rethink **the bedrock telecom investment assumption:** ***that the telecom sector generally grows significantly faster than the economy.*** With the economy now bouncing back, a technical or historical view could suggest telecom *stocks* may outpace the market. However Precursor's analysis indicates that telecom's future will be very different from the 1990s and that, ***fundamentally*, the telecom sector has largely become *decoupled* from the larger growth engine of the overall economy**. Telecom has developed its own countervailing and highly deflationary economic fundamentals; it's gone from an economic propeller to a drag on the economy. The critical "backbone" transport segment, the third of the sector that interconnects every carrier, effectively is imploding—"dead model walking." And highly deflationary government competition policies effectively are eroding margins for most of the rest of the sector. This tele-deflationary dynamic reinforces the broader trend in the economy, where consumers are sucking value from producers in the form of increased competition and lower prices. **Precursor reiterates its advice to continue under-weighting telecom, because for the foreseeable future, telecom overall will grow relatively slower and margins will increasingly come under pressure.**

I. Investment Implications of Slower Growth Far-Reaching. (A) The current cascade of **telecom bankruptcies could eventually reach Qwest, Sprint, Level 3 and WorldCom.** Debt-laden transport business models may now be entering "the insolvency zone," where *without growth or strong faith in their future growth potential*, they may not be able to continue to convince creditors that they can stay ahead of their *increasing cost of capital*. High-fixed cost companies can't easily cost cut their way to *long-term* solvency. (B) **Much of the "juice" in past aggressive growth and momentum investing may be over for a while,** given that the peak of the bubble was driven by roughly seven NASDAQ telecom-data stocks with eye-popping runs: Cisco, JDS Uniphase, Juniper, Sycamore, Ciena, Nortel, and Corning. Chronic over-capacity and over-regulation means precious little new capex spending anytime soon. This may suggest a *new fundamental bias toward value over growth in telecom investing.* (C) **Consolidation and IPOs could be much more modest** without high-flying stocks as currency. Since companies pay an acquisition premium for growth, future consolidation could be less satisfying for shareholders.

II. "Tele-Deflation:" Why Telecom Growth Rate Is Slowing. **(A) Real core demand is slowing and changing.** (1) For new business, growth curves are beginning to plateau across the sector for reasons largely unrelated to the recent recession. From 2000-2001, Precursor estimates that growth has slowed: for wireless subscribers from 27% to 18% with 46% penetration; for PC homes from 33% to 10% with 57% penetration; for online subscribers from 99% to 20% reaching 51% penetration or 90% of computer households; and for broadband subscribers from over 200% to 70% at 10% penetration. (2) There's also a dearth of new potential "killer apps" on the horizon. Ultra-Wideband may be the best *potential* candidate, but that is more a 2003-4 and beyond story. (3) Incremental subscribers going forward generally have less upside profitability and have higher risk of churn. **(B) Government competition policies have made *core* traditional markets uneconomic and have created a hostile investment climate.** The Telecom Act's flawed "unbundling at cost" premise has: devalued telecom facilities; discouraged new investment; added huge regulatory costs with little value-added to the customer; and skyrocketed business risk with no offsetting way to earn back the new risk premium. Government resale competition policies are largely price-regulation, regulatory re-branding exercises that create little customer or shareholder value. The capital markets now view the FCC's TELRIC resale policies (especially UNE-P) as value-destroying government redistribution of market share. Government competition policies have encouraged overcapacity in transport and wireless networks, which has helped spawn the unintended consequence of the *"Telecom Debt Spiral"* dynamic (see *Precursor 2/5/02)*. **(C) Tech trends are deflating profitability and shifting value from producers to users.** Contrary to conventional wisdom, convergence is less about growth and more about cannibalistic competitive risk. Overall, the consumer expects more services for a lower overall price. In general, technology is now deflationary; it is expanding capacity much faster than demand can consume it. These dramatic increases in efficiency are accelerating commoditization. In particular, data growth is highly deflationary because low data margins erode high voice margins. Wireless substitution is highly deflationary because a faster-growing, less profitable wireless business is cannibalizing the very profitable wireline business. **(D) Pricing trends are "flattening" revenues and profitability.** (1) One of the most ominous trends undermining telecom revenue growth and profitability is the inexorable trend of consumers/businesses demanding flat-rates over usage-based rates (e.g., 800 service, special access, data, wireless buckets of minutes, and now AT&T's new flat rate long distance plan). This flat-rate trend is a double whammy because flat-rate pricing models grow revenues more slowly than usage-rate models and because the risk of recovering the cost of incremental investment shifts from the user to the producer. (2) Finally, the trend toward "bundling" is less about growth and more about defensively reducing competitive churn. * * * * *

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U.S. Energy Companies' Exposure to Downturns in the Telecom Market

Written Testimony

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Committee on Financial Services,
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I. Market Conditions of the U.S. Telecom Sector, As Illustrated by the Bankruptcy of Global Crossing, Inc.

Global Crossing filed for bankruptcy on Jan. 28, 2002, representing the fourth-biggest U.S. bankruptcy in history. (Enron Corp. being the largest, followed by Texaco, Inc., and Financial Corp.). In its bankruptcy filing, Global Crossing listed assets of $22.44 billion and debts of $12.39 billion. From a broad perspective, the company's dramatic fall represents the leading case study of how quickly telecom-asset values diminished, possibly damaging both pure-play telecom firms and U.S. energy companies that invested heavily into the telecom sector. Global Crossing was once considered the strongest of the challengers taking on incumbents that were too slow to cater to "new economy" demands for more bandwidth. It was also seen as one of the most ambitious telecom ventures to emerge from the worldwide boom investment in the industry in the late 1990s. Consequently, its staggering fall can provide valuable insights to the exposure to the telecom sector currently faced by other companies.

In the interest of providing a cursory background, the following is a brief summary of Global Crossing's rise and fall. The company was founded in 1997 by former Drexel Burnham Lambert executive Gary Winnick. John Legere became CEO in October 2001. The company expanded aggressively and quickly, ultimately building 100,000 miles of cable spanning five continents. The network reportedly reaches 27 countries and 200 major cities around the world.

Global Crossing went public in 1998. Global Crossing's business objective was to become a telecom-sector titan out of the Internet age, and worked toward accomplishing this goal by carpeting the world's oceans with fiber-optic cable. Global Crossing reportedly spent $13.7 billion to build its fiber-optic network. The construction of the network was greeted with great enthusiasm among many market analysts and investors, who collectively shared or accepted Global Crossing's expectations that the increase of Internet-based businesses would dramatically increase the need for broadband capacity. In fact, at first Global Crossing's plan made the company the darling of investors and telecommunications analysts. The company's executives remained confident, and convinced Wall Street, that Global Crossing would be able to sell capacity directly to big multinational companies such as Coca-Cola or American Express.

Further, Global Crossing found that capital markets were more than willing to loan the company money as it was building its network with grand expectations in the late 1990s and into 2002. In fact, the boom for Global Crossing came at a time when even some companies that didn't have investment-grade ratings could borrow without posting collateral. About 100 banks are now involved in the proceedings over Global Crossing to some degree. Since 1998, Global Crossing and its rivals involved in the telecom / broadband sector raised over $1 trillion from the capital markets in equity and debt,

according to data from Morgan Stanley & Co. The figure doesn't include bank loans, financing from vendors whose equipment the carriers bought, or the money raised through securitizing their own accounts receivable.

However, the downfall of the company has its roots in the lack of demand in the telecom sector, which led to a glut in capacity for such high-speed networks as the massive one built by Global Crossing. A massive overinvestment in such "backbone" networks, along with slowing of growth in Internet traffic, produced a slump in demand for the wholesale communications capacity sold by companies like Global Crossing and left them unable to support mountains of debt. As a result of the lack of demand, prices for the bandwidth capacity plummeted in 2000 and into 2001. Global Crossing's financial status became impacted over the last two years as the dried-up funds among long-distance telecom carriers caused demand for leasing subsea communications links to evaporate. Meanwhile, the carriers that did want capacity were able to negotiate low prices between Global Crossing and its competitors.

