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# CORPORATE ACCOUNTING PRACTICES: IS THERE A CREDIBILITY GAAP?

## HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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# CORPORATE ACCOUNTING PRACTICES: IS THERE A CREDIBILITY GAAP?

**WEDNESDAY, MAY 1, 2002**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, DC.*

The subcommittee met, pursuant to call, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Gillmor, Castle, Oxley, Lucas of Oklahoma, Miller, Kanjorski, Bentsen, Sandlin, Hooley, S. Jones of Ohio, Sherman, Moore, Maloney of CT, Meeks, Inslee, and Lucas of Kentucky.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order. The hearing today is called for the purpose of examination of the adequacy of our current financial reporting system in light of the speed with which market transactions occur.

Although much attention has been given to the failure and use of sophisticated accounting instruments, there, quite frankly, is a much larger question, I think, that the subcommittee will turn its attention to; that is, the adequacy of the current regulatory system to appropriately and timely assess the accuracy of financial reporting statements.

There is, it appears at least, extraordinary pressure on management to meet quarterly earnings expectations, and if by utilizing available methodologies they can meet or exceed street expectations for quarterly reports, that, in fact, enhances shareholder value. Unfortunately, when those expectations are not met, the perverse result of these accounting mechanisms is to leverage the amount of loss for shareholders as a result of management's use of these instruments.

It does not follow, however, that the utilization of those instruments is inherently in itself a bad thing. There are those who have used similar instruments for legitimate business purposes and, in fact, have profited from their use, resulting in enhanced corporate value for shareholders.

Going back just for a short period of time, immediately after the Orange County bankruptcy proceeding, there was much skepticism in the market concerning inappropriate use of derivatives, causing many in the Congress to express support for an outright ban of their use. I think further discussion by those appropriately uti-

lizing those risk-hedging devices found there to be value added, and a responsible use benefited all parties concerned. That is why I believe that the use of special purpose entities and indefeasible rights of use or whatever else may be devised in the near term in themselves do not lead one to conclude there is inappropriate conduct, but without appropriate explanation by those responsible market participants, it makes the subcommittee's work very difficult.

Unfortunately, there were many asked who were unable to appear today that perhaps could have shed more light on the appropriate utilization of those instruments for the subcommittee's analysis. And I would hope that in future hearings we have the opportunity to better understand market function in relation to these sophisticated accounting tools.

However, the Financial Accounting Standards Board, which is the primary location for initial approval of the utilization of these instruments, unfortunately has been unable to act very swiftly or act at all in light of the apparent identifiable instances in which these instruments have not been appropriately utilized.

The elimination of fuzzy accounting is our principal goal. We should have an ability for a shareholder, a consumer, to pick up a piece of paper and get an accurate understanding of the true financial condition prior to making an investment. We start there, and it should go all of the way up from the pension manager to the institutional investor. All should be treated similarly. Ultimately the performance of a sound capital markets economy must be based on the free flow of information to all parties concerned in the same timeframe, without prejudice or manipulation.

Today, I hope to hear from those who have chosen to participate in our hearing today, for which I am grateful, how the Congress may appropriately respond or work with others to instill confidence in the marketplace, enable consumers to make informed investment decisions, and assist in the free flow of capital that ultimately creates jobs and opportunity in this country. The current question, the current skepticism serves no one well, and we must figure out the best and most appropriate manner in which to respond to the problems we face.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we meet today to learn more about the problems in corporate accounting practices. Although this matter has attracted considerable media attention in recent months, I have held serious reservations about the reliability of certain corporate accounting practices for some time. These problems could also have potentially serious and negative consequences on our country's flourishing capital markets. After all, if investors cannot trust the reliability of the numbers produced by corporate accountants in audited statements, then they might as well spend their hard-earned money on lottery tickets.

Because of my concerns, Mr. Chairman, I wrote to you last June, well before the collapse of Enron, about the techniques used by some corporations in order to meet their quarterly earnings estimates. In that letter I urged you to convene hearings on the many accounting irregularities that contribute to the problem of earnings management. Included among those practices are the accounting

treatment of derivatives, swaps, special purpose entities, goodwill and stock options.