It is clear that the fortunes of Global Crossing sank with the larger downward trends of the telecom sector. This became apparent to the public only when the company encountered serious financial trouble late last year. It should be noted, however, that the company's stock had been dropping since early 2001, tracking the general downturn in the telecom market. Further, although Global Crossing had built a worldwide fiber-optic network during the tech boom, the company has never made a profit. Global Crossing announced in mid-December that it would halve dividend payments to save $46 million each quarter. The company then refused to honor a $400-million loan agreement with its subsidiary, Asia Global Crossing, and warned that it would be in violation of covenants on loans worth $1.8 billion by the end of the year. Its bankers agreed to a waiver on those covenants but attached new conditions. Those waivers were set to expire on Feb. 13. Global Crossing reported a third-quarter 2001 loss of $3.35 billion and said that sales fell 26 percent from its second quarter to $793 million. In addition, the company reported $3.4-billion losses in the 4Q 2001, as sales of bandwidth continued to fall.

Capital expenditures at the company have historically been high as Global Crossing built its 27-country telecommunications network. Now, capital expenditures are expected to shrink to $200 million in 2002 from $3.2 billion in 2001. According to Mr. Legere, Global Crossing was spending $2 million to $3 million a day in interest payments on capital funding. When and if the company emerges from bankruptcy proceedings, it hopes that it will not have that kind of capital pressure. Share prices have been declining for a long time, falling from a 52-week high of $169 down to 22 cents.

In addition to the downturn of demand for broadband capacity, the accounting techniques used by Global Crossing have also come under question in a Securities and Exchange Commission investigation. Known as indefeasible rights of use (IRU), the technique that

Global Crossing used is a fairly standard practice in the telecom market, but has the potential of distorting the financial earnings and losses of telecom companies. An IRU is a type of long-term lease of capacity on a fiber-optic network. Fiber-optic carriers frequently swap capacity with other companies that own fiber-optic networks. Swaps occur when a company such as Global Crossing sells IRUs to another company, and at the same time paid an equal amount to buy IRUs from the same company. In other words, this should have represented an even trade, but both companies might record earnings and capital expenses on their balance sheets. Global Crossing and its telecom competitors frequently bought space on one another's network in areas not covered by their own systems to offer corporate customers a more complete data system. Such swaps are attractive to carriers, because accounting rules allow them to book an incoming contract as revenue, and then book the outgoing contract as a capital expense, which they typically emphasize as separate from operating results.

It is known that Global Crossing used these IRU instruments to sell bandwidth on its fiber-optic network, typically in contracts lasting for 25 years. Further, according to many reports, since it went public in 1998, Global Crossing continued to emphasize metrics that removed capital and interest costs from its balance sheets, and the SEC investigation is looking into whether or not the use of IRUs at Global Crossing may have intentionally misled investors and commercial bankers about the company's financial performance. According to available evidence, in some cases Global Crossing would buy an IRU and book the price as a capital expense, which would spread the expense over a number of future years. It would then resell that capacity and book the proceeds as revenue, leaving some investors to see the increase in revenue, but not the expense. Obviously, the bottom line is that revenue at Global Crossing may have been inflated, giving investors an inaccurate impression of the company's financial status.

Global Crossing is presently trying to sell the business to other companies. On March 11, 2002, Mr. Legere said the company had attracted interest from 40 financial and strategic investors out of 76 contacted. The company is now reportedly less reliant on debtor-in-possession financing and a $750-million preliminary bid from Asian technology companies Hutchinson Whampoa Ltd. and Singapore Technologies Telemedia Pte to purchase a 79-percent stake. Under that plan, creditors would receive $300 million in cash and new equity in the reorganized company. A class-action suit could block this proposed deal. The company wants to keep additional cash on hand until demand for its fiber capacity increases.

Global Crossing says that its problem is a balance-sheet issue, not an operational issue, after piling up debts of $12.4 billion and has found it increasingly difficult to find new clients to replace some of its major Internet customers, which either collapsed or dramatically cut back spending. Mr. Legere says that Global Crossing has a good

business and a sick balance sheet. However, the company may not emerge from bankruptcy by the fall of 2002, as originally hoped. The company has more than $1 billion in cash, up from about $900 million when it filed for bankruptcy. Note that there is also a pending class-action lawsuit against Global Crossing that the company overstated revenue from the sales and gave a misleading picture of its financial performance. Also note that within weeks of the bankruptcy filing, the SEC and FBI began investigating the company's accounting practices.

Moreover, only little more than a year ago, the telecom sector was at its peak, with billions of capital investment flooding into the sector as wildly optimistic expectations for demand seemingly exaggerated the scale of the market. However, a massive downturn has ensued, impacting not only companies operating in the telecom space but the nation's entire economy as well. The bottom of the telecom sector has fallen out, due in large part to the fact that the increase in bandwidth capacity has outpaced the growth in market demand. While some companies maintain that a liquid market for telecom and bandwidth trading is still on the horizon, it most likely is another two years away (at the earliest), which could make the next several quarters rather difficult for those companies with exposure in the telecom sector. At this juncture, telecom does appear weak, but it could also be argued that weak telecom companies are being weeded out, leaving stronger operations to survive and potentially succeed as the market grows. The bottom-line criterion in this "survival of the fittest" process in the telecom sector may be the companies that can effectively manage their own costs will remain. Whether there are long-term prospects for growth in the telecom sector is the question to be asked when determining which companies will succeed in this sector. Regarding Williams Communications specifically, the company certainly faces a rather constricted telecom market. However, in hindsight, a case could be argued that Williams Cos. made a smart move in transferring the telecom business into a stand-alone operation in advance of the implosion that subsequently occurred in the telecom sector.

II. Risks Associated with the Expansion of U.S. Energy Companies Into the Telecom Sector

In the mid-1990s and into 2000, telecom seemed like a boom market to many energy companies, just as it appeared to Global Crossing. Like many other businesses, some power firms began buying telecom companies and building bandwidth infrastructures in anticipation of a liquid trading business. In addition, especially for small and mid-sized electric utilities, telecom seemed to present an opportunity to take advantage of wholesale broadband solutions to deliver value-added options to their customers. The pressure of keeping up with new technologies in the telecom arena led many energy companies to acquire or partner with an already-established telecom company, as Dynegy, Inc. did with Colorado-based Extant Communications last year. The need for alliances arguably forced many firms primarily active in the power space to spend additional funds to support a

venture into the telecom market. The convergence between energy and telecom got into high gear about two years ago (late 1999 and into 2000), and became somewhat of a "groupthink" trend in the industry in which Enron Corp. and Williams Cos. were leading participants. In fact, Enron's former CEO Jeffrey Skilling projected a $450-billion worldwide market for communications bandwidth trading and services by 2005, and the valuation of Enron's own broadband business at $40 a share, or $35 billion. As a point of reference, Enron's expansion into the telecom market was spawned in part by its acquisition of Portland General, a utility in Oregon that had constructed some fiber-optic capacity in the Pacific Northwest.

Utility holding companies are allowed to purchase telecom businesses per an exemption provided under the Telecommunications Act of 1996. However, most utilities (for example, Southern Company) that typically fall under such restrictions from the Public Utilities Holding Company Act (PUHCA) have not plunged into the telecom sector to the extent that merchant energy companies such as Enron, Williams, Dynegy, Reliant, and AES did. Some utilities may have been drawn to the telecom market, either through a comparatively large or small investment, because electric utilities generally have internal expertise and assets such as transmission infrastructure that can be leveraged into the telecom business.