In my view, we should have convened this hearing before considering the Corporate and Auditing Accountability, Responsibility, and Transparency Act on the floor of the House last week.

Such a hearing would have helped us to develop a more comprehensive piece of legislation. Nevertheless, Mr. Chairman, I am pleased that you have called this hearing today. I believe that we must continue our efforts to guarantee that we maintain the vibrancy of our country's capital markets in the long term. Our work today will begin that process.

Our capital markets are the most successful in the world for one simple reason: investor confidence. The transparency fostered by the application of the United States Generally Accepted Accounting Principles, or GAAP, has played an important role in this achievement. Unfortunately, the failure to implement GAAP consistently has now led to an almost daily discovery of accounting irregularities at American corporations. This evolving situation has also sparked a crisis of confidence that continues to ripple through our capital markets.

We have, however, known about these problems for some time. For example, research published in 2001 by Financial Executives International identified some startling facts. The study found 464 cases of earnings restatements in corporate America over a 3-year period, more than the previous 7 years combined. It also determined that 156 earnings restatements in 2000 wiped out more than $31 billion in market capitalization. I suspect that when we tabulate these figures for 2001, these two already sizable statistics will grow considerably.

In recent months the Securities and Exchange Commission has also broadened the scope of its inquiry beyond the accounting issues raised by the collapse of Enron to include a laundry list of other potential accounting abuses at some of the country's largest companies. In fact, during the first quarter of 2002, the Commission opened 64 new financial reporting investigations, an increase of more than 100 percent over the cases begun during the same timeframe in 2001.

What factors contributed to this troubling state of affairs? In recent decades the rules governing corporate accounting have become increasingly complex. Since the early 1990s, for example, the Financial Accounting Standards Board has developed several fair-value measurement, recognition and disclosure standards. These standards often permit multiple interpretations. Accounting has also evolved from determining the cost of producing and the revenue from selling a good like a screwdriver to ascertaining the cost and revenue from selling an intangible service like a 25-year energy derivative. These and other developments have helped to make corporate financial statements increasingly impenetrable and confusing.

From my perspective, an effective accounting system must ensure the comparability of financial data from one company to another. Comparability in the data used by investors will allow them to evaluate apples against apples, and oranges against oranges. Im-

provements in accounting transparency will also facilitate the efficient flow of capital.

Since we assumed jurisdiction over securities issues last year, investor protection and financial literacy have become top priorities for my work on this panel. Investors deserve to have timely financial reports that they can read and understand instead of annually receiving a Byzantine, incomprehensible document dotted with countless footnotes.

The collapse of the internet bubble and the downfall of Enron have only heightened the skepticism of American investors about accounting practices generally. After our hearings today, we need to work to change those attitudes by ensuring that our public companies return to the basics of accounting and avoid financial gimmicks and gymnastics in their future filings.

In closing, Mr. Chairman, I believe our committee should comprehensively explore the issues related to corporate accounting practices. This hearing should also help us to alert investors about some of the key accounting issues that could affect their portfolios, and assure them that they are being examined by the Congress.

[The prepared statement of Hon. Paul Kanjorski can be found on page 96 in the appendix.]

Chairman BAKER. Thank you.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. And I want to commend you for this hearing.

As we all know, last week the House overwhelmingly passed H.R. 3763, The Corporate and Auditing Responsibility, Transparency, and Accountability Act of 2002, or CARTA. Chief among the provisions passed by a strong bipartisan vote were mandates for increased financial disclosures by publicly traded companies. We also set forth a new regime for tough oversight of the accounting profession by the creation of a new board under the SEC, which is the only legally recognized authority over this important function of our economy. We look forward to the Senate's swift and bipartisan passage of CARTA.

However, our responsibilities for protecting American households, public pension funds and private investment accounts cannot end with CARTA. We must continue to review the generally accepted accounting principles and discretionary accounting practices that American companies use every day to report on their operations.

During the initial phase of our CARTA hearings, and by the way, we had 7 hearings with 33 witnesses, the Committee publicly discussed the complex principles involved in accounting for financing tools, such as special purpose entities. We disclosed that those principles had not been clearly stated by the FASB and the SEC, and that Enron clearly and continually abused these principles.

We also discussed the principles involved in accounting for sales and swaps of fiber-optic cable capacity among telecom companies such as Global Crossing, QWEST and WorldCom. After a change in the principles in 1999, companies increasingly turned to unaudited pro forma statements to better explain the cash flow in their business. There is no guidance on the consistent preparation of those statements, however, which leaves investors and even sea-

soned professionals unsure of a company's or industry's results or direction.

Clearly there are plenty of other events that we should have also reviewed. Accounting principles and corporate practices for reporting revenue from the sale of a business, changes to accounts receivable, company loans to corporate insiders, special accounting mechanisms designed to minimize taxes, and pension fund transactions have all been raised in the financial press and have been the subject of SEC reviews.

There have been too many restatements of financial statements, too many SEC investigations, and too many pension plan losses for us not to dig further into this area.

Our witnesses today will give us their perspectives on the problems in accounting principles and practices and the impacts on different sectors of American life.

I am especially pleased that Betty Montgomery, the distinguished Attorney General of Ohio, has taken the time from her extremely busy schedule to come to Washington today in order to discuss how she is trying to recover losses suffered by public employees. Attorney General Montgomery, who, by the way, is the first woman Attorney General in the State of Ohio, is now serving her second term. She and other expert witnesses will, I am sure, advise us of ways by which we can help investors and employees by encouraging more information and updated financial information by publicly traded companies. As I said at our Global Crossing hearing on March 21, it is only by reviewing those practices that we can help investors to base their decisions upon a company's real financial condition.

Mr. Chairman, I am going to be having to leave for the floor relatively soon for the Export-Import Bank debate, but we appreciate your hard work in this area and look forward to a continued dialogue with you. And I yield back.

[The prepared statement of Hon. Michael Oxley can be found on page 92 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. Of course, I am appreciative of your participation here today. I know of the legislative schedule on the floor today, and more importantly your keen interest in having the committee take appropriate action with regard to all of those matters. We are always appreciative of your willingness to be such a leader in these issues.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. And thank you for calling this hearing. I think that it is appropriate that the committee continue its hearings on these issues even after the passage of the CARTA bill, which, as I said at the time during the debate, was a good first step. But we may find there are other things that we have to do, so I am eager to hear from our panel.

I might also add in a speech that Fed Chairman Alan Greenspan gave recently, which caused a lot of focus for other reasons, he commented that our economy is changed to where we value companies not so much because of physical assets, but because of conceptual assets. And I think because of that it has changed a lot of the ground rules of accounting to things that we don't know in the Congress, where a lot of judgment calls are having to be made in

the profession. And so as such, I think it is appropriate that both the Congress as well as the industry itself and the ancillary industries, the research analysts and others, continue to review exactly how you are able to provide a proper assessment of value to investors, to analysts and others.

And so I appreciate the fact that you called this hearing. I hope that it is one of many more that we will have.

Chairman BAKER. Thank you, Mr. Bentsen.

Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman, Chairman Oxley, other Members of the subcommittee. I am pleased to have an opportunity to give a brief opening statement. I would ask that my written opening statement be made part of the record, Mr. Chairman.

Chairman BAKER. Without objection.

Mrs. JONES. First of all, I would like to welcome Ohio attorney general Betty Montgomery to Washington as well. We were prosecutors together in our prior lives, and so I am glad to see you. And also I am a PERS retiree, so I am also interested in you holding onto my dollars. That is personal.

But it is very important that we continue those hearings. I was one of those Members who voted against the legislation we passed last week, and the reason I voted against the legislation was because we refused to hold the CEOs accountable for the representations of the financial viability of their companies. I think in order for us to get by the situations that we find ourselves in in these current times, we should hold them individually accountable for their representations of financial viability.

As we go through this process this morning, I will be interested in hearing from each one of the witnesses who will be testifying. I thank you very much for taking time out of your schedule for coming this morning. And I yield the balance of my time.

[The prepared statement of Hon. Stephanie Jones can be found on page 98 in the appendix.]

Chairman BAKER. Thank you.

Mr. Gillmor, did you have an opening statement?