In any case, the fiber-communications market now finds itself at a stunning impasse, after having invested hundreds of billions of dollars in long-haul fiber networks that exceed current demand for voice and data services. Despite the increased investment in the sector, there still appears to be an insufficient infrastructure of fiber capacity to support the needs of end users, which has also caused demand to trail off. The boom-and-bust trend of the telecom sector has had a dramatic impact on the nation's economy as a whole, as some smaller telecom companies went bankrupt and investors remain very hesitant to put further large sums into the sector until supply and demand become more balanced. According to one report, the telecom business (including local, long distance and wireless companies, along with telecom equipment makers) reached a peak in March 2000, with a combined market value of $2.7 trillion. Over the subsequent year, the market shed $1.7 trillion of that figure, accounting for more than 90 percent of the net loss in stock wealth in the period. It is unlikely that energy companies as a whole will exit the telecom market altogether, as many companies continue to see telecom as a valuable long-term way to expand their customer base and eventually increase value for shareholders. However, it is clear that the next few quarters will be difficult and unlikely to provide any real profits for energy companies with telecom exposure. Looking forward, bandwidth trading may be another potential moneymaker in the post-deregulation world of utilities' diversification ventures, but energy companies need to proceed with caution. At this time, capacity clearly has outpaced demand. However, if this equation becomes more balanced (as Enron, Dynegy and Williams, among others, are projecting), the market could still become lucrative in the next two years.

Other companies apparently foresaw the market downturn in telecom and began exiting the market altogether. For instance, in June of 2001, Conectiv announced that it had sold its telecommunications business (along with a stake in a New Jersey power plant) for a total of $29 million, in order to focus more heavily on building a more targeted generation business. Conectiv's new approach seems to be particularly prudent as it gets the company out of the struggling telecommunications industry (which has also taken a tumble on Wall Street), and expands upon what is already a lucrative trading operation in advance of the company's pending partnership with Potomac Electric Power Company (Pepco).

III. Specific Examples of Energy Companies' Investments in the Telecom Sector

Enron Corp: Just as Enron Corp. appeared to achieve unparalleled success in electricity and natural-gas trading in the mid- to late-1990s and into 2001, the company also invested a great deal of capital into building a high-speed broadband communications network, under its subsidiary Enron Broadband Services, to support its planned move into bandwidth trading and marketing. Enron Broadband Services focused exclusively on two key areas: bandwidth trading and package services for business customers (which would basically include the delivery of data and entertainment through fiber-optics). As noted, Enron executives, particularly former CEO Jeffrey Skilling, confidently projected a $450-billion worldwide market for communications bandwidth trading and services by 2005, and the valuation of its own broadband business at $40 a share, or $35 billion. Again, as with the case of Global Crossing, Wall Street seemed to agree with Enron's aggressive projections for the telecom sector. Some analysts reported that interest in Enron's expansion into this area, validated by investor interest in new technologies in general, drove an 87-percent rise in the company's share price last year. The company planned to trade excess bandwidth capacity, and in order to do so began constructing its own network, which cost a lot of money. Enron acknowledged that it intends to sell between $2 billion and $4 billion in assets over the next 12 months in order to reduce debt and support the new business in broadband (among other businesses in pulp and paper, data storage and advertising).

However, while prior to the bankruptcy, Enron maintained that it still projected a strong market for telecom, losses in its telecom sector contributed to the company's financial collapse. In fact, for year-end 2000, Enron Broadband Services reported a $60-million EBIT loss, reflecting startup costs to build the new business. The company seems to have anticipated the slow growth of its broadband business. In fact, then-Enron CEO Jeffrey Skilling did not appear concerned over the loss and said that it took between five and six years for the company's natural-gas business to develop standardized contracts and increase liquidity. Mr. Skilling has said that these numbers do not dilute his belief that bandwidth trading will soon become a strong performer for the company. While Mr.

Skilling remains optimistic about the potential of the broadband business, investors may not be as patient. (Note that while Enron's broadband business took a loss for 2000, the company as a whole reported a 25-percent increase in earnings per diluted share to $1.47 and a 32-percent increase in net income to $1.3 billion.)

In 2Q 2001, Enron's broadband business reported a $102-million operating loss, compared to an average loss of just $24 million for the four previous quarters. Former Enron CEO Jeffrey Skilling has openly acknowledged that revenue opportunities in the company's broadband unit have "dried up." Basically, Enron faced an unanticipated excess of fiber-optic lines, which has prevented the demand for the division's services from materializing as anticipated. Mr. Skilling remains optimistic that the business will become profitable, but that it is probably six to 18 months away. As of the third quarter of 2001, Enron stopped including its telecom financials in its wholesale and retail energy services sector. In other words, Enron stopped identifying telecom financials as a stand-alone line item anymore, which some investors perceived as an effort to hide additional losses. We do know that Enron took a $638-million loss in the third quarter, which included such businesses as broadband and water. In any case, as has been well documented, by early December 2001 Enron Corp. had declared bankruptcy.

The company planned to trade excess bandwidth capacity, and in order to do so began constructing its own network, which cost a huge amount of money. However, Enron's exposure to telecom became one of many factors that brought the company into a downward financial spin. In its third-quarter 2001 earnings report, Enron posted $180 million in charges related to the downsizing of its broadband operations (including severance costs and losses on inventory sales and customer contracts). Prior to that the company acknowledged that its telecom sector had "dried up." The problem with Enron's bandwidth unit, which now seems like a foreshadower to the problems that other companies exposed to telecom are experiencing, is that the company faced an unanticipated excess of fiber-optic lines, which prevented the demand for the division's services from materializing as anticipated.

Williams Cos.: Williams Communications launched a rather successful initial public offering (IPO) in October 1999 and became a fully independent company on April 23, 2001, when the tax-free spin-off was approved by former parent company Williams Cos. The IPO was seen as a move to make Williams Communications more independent from the parent company, but as we will see an inherent financial relationship between the two companies kept them interconnected. Williams Communications provides broadband fiber-optic network services. The company's network customers are carriers of voice, data and multimedia, including the largest regional/national telecom companies, interexchange carriers, local exchange carriers, competitive local exchange carriers, Internet service providers, application service providers, and utility companies. A key component of the company's business model is its efforts to trade bandwidth, or the ability to move voice

and data over fiber-optic networks. Toward that end, Williams Communications claims that it achieved a significant milestone at the end of 2000 by establishing 33,000 route miles of broadband capacity connecting 125 cities, a full year ahead of its initial schedule.

However, energy trader and pipeline operator Williams Cos. said on March 4 that it expects a restructuring of $1.4 billion in notes to be completed in the "very near future," after favorable talks with investors. The talks concern $1.4 billion of notes issued by the WCG Note Trust, an indirect wholly owned subsidiary of Williams Communications Group Inc. Williams Cos. has been under pressure by the potential bankruptcy filing of its former subsidiary Williams Communications. Williams Cos. spun off 95 percent of Williams Communications to its shareholders in April 2000, but may have to assume debts of $2.2 billion under various financial guarantees arranged at the time of the spin-off. Credit-rating agency Moody's Investors Services said it was maintaining an investment-grade Baa2 rating for the senior unsecured debt of Williams Cos., but had downgraded the outlook for the company to negative from stable.

In addition to the potential bankruptcy that Williams Communications may have to declare to stave off its growing debt-ridden condition, the real story here may be the impact that the communications unit's problems could have on its former parent, Williams Cos. Despite the fact that Williams Cos. spun off 95 percent of WCG in April 2000, when prospects looked bright for the telecom and broadband trading markets, the energy-merchant and gas-pipeline company could still take a financial hit due to agreements that were made between the two firms when the spin-off occurred nearly two years ago. While conventional wisdom might have been used to make the argument that Williams Cos. made a smart move in transferring the telecom business into a stand-alone operation in advance of the implosion that subsequently occurred in the telecom sector, the reality now taking shape is that the former parent company may still hold some financial responsibility for the current problems of WCG. At the heart of this case is a complex, but increasingly common, use of financial accounting in which certain investments are backed by company stock. Although many issues are still being sorted out in its own bankruptcy proceedings, Enron apparently used this technique to back many of its off-balance-sheet partnerships. The current story unfolding around Williams Cos. and WCG is that the former parent of the telecom unit used its own stock as a backing for certain financial obligations held by its former subsidiary that may have been kept off of Williams Cos.' balance sheets. The financial obligation would potentially expose Williams Cos. to the financial turmoil that currently hovers around WCG, unless the renegotiation of various bond notes on which Williams Cos. is presently working prove successful.

The current plight for WCG is that it reportedly spent about $6 billion to build a fiber-optic network before the telecom boom faded, and presently faces about $5.16 billion in

debt, including about $2.4 billion in notes and other obligations owed to Williams Cos., which has prompted the company's consideration of bankruptcy. For the fourth quarter of 2001, WCG reported a loss of $372 million, or 76 cents a share, compared with $547 million, or $1.18 a share, for the period a year earlier. In addition to the debt, WCG shares have recently traded as low as 13 cents (down from a 52-week high of $14.20). Given that the stock has been below $1 for over a month, the New York Stock Exchange is presently reviewing whether or not shares of the company should be delisted.

The appendage that links Williams Cos. and WCG is Williams Cos.' decision to back bonds sold by the telecom unit, which reportedly were in the range of $1.4 billion. In a financial-structuring move that is fairly common but for which Enron has received a great deal of negative publicity, the bonds issued by WCG were backed by Williams Cos. shares. As you may recall, a major catalyst in the swift and dramatic collapse of Enron was the fact that the company had backed many of its off-balance-sheet partnerships with Enron stock, even though debt for the partnerships was often not recorded on the corporation's balance sheets. Williams Cos. reportedly backed as much as $2.2 billion of WCG's financial obligations. According to comments by Scott E. Schubert, chief financial officer of WCG, the company had interest payments of $500 million this year and a payment on $2.5 billion worth of unsecured bonds is due on April 1. However, although the debt in question belongs to WCG, Williams Cos. would have to pay $1.4 billion in principal within 60 days if WCG cannot make its own payment (and if terms of the notes are not restructured). In fact, Williams Cos. has said in the past that it could face liability for up to $2.2 billion of WCG debt under certain circumstances.

Thus, as noted Williams Cos. remains tied to WCG, and could suffer some financial consequences as a result of WCG's current debt-ridden condition, due to the agreement over financial backing that was reportedly reached between the two companies back in 2000. Now that WCG is struggling financially, it has the potential of also impacting its former parent. That is why Williams Cos. is feeling the heat to restructure about $1.4 billion in notes and is stressing its belief that the restructuring will be resolved in the "very near future." Williams Cos. is also negotiating with bondholders to reach an agreement that, if it does take over responsibility for making payments on the bonds for WCG, the payments would be made over time rather than being forced to pay the entire principal in a lump sum. A valid concern among some investors is that if Williams Cos. is forced to pay the debt obligation it might have to issue more common stock, further damaging the company's share price which has been impacted by larger market conditions including the Enron collapse and softening wholesale prices. A year ago, Williams Cos.' shares were priced at almost $50 and were priced at about $22 (as of March 16). Along with the renegotiation of bond terms, Williams Cos. also announced that it would sell its Midwest natural-gas pipeline to raise cash to help WCG. Also note that Williams Cos. has delayed the release of its own 4Q 2001 net earnings report while it continues to sort out the financial exposure to its obligations to WCG.

In another set of challenges that continue to bind Williams Cos. and WCG, the companies face mounting shareholder lawsuits alleging that the communications venture was fraught with misstated financial results and debt. Those launching the litigation against Williams Cos. and WCG say that Williams Cos. misrepresented the actual finances and future potential of the telecommunications firm, which led to an artificially inflated stock price when WCG first went public. According to the claims, this alleged misrepresentation enabled Williams Cos. to transfer what may have been mounting debt accrued by WCG off the balance sheet of its former parent. In other words, the suits charge that WCG was operating below expectations, revenue forecasts were overstated, and costs and expenses were understated. The end result, the argument goes, was that Williams Cos. appeared financially stronger and was able to continue growing its energy-merchant and pipeline businesses while shareholders supporting the telecom business may have been misled. Of course, it should be noted that Williams Cos. claims that the lawsuits are baseless and that the company will be vindicated in court.

When we break down the various lawsuits now facing Williams Cos. and Williams Communications, the legal claims against the companies essentially boil down to one core issue. In a nutshell, those launching the litigation against Williams Cos. say that the company misrepresented the actual finances and future potential of the telecommunications firm, which led to an artificially inflated stock price. Nevertheless, whatever financial misrepresentation may have taken place at Williams, perhaps the important subtext to this story is the ongoing meltdown of the telecom sector and how many of the energy companies that aggressively plunged into the telecom sector may find themselves ultimately burned by the expansion.

Moreover, although both Williams Cos. and WCG are presently trying to avert the potential bankruptcy filing of WCG, perhaps the larger issue to be addressed at this juncture is the financial exposure that Williams Cos. may continue to face with regard to the existing bond notes. Obviously, WCG does not have the available cash to repay the bonds and Williams Cos. has put itself at risk given the financial-backing arrangement forged between the two companies. Although Williams Cos. is now espousing confidence that the notes will be restructured in a favorable manner for the company, the lesson learned from this case may be the dangers of backing business deals, particularly those in off-balance-sheet arrangements, with company stock. Further, this case demonstrates the now-obvious risks associated with the telecom sector, to which Williams Cos. exposed itself when it financially supported the loan obligations of its former telecom unit.

Dynegy, Inc.: Dynegy has not fared much better with its telecommunications unit, which it initiated in late-1999. During the first six months of 2001, Dynegy Global Communications lost a total of $31 million. Losses in the second half of the year are not expected to be that severe, however Dynegy's CEO Chuck Watson disclosed that the

telecommunications unit will lower overall corporate earnings for the year by 13 to 16 cents. Without naming any companies specifically, Dynegy claims that its exposure to the market downturns in telecom are not as extensive as other power firms that have developed a telecom unit, due to its decision to be cautious about its invested capital. "We didn't beef up our personnel and assets, so we don't find ourselves in the same position as others," Mr. Watson said. Further, however, Mr. Watson conceded that Dynegy can't make any money off of its telecom business until its own network is completed, which could be still a year out or more. Dynegy has been focused on developing a state-of-the-art, cost-efficient global network to enable the company to participate in the broadband marketing and trading arena. The network reportedly will consist of approximately 20,000 route miles and more than 40 points of presence (POP) and should be completed by the fourth quarter of 2001. In addition, in late-2000 Dynegy completed its purchase of Extant, a privately held, Colorado-based communications solutions and e-commerce company. Extant provides centralized clearinghouse services, OSS integration and network-expansion capabilities to communications service providers.

Denver-based Dynegyconnect, L.P., a subsidiary of Dynegy Inc. announced the launch of Dynegyconnect Internet Service, a connectivity product that enables service providers to expand their networks or add Internet access to their service portfolios using Dynegyconnect's optical mesh network. "Competitive pricing and reliability make Dynegyconnect Internet Service a dynamic product for our customers," said Mark Stubbe, president and chief operating officer of Dynegyconnect. "Our goal is to provide network products and services that will help our current and future customers to be competitive in the marketplace." Dynegyconnect, a joint venture between Dynegy Inc. and Telstra Corp., is aggressively following opportunities in the converging energy and communications marketplace.

AES Corp.: AES is taking one step that is both clear and positive. The company has said it wants to return to its "core business of power generation and marketing." This might be viewed as a veiled reference to AES' intent to retreat from an expansion into the telecom sector, which has not been received well by investors. Specifically, AES spent a great deal of time and money launching a $1.37-billion hostile takeover of Venezuelan telecommunications firm CANTV, or Compania Anomima Nacional Telefonos, in which it already owns a 6.9-percent interest. AES ultimately dropped its bid when CANTV launched its own share-repurchase program. However, the fact that AES seemed adamant in launching a risky expansion into the telecom market of Latin America did not sit well with investors, and clearly was one of the factors that sent the company's stock price on a downward cycle in the fall of 2001. AES' venture rattled confidence in the company, as some investors believed that the company was imprudently expanding into the telecom sector, which was already significantly troubled, and becoming too heavily entrenched in Latin America, a market that is prone to political and economic volatility. I think AES'

newly renewed focus on its core generation business is a direct response to the negative reaction it received from investors last year. Nevertheless, while the return to its generation focus may help to present the company's business model in a clearer light, AES could find that it is making this retreat back into power generation and marketing at the wrong time. Since the time that AES became more diversified, the unregulated power market has clearly become restricted. Among other factors, demand for power and wholesale prices have both dropped, which has resulted in considerably less favorable market conditions for the generation market than existed a year ago. Only time will tell if AES' retooled business model will be sufficient to restore confidence in the company.