Mr. GILLMOR. Thank you, Mr. Chairman. Very briefly. I am sorry that I was delayed. I have another Subcommittee on Oversight and Investigations going on.

I just wanted to welcome Betty Montgomery, our attorney general. When I was elected to Congress and left the State senate, Betty took my place as a State senator. She didn't stay there long. She became the attorney general. She has been doing a great job. A lot of people would like to see her stay in that position, but we have term limits in Ohio, so she is going to be our auditor next year.

I just want to welcome you to Washington, Betty.

[The prepared statement of Hon. Paul E. Gillmor can be found on page 94 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Gillmor.

Chairman BAKER. Mr. Lucas. No.

Mr. Miller.

Mr. MILLER. Thank you, Chairman Baker. I really appreciate you holding this hearing today on accounting practices. I would like to

thank you for your leadership on H.R. 3763. It was commendable. And I just look forward to the testimony today. Thank you.

Chairman BAKER. You could have taken a bit longer. You were on a roll there.

Is there any further opening statement? If not, I wish to comment on most Members' observations that we have a continuing obligation. The passage of CARTA is a significant first step, but we recognize as a committee that market conditions are continually changing, and our responsibility can no longer be a one-press-conference obligation. It has got to be an ongoing oversight and attempt to understand what is happening in the marketplace.

To that end we very much appreciate each of you participating here today and giving us your perspectives. As is the custom, your written statements will be made part of the official record. To the extent possible, if you can constrain your remarks to the 5-minute opening period, it helps us in having a better interchange with Members in the follow-up question period.

I would first like to welcome, as others have, the Honorable Betty Montgomery, Attorney General for the State of Ohio. We are indeed pleased that you would give up of your time to be here today. Welcome.

**STATEMENT OF HON. BETTY D. MONTGOMERY, ATTORNEY GENERAL, STATE OF OHIO**

Ms. MONTGOMERY. Thank you, Mr. Chairman.

I want to thank you so much for allowing me to testify today and inviting me to be here today, as well as thank Congressman Kanjorski and all of the other Members.

As you have noted, Mr. Chairman, this committee has a number of Ohio legislators, so I forgive you for being provincial with each other, but you have a great committee.

I was interested particularly in coming to talk to you today because of the enormous impact Enron and Global Crossing, just those two cases alone, have had on our pension systems in Ohio. And I have to applaud the House for passing Congressman Oxley's legislation in reining in the fraudulent accounting practices which have cost billions of dollars to investors, millions of dollar to Ohio pensioners.

My goal today is twofold: to help you draw further public scrutiny on the practices and concerns that have brought us here today, as well as to help you continue the congressional pressure that you are discussing here today also. The more public scrutiny that we place on the scenarios that led to the debacles such as Enron and Global Crossing, the less likely other companies will be to issue blatantly false and misleading financial statements.

The impact of Ohio in the "for what it is worth" department, which we think is very important, is significant. Two of Ohio's public employee pension funds have lost millions of dollars as they were investors in both Enron and Global Crossing. We lost more than $116 million in Global Crossing. We have lost an additional $114 million in the Enron debacle.

The reason for—we are, at this point, engaged in seeking to be lead counsel on the Global Crossing litigation as a class action lawsuit, because at this point even—we are unfortunately the larg-

est—I think we have lost the most among those who have any losses in the Global Crossing battle here.

Ohio's pension funds, I want to remind everyone, however, are strong. We are some of the largest pension funds in the world, and so this tends to be—although it is an enormous number, still I think it is certainly, I believe, only less than 1 percent of the value of those funds.

But nevertheless, one of the things as we sat down with our pension funds and pressed to forward litigation on this is that it was so critical for us as public entities and certainly critical because of the fraudulent practices involved that we stand up and draw focus and spotlight on the problem. It is incumbent upon us as public servants, just as your obligations are, to work diligently to ensure that these kind of fraudulent disasters don't happen again.

Since before Global Crossing went public, Arthur Andersen was its accounting firm, and Andersen not only provided auditing for Global, but provided consulting work for them, as you know. For the year 2000, the most telling statistic that we have is that Global allegedly paid Andersen $2.26 million for auditing, yet paid a staggering $12 million for consulting. Herein lies the beginning of the problem.