Montana Power / Touch America: The case of Montana Power Corporation (MPC) represents the extreme scenario in which an electric utility exited the energy business and transformed itself into a pure-play telecom operation, suffering some negative consequences as a result. Montana Power announced its decision about 23 months ago to exit the utility business and morph into a stand-alone telecom operation. The company sold its generation assets to PPL Corp. and was in the process of selling its T&D operation to NorthWestern, a provider of electricity, natural gas and communications services to Midwestern customers. Under an agreement established in October 2000, NorthWestern was slated to acquire MPC's utility operations for approximately $602 million in cash and the assumption of $488 million in existing debt.

However, a series of setbacks collided and called into question whether or not MPC's transformation would ever be completed. The setbacks included financial losses for the company, a lawsuit launched by shareholders, and community backlash in response to MPC's intention to raise electric rates by 20 percent to cover its subsequent costs for purchasing wholesale power. Note that MPC is considered the default provider to about 288,000 customers and needs to buy an average of 670 MW to serve them. The company also needs to keep a total of 1,050 MW as a peak load during the winter months and aims to keep 100 MW of reserve power.

Along with general concern about the business prospects of Touch America, considering that the market for telecom has significantly diminished since MPC announced its plans 21 months ago, there were essentially two main obstacles facing the sale of MPC's utility business to NorthWestern. The first obstacle was a concern about the impact that the sale would have on MPC's distribution customers, particularly after the start of new power-supply contracts MPC has negotiated that are set to take effect in the summer of 2002. The second obstacle related to questions about how MPC would be able to pay off its existing stranded costs, which reportedly are in the range of $300 million. Under Montana restructuring law, MPC was entitled to the full recovery of its stranded costs. However, the issue became clouded when the company voluntarily decided to sell its generating plants and dams to support its transformation into Touch America. In a nutshell, both obstacles facing this sales transaction relate to money and how much of the

profit of the sale of MPC's utility business would be returned to the company's customers. MPC had routinely argued that the 20-percent rate increase would be necessary for it to secure power on the wholesale market, and that the stranded costs should be charged to its electricity customers as they resulted from expenses associated with the company's obligation to serve.

Nevertheless, the Montana Public Service Commission (PSC) unanimously approved an agreement on Jan. 29 that let MPC sell the last of its utility holdings and reduce the size of a rate increase expected in July. The five-member commission's approval ends months of uncertainty for Montana Power, clears the way for the Butte-based utility to complete transformation into its telecommunications subsidiary, Touch America Holdings Inc., and resolves regulatory issues that have been before the PSC for four years. The ruling was an endorsement of the settlement agreement between MPC, NorthWestern and the Montana Consumer Counsel, which represents residential and small business commercial customers, and the Montana Large Customer Group.

In mid-February, Touch America Holdings, Inc. announced that it had completed its transition to a stand-alone fiber-optic network and broadband products and services telecommunications company with the sale of its Montana electric and natural-gas utility subsidiary to NorthWestern Corporation

Reliant Energy: Reliant Resources can now be added to a growing list of energy companies that have found their expansion into the communications sector to be far less than lucrative. At this juncture, it appears that Reliant Resources is pondering two options: sell off the telecom unit altogether or partner with another company to gain scale and possibly buy some additional time to grow the business. However, rather than sinking any additional capital into this market, Reliant Resources, which was partially spun off from parent Reliant Energy in 2001, seems to be leaning toward a complete divestiture of this business unit (although partnerships may keep it alive). What may make for an interesting turn of events are the market realities of the telecom sector, which for the most part remains quite depressed. Just as Reliant Resources takes steps to exit from its telecom business, other power firms—some located in Reliant's hometown of Houston—seem to be the exception of the lackluster telecom trend and in fact are expanding their communications business. What this means is that Reliant Energy Communications could find itself significantly undervalued and an acquisition target for one of Reliant's competitors.

For background, Reliant Energy first ventured into the telecom space in 1999, two years before it split its operations into regulated and unregulated businesses. Reliant's approach toward telecom was rather parallel with other energy companies that believed the communications space—perceived as offering high-growth potential in the 1999/2000 timeframe—would become a natural extension of the expertise that the company has

cultivated in the energy space. Its telecom business was inaugurated when Reliant became a competitive local exchange carrier (CLEC) and was later expanded in April 2000 when the company bought Insync Internet Services. Presently, Reliant Energy Communications is a facilities-based communications provider that offers Web, data and voice services to business customers and governmental agencies in Texas. The company's services include high-speed Internet connectivity, co-location facilities, Web hosting / design, and managed data services. The unit also offers data services including private line, ATM and Digital Subscriber Line (DSL), along with construction services related to private fiber-optic networks.

Attempting to capitalize on the anticipated growth of its unregulated businesses, Reliant Energy spun off approximately 20 percent of Reliant Resources into a stand-alone company in May 2001. The newly formed public company consists of Reliant Energy's unregulated power generation and related energy trading, marketing, power origination, and risk management services in North America and Europe; a portion of its retail electric operations; and other operations including Reliant Energy Communications, an e-business group and a venture-capital operation. The company's IPO raised about $1.56 billion and was considered one of the most successful offerings this year. Reliant Energy presently owns a little more than 80 percent of Reliant Resources, whose business model is focused primarily on wholesale power marketing, maintaining generating and trading assets, and selling retail energy. The spin-off is expected to be fully completed by May 2002.

While it remains purely speculative at this point, the names of power companies operating in the telecom sector that might have an interest in acquiring Reliant Energy Communications represent a short list. Thus, even though Reliant Resources maintains that it has made no ultimate decision about whether to sell its communications unit or expand it through partnerships, a case can be made for several prospective buyers. One obvious prospect might be Aspect, LP, a new provider of Internet-based financial risk-management services. The two companies recently announced a partnership in which Reliant Energy Communications will provide managed Internet hosting and security services to Aspect. It is important to note that Aspect is an affiliate of Koch Internet Business Strategies, the e-business development arm of Koch Industries, which is involved in energy trading and has an extensive partnership with Entergy Corp. While Reliant Energy Communications does operate in business lines that are outside of Aspect's current scope, Aspect may find that the company's high-speed Internet connectivity and fiber-optic assets could be used to support further expansion of its operations.

Other possibilities are companies that are direct-line competitors to Reliant, operating in both the energy and telecom markets. For instance, TXU Communications, which has more than 206,000 access lines throughout Texas and operates an 1,800-route mile fiber-

optic network, just announced that it is expanding its senior management team. TXU Communications is reportedly ranked as the fifth-largest telephone company in Texas and the 16th-largest in the nation, and presumably could benefit with an expansion of Reliant Energy Communications' assets. Further, Dynegy, Inc., Reliant Resources' Houston neighbor, also has a telecom unit (known as Dynegy Global Communications), which has created a network of approximately 16,000 route miles and more than 40 points of presence. Dynegy intends to become a leader in the broadband marketing and trading arena. Across the country, DukeNet Communications, Duke Energy's telecommunications subsidiary, just announced that it will be expanding its fiber-optics network with an acquisition of more than 500 miles, which may or may not be located in its primary service area of the Southeastern United States.

Moreover, given the depressed nature of the telecom sector these days, should Reliant Resources opt to sell Reliant Energy Communications instead of growing it through partnerships, the company could be undervalued and represent a strong buy for one of the companies that I've mentioned. The telecom business does tend to be geographically based, so it would make more sense for one of the Texas-based companies to move in for an acquisition of Reliant Energy Communications. However, as some power companies that have ventured into telecom remain optimistic that the broadband trading market will offer liquidity within two years, purchasing the telecom service business and fiber-optics network construction business of Reliant Energy Communications could be attractive to any number of companies operating in this space.

On the other hand, divesting Reliant Energy Communications could make for a tough sell. Only little more than a year ago, the telecom sector was at its peak, with billions of capital investment flooding into the sector as wildly optimistic expectations for demand seemingly exaggerated the scale of the market. However, a massive downturn has ensued, impacting not only companies operating in the telecom space but the nation's entire economy as well. By heeding the sage advice of stock analysts in a macro sense to "buy low, sell high," now is definitely the time to buy as the bottom of the telecom sector has fallen out, due in large part to the fact that the increase in bandwidth capacity has outpaced the growth in market demand. While some companies maintain that a liquid market for telecom and bandwidth trading is still on the horizon, it most likely is another two years away (at the earliest), which could make the next several quarters rather difficult for those companies with exposure in the telecom sector.

IV. Comparisons Between the Telecom Industry's Use of IRUs and the Energy Industry's Use of the Mark-to-Market Technique

Many energy companies have used a reporting technique known as "mark-to-market accounting." Put in a nutshell, this legal technique (endorsed by the Financial Accounting Standards Board, an accounting rule maker) has enabled a good number of energy-

trading companies whose earnings come in large part from forward contracts and spot-market transactions, to include in current earnings the profits they expect to realize in future periods. Under current conditions, energy-trading companies have been given rather wide latitude to estimate the fair value of pending contracts that have yet to materialize and record the projected value, either as assets or liabilities, on their balance sheets. With every quarter, and sometimes long after the quarter has ended, trading companies typically declare non-cash earnings based on the current market value of trading positions. Further, some trading companies can tweak their price curves if markets are illiquid enough so that mark-to-market results meet earnings expectations. The unrealized gains often can account for a huge chunk of an energy trader's estimated earnings. For instance, Enron's unrealized trading gains reportedly accounted for slightly more than half of the company's $1.41 billion of originally reported pretax profit in 2000. It is important to note that credible companies do not tweak their price curves, but the important point is that price curves are subject to interpretation.

However, in the volatile trading market where forward prices can fluctuate wildly, it is not uncommon that a large portion of expected earnings go unrealized, causing the company to issue earnings revisions. Due to the rather limited disclosure requirements that are currently in place, it has become increasingly difficult for investors or analysts to assess when a company might be making assumptions that are overly aggressive, or anticipate any market conditions within the trading sector that might have an impact on the company's projected earnings. Enron acknowledged that it had a hand in creating these accounting standards through aggressive lobbying efforts with the SEC, but it is by no means the only trading company that has engaged in the mark-to-market technique. Other large trading companies such as AEP, Duke, El Paso Energy, Entergy, Mirant, and Williams have also engaged in this common practice.

It is important to note that the mark-to-market technique is also used for risk management among many energy companies. Its use has an important purpose from the perspective of risk management, and therefore should not be eliminated entirely. The component of the mark-to-market technique that has proven troubling via the Enron case is that the methodologies for how a company is determining the value of its future transactions has been considered proprietary information up to this point. The fact that this information was not disclosed in the past made it difficult for analysts and investors to determine the accuracy of the company's valuations. Consequently, it is unlikely that the mark-to-market technique will be prohibited. Instead, the SEC will probably call for fuller discloser requirements on the methodologies that companies use within the mark-to-market technique.

There is a striking parallel between the use among energy companies of the mark-to-market technique and the use among telecom companies of the IRU technique. The similarity lies in the fact that companies in both industries were able to inflate current

earnings on the basis of projected revenue that may have materialized down the line. In the use of mark-to-market, energy companies that sold futures contracts for power trading counter potential and subsequent revenue as real and current revenue. In addition, energy companies had fairly unrestricted ability to assign the value of the futures contracts without having to divulge the methodology that they used to determine those values. In the use of IRU techniques, telecom companies often swapped capacity with other telecom companies at equal value, but recorded revenue or expense in such a way as to make their financial reports look stronger. Although used differently and embraced by different markets, the mark-to-market and IRU techniques both have the potential of creating artificially inflated financial earnings. Investors and analysts who are not educated on the intricacies of these techniques (the methodologies for which are often undisclosed) may be misled into thinking that the company is financially stronger than it actually is. In addition, as we have seen in the staggering and sudden bankruptcies of Global Crossing and Enron Corp., companies that had appeared as market leaders and fiscally strong to the general public crumbled when faced with their respective financial setbacks.

V. Comprehensive Solutions to Revive Investor Confidence in Financial Disclosures of Energy and Telecommunications Companies

While my testimony chooses not to speculate on what changes the Committee on Financial Services should make to revive investor confidence in the financial disclosure of energy and telecommunications companies, it is fairly clear the changes that should be expected along these lines from the Securities and Exchange Commission. Responding to growing pressure over Enron's collapse, the head of the SEC has proposed to have a group of outside experts discipline accountants rather than relying on the industry to police itself. Harvey L. Pitt, the SEC chairman, said that antiquated rules on corporate disclosure and accounting ethics had allowed investors to suffer from a series of auditing lapses over the last decade. "This commission cannot and, in any event, will not tolerate this pattern of growing restatements, audit failures, corporate failures, and then massive investor losses," Chairman Pitt said. "Somehow, we have got to put a stop to a vicious cycle that has now been in evidence for far too many years."

While there is little doubt that changes in the accounting practices of U.S. corporations are necessary, just what those changes will be and how they will be implemented remains a complicated issue. The Enron collapse certainly has brought a host of accounting problems into a national debate, as the company's bankruptcy seems to be the direct result of manipulation that occurred with regard to corporate financing. However, those immersed in the development of financial standards know that many fundamental problems have persisted for decades and have just recently boiled over to a level that is publicly intolerable. Clearly, the conditions necessitating market reform have elevated in recent years, which the Enron collapse accentuates. The last report I saw indicated that the number of restatements of financial statements of publicly traded companies

increased from 116 in 1997 to more than 230 in 2000, supporting the argument that the existing standards offer too many loopholes that result in unreliable financial reports. It should be noted that the new measures taking shape are primarily for the benefit of investors, analysts, credit-agencies, employees, and other stakeholders, and not necessarily for the benefit of the companies that will be impacted. In other words, the changes that may be imminent from the SEC would not be put into place to protect other companies from declaring bankruptcy. Chairman Pitt realizes that bankruptcy filing may be an inevitable reality among businesses. Instead, the changes that are likely from the SEC would be put into place to require companies to provide fuller and more accurate information about their financial position to investors and analysts.

In other words, Chairman Pitt has made it clear that the SEC, or other lawmakers and regulators for that matter, should not intervene if a company such as Enron is going under. The chance of bankruptcy, according to Chairman Pitt, is an essential counterpart to the dynamic of a free and fairly operating marketplace. Rather, the sweeping changes that appear probable for the accounting industry should seek to address the manipulation that can occur from the wide opportunity for individual interpretation that companies presently have when formulating their own financial records.

Granted, dysfunctional aspects of the methods that American corporations use to report their financial health to investors, lenders, credit-rating agencies, employees, and other stakeholders represent a complex arena of policymaking that may take many months or years to resolve. The impact that the Enron collapse will have as a catalyst for change in the financial accounting is not fully known, as this is a story that is still unfolding. However, based on both formal and informal material that has been released by the SEC (including cautionary advisories, public notices, speeches, and comments by Chairman Pitt, and actual rules), there are various pending changes that can be expected with regard to financial reporting that should come to fruition in the future. Looking at the energy industry as a whole, all corporations (including utilities that have regulated and unregulated operations and energy companies that are strictly merchant energy companies) will be impacted by these changes to one degree or another. Based on the information that we have at this time, I project that policy changes anticipated by the SEC will manifest in the following ways:

A new, independent review board focused exclusively on accounting standards. Auditing firms exist to determine whether a company's financial statements fairly reflect its condition within the broad parameters of what accountants refer to as generally accepted accounting principles (GAAP), sometimes referred to as MOPAP (for "my own personal accounting principles," a reference to the lack of standardization in methodologies). However, as financial statements and the methods of reporting income and losses have become more complex, the general consensus appears to be that those principles are no longer adequate.