Andersen lead auditor for Global Crossing was Joseph Perrone. Perrone co-wrote a memo outlining the aggressing plan for Global's executives. He talked about aggressive accounting treatments called swap agreements—I know you have alluded to this, and you heard the testimony already—allowing Global to circumvent certain rules regarding swaps. A swap is an exchange of network capacity between telecommunication companies, as you know. Perrone's idea: Use swaps to enable Global to record huge gains on exchanges of capacity, and the exchange of capacity on the books, even though the swaps had no cash value. Yet it allowed plumping up of the financial statement to make it look a much wealthier company than it was.

Global adopted Perrone's proposal and, frankly, adopted him, handsomely rewarding him with a position as executive vice president of finance. We know, we believe, we will show in the litigation, that Global entered into swaps that had no legitimate business purpose except to enhance the financial statements, and that is a very troubling problem that you need to address.

Roy Olofson, the formal Global executive vice president for finance and the whistleblower, said Global routinely entered into swaps, exchanged network capacity for identical or unnecessary routes, without exchanging any cash. The sole purpose was to generate paper revenue, increase cash flow, show higher earnings.

We have begun as part of the litigation interviewing employees of Global Crossing. Part of the ongoing investigation confirmed that Global entered into the swaps with the knowledge that the transactions and the improper revenue accounting go to the highest levels of Global Crossing. Specific examples are included in my submitted testimony which you have before you.

There are obscure and misleading disclosures, and in no way did the financial statements disclose the real truth about the swaps. Frankly, Global Crossing lied to the expense of pensioners, inves-

tors and individual John Qs that you and I represent on a daily basis.

The whistleblower we are lucky to have, Roy Olofson, was Global's former executive vice president of finance. He sent letters and memos to ethics officers, requested an investigation of the accounting methods. He wanted to review the priority of the swaps. And yet nothing happened with Global Crossing.

Finally, the house of cards began to fall. Cash revenue statement for the third quarter of 2000 was $400 million less than analysts had predicted. And in January of 2002, Global filed their voluntary bankruptcy. So within 2 months we have, between Enron and Global Crossing, two of the largest bankruptcies this country has ever seen, both involving allegations regarding the accounting and the false accounting, inappropriate counseling.

You know, when Global first entered the publicly traded market, they were worth $64 per share. Now it is down to literally nothing, and that is based on fraud, deceit, untruthful accounting and the like. I conclude by saying to you, we believe it is clear that Global used false accounting methods to undertake schemes to circumvent existing rules and to essentially defraud investors.

We thank you for the ability to speak to you today. Unfortunately, Enron was not an isolated incident. Investors, both public and private, deserve accurate, honest information so they can make sound investment decisions. Even expert investors, such as those working for public pensions funds, cannot make good choices when the financial information provided is less than truthful. If the market can't trust financial information validated by supposedly independent corporate auditing firms, our free market system of trade is in great danger.

Thank you so much, Mr. Chairman, for allowing me to speak today.

[The prepared statement of Hon. Betty D. Montgomery can be found on page 100 in the appendix.]

Chairman BAKER. Thank you very much, Attorney General. We appreciate your presence today.

Our next witness is Professor William Holder, Professor of Accounting, University of Southern California. Welcome, Professor.

**STATEMENT OF WILLIAM W. HOLDER, ERNST & YOUNG LLP PROFESSOR OF ACCOUNTING; DIRECTOR, SEC AND FINANCIAL REPORTING INSTITUTE, UNIVERSITY OF SOUTHERN CALIFORNIA**

Mr. HOLDER. Thank you, sir. Thank you, Chairman Baker. I am pleased to appear before you today to testify about corporate accounting practices that are of significance to our capital markets. The topic is of obvious great importance, and your attention to it is essential.

As the subcommittee has requested, my testimony will be based on publicly available information and will address two matters: One, the use of questionable accounting practices and the degree of management discretion that is involved in reporting results of operations that have led to financial statement restatements; and second, the circumstances surrounding reports of accounting problems at the following companies: Xerox, Adelphia, Dynegy, AOL

and WorldCom, and whether these problems at these companies are further reflected in other publicly traded companies.