Presently, the accounting profession is "regulated" by the Public Oversight Board, a group affiliated with the American Institute of Certified Public Accountants (AICPA), which oversees ethics and rules violations. AICPA is a professional association for accountants and makes recommendations to the Financial Accounting Standards Board (FASB), which actually makes the rules. The SEC traditionally files complaints for more egregious violations, particularly federal violations. In addition, state boards can take the extreme measure of stripping an accountant of his or her license if it is determined that rules have been violated. However, in reality, there really is no regulatory oversight of the accounting industry that occurs on a day-to-day basis. In fact, since 1977, the accounting industry has operated on a peer-review system, in which one accounting firm monitors how another firm conducts its audits. The new agency proposed by Chairman Pitt would oversee the disciplinary reviews of accountants and also spearhead a series of accounting-industry reforms. Further, the organization would reportedly have full regulatory authority to investigate wrongdoing by accountants and to issue penalties ranging from censures to bans from the industry. Interestingly, Chairman Pitt has said that the federal government cannot afford to front this new separate advisory panel, and thus is looking for private funding to front the proposed agency. In fact, under Chairman Pitt's vision, the private-sector panel would replace the functions currently provided by the Public Oversight Board and the AICPA. The fact that Chairman Pitt has called for private-company funding for the new agency has sparked the ire of many politicians, who have likened the idea to letting "a fox guard the hen house." Chairman Pitt claims that the panel would ensure its objectivity by employing a majority of public members who are independent from the accounting industry.

In my opinion, the funding issues around the creation of this oversight board are rather troublesome. If an oversight board is to receive funding from private interests such as utility companies, it raises conflict of interest issues. It would be preferable to not have the board funded by private interests. However, at the same time, it should be noted that electric utility companies often fund state and federal regulatory boards, so the practice of private funds supporting a regulatory oversight agency is not unprecedented.

Distrust for pro forma accounting. In recent history, many corporations have embraced pro forma accounting, a practice that essentially allows a company to show profits and losses without demonstrating these changes in tangible values on their main balance sheets. Some would go further and say that pro forma accounting enables the management of a company to issue upbeat financial results by hiding unprofitable deals or other financial problems. The technique came into heavy practice in the late-1990s with the dot-com craze and the emergence of Internet companies, which use pro forma accounting to keep off of their financial reports disadvantageous expenses often related to mergers or sudden changes in an accounting period. Pro forma accounting has been particularly advantageous to start-up companies that do not have strong cash flow,

because they are able to appear financially strong based on their goals instead of realized gains. Under pro forma accounting, items kept off the financial records can be classified as one-time occurrences (also known as non-recurring items) and therefore the company can justify excluding them on the primary balance sheet. The result, according to some observers, has been a new accounting system without any set rules to govern it, and companies have been given wide latitude to report their performance in any way they want to (regardless of its correlation to reality).

Moving forward, the SEC will most likely require greater transparency in the financial statements that companies provide, along with placing an intent eye on how companies may attempt to transfer debt off of their balance sheets. The requirement of real-time financial reports appears inevitable, but could take many years to implement as the transition could be quite complex for many companies. As a side note, Amazon.com just posted its first profitable quarter and announced its intent to replace pro forma accounting with cash-flow accounting. This example could be used in the argument that any publicly traded company should adhere to a strict accounting standard rather than the more flexible pro forma approach.

In my opinion, one option that the SEC should consider would be to require companies to submit both pro forma and cash statements. Instead of requiring one or the other, if both pro forma and cash statements were submitted by companies, then investors would have more information about the company and be able to make decisions that are better informed. In addition, also in my opinion, subsidiaries of larger companies should be required to submit financial reports just like their larger parent operations. Often, the financial statements of a subsidiary company are buried within the larger and more complex statements of the subsidiary's parent. In my opinion, subsidiaries should not be exempt from financial reporting standards that will be created for larger parent operations.

Scrutiny of mark-to-market techniques. This is another likely change for which Enron can be seen as a primary catalyst. As has been well documented, Enron embraced this accounting technique as it enabled the company to inflate its present financial strength on the basis of projected earnings. In other words, in Enron's derivative trading business, the company was able to count all contract revenues, no matter how forward looking, as current income, which obviously gave a skewed vision of the company to outsiders. The mark-to-market technique (which was endorsed by FASB) has enabled a good number of energy-trading companies whose earnings come in large part from forward contracts and spot-market transactions, to include in current earnings the profits they expect to realize in future periods. Under current conditions, energy-trading companies have been given rather wide discretion to estimate the fair value of pending contracts that have yet to materialize and record the projected value, either as assets or liabilities, on their balance sheets. With every quarter, and sometimes long after the quarter has ended, trading

companies typically declare non-cash earnings based on the current market value of trading positions. Further, trading companies often can tweak their price curves if markets are illiquid enough so that mark-to-market results meet earnings expectations. The unrealized gains often can account for a huge chunk of an energy trader's estimated earnings. Moving forward, the mark-to-market technique may remain an acceptable accounting technique, but the SEC could mandate that companies using this approach clearly identify the individual methodologies that they use to quantify projected earnings.

Full, fair and real-time financial reporting. One of the keys to the Enron collapse is that the company was not particularly forthcoming with its financial methodologies, either internally or externally. One of the significant changes that can be considered a direct result of the Enron case is the call for full disclosure in the operation of capital markets. Moving forward, executives, analysts and accountants will most likely be required to fully disclose a good deal of what was previously considered proprietary information. On both a company's balance sheet, which shows its assets and liabilities, and its profit-and-loss statement, companies will probably be required to incorporate a policy of full disclosure. Enron's convoluted use of special purpose entities (SPEs) has been a catalyst in this area, as new standards for full disclosure will most likely weed out financial statements that are dense or overly complex. In addition, increasingly a case is being made that quarterly and annual reports, the mainstay of access that investors and analysts have into a company's financial performance are no longer relevant or useful because it takes so long for auditors to certify them. Perhaps more importantly, we are finding that, given current market conditions, a company's financial standing can change quickly over the course of three months, so reliance on the financial report from the previous quarter may not be sufficient for investors or analysts to make an educated decision on the company's performance. According to reports I've seen, the system that Chairman Pitt envisions regarding real-time disclosure is one in which companies and their auditors seek the guidance of regulators in advance of an action, rather than after a violation has occurred. This would dramatically change the financial reporting process that companies have become accustomed to, and would require a radical calibration of a company's financial records.

In my opinion, the call for real-time financial reporting may be unrealistic. However, monthly reporting (as opposed to quarterly reporting) is more feasible and is something that companies could be reasonably called to submit.

Ensuring the independence of auditing firms. There are two issues at play within this area, and they are the expected restriction against a firm having both auditing and consulting practices, and the scrutiny of whether the compensation that auditing firms receive has made them less likely to conduct a thorough examination of a company's books. For reference, the so-called "Big Five" accounting firms include Arthur Andersen (which Enron used, but recently fired), Ernst & Young, KPMG, Deloitte Touche

Tohmatsu, and PricewaterhouseCoopers. Historically, the fees associated with auditing services have not been particularly lucrative, so such firms moved into other lines of business such as consulting (for personnel, technology or legal issues) that had a higher monetary yield. In fact, according to the AICPA, more than 90 percent of the nation's accounting firms are engaged in consulting, financial advising or something other than traditional tax work. However, conflicts of interest between auditing and consulting, particularly when one firm is serving a company in both capacities, have been the source of concern for years.

The Clinton-era SEC had tried to implement a separation between auditing and consulting services but was unsuccessful. The issue may have more support now, but it is important to note that Chairman Pitt reportedly has dismissed suggestions that he take steps to keep auditors from performing other work for the same clients. Chairman Pitt has defended auditing firms' rights to continue cross-selling consulting services to auditing clients. However, given the publicity over the Enron collapse, Chairman Pitt may change his mind on this issue and decide to invoke a separation between consulting and auditing services.

Another area of concern is the high level of compensation that some auditing firms receive, either for straight auditing work or consulting. For instance, Andersen reportedly received $25 million to audit Enron's books and another $27 million for consulting services. The concern is that many auditing firms are not operating at arm's length from their clients and thus may be dissuaded from asking tough financial questions that could reveal concerns about a company's financial performance. Certainly, the issue has been raised with the Enron / Andersen partnership, as both companies have engaged in some finger pointing against the other and the industry is still sorting out the extent to which Andersen bears culpability for Enron's misleading financial statements.