Our system of financial reporting which supports the functioning of our capital markets has developed over a relatively long period of time, and like other complex systems, financial reporting has been developed with certain expectations, capabilities, limitations and conditions in mind.

That system has served us exceptionally well for many years, but like many such systems, what has been historically exceptional may require substantial improvement to continue to fulfill its responsibilities. The financial reporting problems of several companies that you have identified provide examples of many of the changes and the related challenges for the financial reporting system.

With respect to AOL Time Warner, I understand that this company wrote down assets approximating $54 billion in recent days. This loss generally resulted from acquisitions of companies that did not prove to be as successful as was anticipated. The need to write down these assets was generally brought about through a new accounting standard, or relatively new accounting standards, recently published by the Financial Accounting Standards Board. I also understand the company has acknowledged that a special purpose entity with which it is related has approximately $2 billion of debt not reflected on its own balance sheet. These circumstances illustrate the effect that new accounting standards can have on financial statements, the subjective nature of many accounting determinations, and how the manner in which a company's management decides to structure and operate a company can affect the financial reporting of its transactions and business activities.

With respect to Dynegy, I understand the company entered info certain derivative contracts that were accounted for in accordance with FASB Statement 133. That standard requires such contracts to be valued at their fair values for financial reporting purposes. As has been pointed out earlier in the session, estimating the value of such contracts frequently involves the use of relatively sophisticated modeling techniques and the use of a number of specific, but necessarily subjective assumptions. Because of the inherent uncertainties involved in developing these assumptions, estimates of the fair value of such instruments requires complex and subjective judgments, and the resulting amounts may vary substantially.

Increasing estimated fair values of contracts boosted the company's income; however, they did not directly nor simultaneously contribute to the company's operating cash flows. According to published accounts, the company developed a device referred to as Project Alpha, involving a borrowing plan which provided income tax benefits, but that also allowed the company to report additional cash flows from operating activities. This circumstance illustrates both inherent uncertainties involved in financial reporting, again, as well as, again, management's ability to design transactions and programs that may accomplish other management objectives, but that also accomplish financial reporting goals as well.

With respect to WorldCom, I understand that certain accounting and financial reporting practices of WorldCom have been characterized as aggressive. Specific aspects of these practices have been

characterized as pushing the envelope by capitalizing certain costs of assets that may have been more appropriately reported as expenses.

The SEC, according to published accounts as recently as this morning's *Wall Street Journal*, is involved in investigating revenue recognition issues at WorldCom with respect to customers who had already dropped services or otherwise couldn't—the company would be unable to collect the amounts. I also understand that there are disputed sales commissions issues resulting in the possible overbooking of sales.

Practices of such as those characterized in the press are illustrative of the inherent subjectivity of many accounting decisions and the related necessary professional judgments. They also indicate that the accounting model, because of those subjective aspects, is subject to potential abuse. These same articles also indicated the belief that WorldCom is expected to write down goodwill in much the same manner as I described for AOL Time Warner.

Adelphia Communications. I understand that an important issue for this company is the appropriate treatment of certain borrowings by its owners. According to press reports, the Rigas family interest in Adelphia is reported to approximate a 23 percent economic stake, majority voting control, five board seats on the nine-member board, and five top executive positions. I understand that the loans to the Rigas are guaranteed by Adelphia. A portion of the proceeds of that debt was used to acquire Adelphia stock, again according to press reports.

An important financial reporting question relates to whether the debt of the owners, which is guaranteed by Adelphia, should be reported as the debt of the company. This circumstance also illustrates some of the judgments that are necessary about such fundamental issues as whether and to what extent a company may have incurred a liability that should be reported on its balance sheets.

Finally, with respect to Xerox Corporation, I understand that the financial reporting problems here involved accounting for agreements that called for Xerox to lease equipment and to provide related goods and services to their customers. I understand that inappropriate allocations of the overall contractual consideration for these various goods and services were made to the equipment lease portions of these contracts. In such a fashion, gross profit on the lease portion was inappropriately recognized at the beginning of the lease agreements.

Professional standards provide much valuable guidance on lease accounting, and they have been in existence since—well, for over 25 years, but, again, the need for professional judgment remains.

I further understand that Xerox changed certain aspects of its employee benefit programs and systematically and improperly recognized the effects of that change over a number of periods, rather than recognizing the effects immediately in earnings.

These examples you have asked me to address, and that I have described very briefly, illustrate that financial reporting requires many subjective judgments and seasoned judgments. Those that are generally unfamiliar with the detailed aspects of preparing financial statements are sometimes surprised at the inherent ambiguity and subjectivity of that process. Although financial state-

ments contain and convey the appearance of great precision, many significant amounts contained therein are inherently imprecise. The inherent subjectivity provides opportunities for management to bias and for bias to intrude on the financial reporting process.

Accounting estimates, management's ability to structure transactions to achieve financial reporting objectives, increasingly complex business transactions and events, and accounting judgments that must sometimes be made in the absence of professional standards which often naturally lag behind the development of business transactions and events that they are designed to address each are important aspects of financial reporting and complicate the accountant's work.

Differing but good-faith interpretations of existing accounting standards can and do result from this process. If management perceives accounting numbers to be important, than it is reasonable to expect them to exercise the inherent discretion provided by financial reporting to manage those numbers.

Management discretion can be abused, and financial reports can be misstated. As pressure increases on management to achieve earnings and other financial goals, the motivation to bias information presented in financial statements increases. Many of the elements of our financial reporting system that are currently in place are designed, in my view, to limit such discretion. Financial reporting standards, the auditing function, the regulatory function, and the system of corporate governance that we put in place should each contribute to attaining this goal. Those aspects of financial reporting do not lend themselves, in my view, to easy solution.

It is not sufficient, in my view, to adopt some simplistic approach, such as an unbending obedience to conservatism, and charge all expenditures about which there is any doubt of realization to expense immediately. Systemic conservatism itself introduces bias into the securities market, and generally unbiased information is considered to be of greater value.

Financial statements are the responsibility of the company. The auditor also has substantial responsibilities for those statements, and those responsibilities today, in my view, require that the auditor consider the substance of the transaction in evaluating whether financial statements may be materially misstated. The inherent subjectivity of many decisions, however, precludes a singular interpretation of the substance of many transactions. The auditor cannot insist, on pain of a qualified or adverse opinion, that the client use accounting principles that the auditor considers preferable today as long as those used by the client are generally acceptable in the circumstances and appropriately meet other criteria. This has led on occasion to the alleged use of least common denominator accounting principles. The importance of and need for objectivity by all of those that are involved in the financial reporting process, I think, are self-evident as a result of this discussion.

In terms of accounting standards setting and regulation, both the FASB and the SEC have worked diligently and for the most part successfully to address significant financial reporting issues. The Financial Accounting Foundation, the organization that oversees the FASB, has recently taken a number of actions to change the structure and process of standard setting. Additional steps may be

necessary. My written submission contains some suggested approaches to address those aspects of financial reporting.

Those who are responsible for interpreting and applying financial reporting and accounting standards must be objective and independent in their work, as I have said, but they also must not perceive themselves as the adversary of those charged with setting the standards and enforcing those standards.

Finally, the accounting profession, in my view, should be structured so that it continues to be an attractive career opportunity for individuals with great intellectual capacity, lofty ambition, and high ethical standards. To do less relegates this essential profession to diminished capacity, to the detriment of us all.

Thank you for your attention. I will be pleased to answer any questions that you may have.

[The prepared statement of Prof. William W. Holder can be found on page 109 in the appendix.]

Chairman BAKER. Thank you.

Our next witness, Mr. Charles Hill, is not a newcomer, Director of Research, Thomson Financial/First Call. Welcome, Mr. Hill.

**STATEMENT OF CHARLES L. HILL, CFA, DIRECTOR OF RESEARCH, THOMSON FINANCIAL/FIRST CALL**

Mr. HILL. Good morning, Chairman Baker, Ranking Member Kanjorski, and Members of the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. Thank you for again giving me the opportunity to testify in front of this subcommittee. I am particularly glad to do so because I believe this subcommittee on both sides of the aisle and its staff have taken the time to do their homework and understand the problems.