These are just some of the changes that are likely on the horizon from the SEC that will impact the financial practices of energy companies, along with other corporations. There are other changes as well, impacting pension programs (including rules related to 401(k) programs), campaign finance and other securities regulation. Many of these changes may still be years away, as the SEC and possibly the U.S. Congress gather additional data and work toward constructing new policy that may in some parts rely on approval from various parties. In any case, we know at this point that the entire accounting industry is under intense review and on the verge of major overhaul.

VI. Summary and Findings

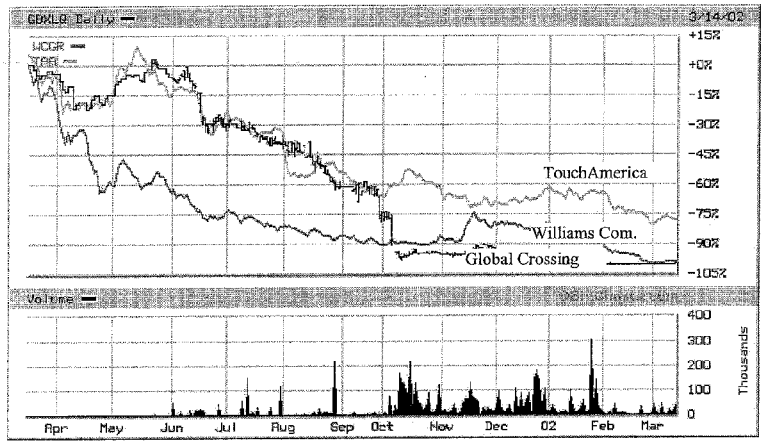
The market downturns in telecom and energy merchant sectors need to be analyzed separately. Although there is some overlap (best illustrated by the Enron case as Enron Corp. invested heavily in the telecom market), the telecom and energy industries faced

different market dynamics that led to the extreme cases of Global Crossing and Enron Corp., respectively. The overlap seems best defined by the use of questionable (although legal) accounting that might have misled investors and analysts by artificially inflating the financial performances of the companies that used said techniques. The accounting techniques used by telecom and energy companies are presently under investigation by Congress and the Securities and Exchange Commission, and modifications to or limits on those accounting techniques may be made as a result.

If we summarize the complex market conditions that brought about the downturn in the telecom market and the bankruptcy of Global Crossing, it essentially can be distilled to a collectively exaggerated projection for the demand in broadband capacity. Telecom companies, and energy companies that expanded into the telecom market, invested heavily in the construction of fiber-optic cable (often with funds obtained through capital loans). As stated in this testimony, the massive overinvestment in such "backbone" networks, along with slowing of growth in Internet traffic, produced a slump in demand for the wholesale communications capacity sold by companies like Global Crossing and left them unable to support mountains of debt. Global Crossing's debts prompted a bankruptcy filing, but other telecom firms such as Qwest and Level 3 are also struggling with impacts from the market downturn in the telecom sector.

However, available data indicate that the telecom sector has been on a market downturn for well over a year, and the sector as a whole began facing extreme volatility in late 2000 and into 2001. As the Global Crossing case represents, the volatility in the telecom sector stems in large part from the extreme imbalance between a surplus supply of fiber-optic network capacity and a much-lower-than-anticipated demand for such capacity.

Consider the following data related to telecom stocks. The following plot reiterates my statement that the telecom sector has been in decline for well over a year.



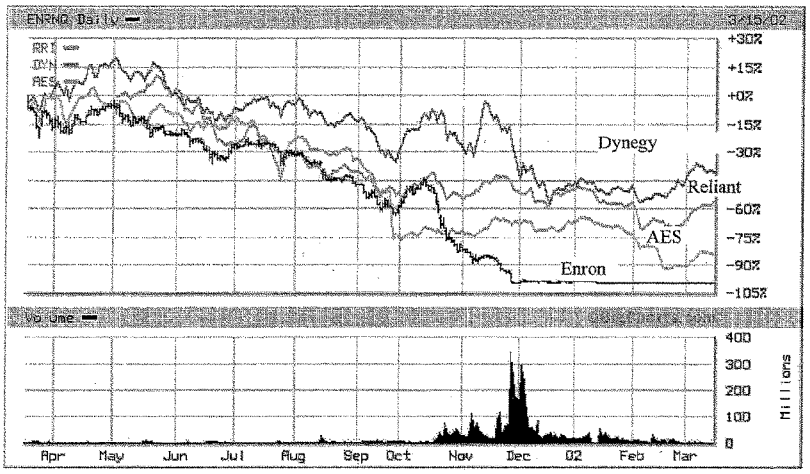
The SEC or other regulatory or legislative bodies may seek to enact restrictions on telecom companies' use of the IRU technique, especially when swaps are used and an equal-value exchange is reported as income or capital expenses by a company. Global Crossing will certainly be a case study for changes in the telecom sector.

The telecom sector could very well rebound if and when demand for broadband capacity increases. Most estimates suggest that a measurable increase in demand may begin to develop in the next four to five years. In the meantime, we may continue to see ongoing volatility among companies that heavily invested in fiber-optic networks and yet could not sell capacity to gain a profit on those networks.

If we summarize the complex market conditions that brought about the current volatility in the energy market, there are a number of factors that have impacted the earnings potential of merchant energy companies and relate to the bankruptcy of Enron Corp. The downturn in the energy market began in the second quarter of 2001, when wholesale prices began a dramatic decline. In addition, mild weather conditions and increased conservation efforts caused demand to drop in many areas of the country. This impacted the earnings potential for energy companies primarily based in the unregulated marketing and trading of power. Companies that have a regulated utility operation did not seem to be as impacted by the drop in wholesale prices because they had a steady stream of

revenue coming from the utility. In addition, concerns about a glut of generating capacity began to concern investors and raised doubts about the ability of energy companies heavily invested in power-plant construction or power trading to make a profit under conditions of excess generating capacity.

These concerns began to drive down the energy merchant business as a whole in the second and third quarters of 2001, after following a period of profitability and strong investor enthusiasm for energy companies throughout most of 2000. Certainly the dramatic collapse of Enron in the third and fourth quarters of 2001 shook the energy market as a whole and cast a shadow over the energy merchant business in particular. Capital markets that had been generous only a year earlier significantly constricted, further impacting the growth and expansion plans that energy merchant companies had previously espoused. However, it must be understood that the collapse of Enron was not the sole precipitator of the downturn in the energy market. The following information shows that the decline in the energy market began about one year ago (in February and March of 2001), and was certainly accelerated by the Enron collapse.



Current data suggest that market conditions may keep the energy market rather constricted for the next three or four years. Wholesale prices for natural gas should remain about $3.00/MMBtu for the next year at least and probably well into 2003. This will tend to lower earnings for energy companies primarily involved in the marketing and

trading of power in wholesale transactions. In addition, according to RDI, a research consulting firm, more plants were added in 2001-2002 than were added in all of the 1990s combined. As a result of this perceived glut, an increasing number of merchant companies are modifying their once-ambitious plans for generation capacity expansion. Thus, claims of an energy glut may be overestimated. In a time period in which many experts suggest is three to four years out, demand and supply balance should even out once more, which would drive the need for additional generating capacity and possibly increase wholesale prices if adequate supply does not exist.

Moreover, energy companies such as Enron and Williams that invested heavily in the telecom market clearly encountered some negative financial consequences as a result of that expansion. However, in the case of Enron's bankruptcy, the telecom exposure was only one factor among many other market conditions within the energy sector and capital markets that contributed to the company's collapse. It would not be accurate to suggest that the company's exposure to the telecom sector was a major contributing factor to Enron's collapse. Further, it would not be accurate to suggest that the market downturn in the telecom sector has been a major driver for volatility among those energy companies that have expanded into telecom. Market conditions in the energy sector (including the dramatic drop in wholesale prices and decrease in demand) and the current restriction in capital markets are clearly the driving forces behind any existing volatility among the earnings and stock prices of energy companies. While exposure to the telecom market may be an added problem for energy companies, it is not the primary factor for the current volatility we are seeing among energy companies.

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