This subcommittee's early involvement got the ball rolling, thereby either stimulating others to get involved or in some cases forcing their hand to get involved. I also believe this subcommittee is truly trying to reach a solution that is for the good of all concerned. Therefore, I am glad to try to help in any way that I can.

The outcome is important not only to restoring investor confidence in the system, but it is important to maintaining the general public's confidence in the capitalist system. My goal today is to examine why the system got to the sorry state and what needs to be done to right the ship.

But why were the abuses greater this time? Three reasons stand out: One, huge management compensation incentives; two, bigger and longer bubble during the last economic expansion; three, increasing dependence of analyst compensation on investment banking.

First and foremost in our judgment is that management compensation at public companies has become increasingly dependent on the relatively short-term performance of the company's earnings and/or stock performance. The potential compensation if certain milestones were met, and often the compensation realized, skyrocketed in the late 1990s to previously unheard of heights. There was so much at stake that the incentive to push the envelope on accounting or on the adjusted earnings cited in the earnings release was huge. Apparently some managers succumbed to temptation.

In general, the abuses can be divided into those generated by cyclical factors and those generated by secular factors. Even without the increased monetary incentives for management, the business cycle would have fostered a number of abuses similar to what happened in previous cycles, but in the 1990s the level of abuses was exaggerated by both the increased incentives for management and by the fact that the bubble created during the last cycle was bigger and longer than in earlier cycles. Therefore, it should come as no surprise that the abuses in accounting and in earnings releases were far more egregious than in the just-ended cycles. That the poster child this time is a company as big as Enron and one who committed so many serious abuses should be no surprise.

The cyclical problems are the excesses that creep into the system at the frothy part of the business cycle when investors tend to be careless and overlook the warning signs that companies are pushing the envelope on accounting rules and earnings releases. The excesses become even more excessive when the economy begins to slow. Companies push even harder in order to keep up the appearances of continuing good earnings growth.

The inevitable market correction tends to correct most of the abuses of this type. The investor backlash causes companies to modify their behavior for the good, and investor confidence returns until the next market correction reminds investors that they again let their vigilance slip and that company managements had again misbehaved. The corrective behavior process starts all over again.

It is kind of like when you go to the carnival, and they have this game there where they have the gophers that keep popping up. Well, when we have a market correction, you get the stick, and you try to beat down as many of these gophers as you can, but you know that in the next cycle they are going to be popping up again. But we are going to keep working on it in each cycle.

Sometimes some tightening up of the accounting rules or other regulations is necessary in each cycle to close some of the loopholes that emerged in the last cycle as a clever way to inflate earnings. Several obvious, but in some cases not obvious until after the bubble broke, loopholes that became newly fashionable in the last cycle include special purpose entities to hide debt off the balance sheet, a more liberal use of stock options to reduce employee compensation on the income statement, indefeasible rights of use swaps to inflate revenues, and heavy use of derivatives that resulted in reduced transparency.

Among the old favorites that blossomed again in the last cycle were the changing of pension funds to inflate or to smooth earnings, and stretching the accounting rules on revenue recognition to inflate current revenues by including those that would not be unequivocally consummated until a later period.

Another abuse created by the increased management compensation incentives was one that was more of a secular issue and not just an extension of prior cyclical abuses. That abuse is the pressure that is put on brokerage analysts to help inflate the perceived earning.

Analysts routinely adjust a company's GAAP earnings, the earnings required to be reported by the SEC using Generally Accepted Accounting Principles as enumerated by the Financial Accounting

Standards Board, to exclude these items, the analysts consider non-recurring or non-operating. Companies often would provide earnings in their quarterly releases that were adjusted to a basis of the company's choosing.

There was a cyclical nature to this problem in that the company pushed the envelope on what they considered non-operating or non-recurring and, therefore, excludable from GAAP earnings.

For example, costs for layoffs and plant shutdowns triggered by a slow economy became a restructuring charge. The new twist in the 1990s was that the companies pressured analysts to go along with the company basis for adjusting earnings, even when the exclusions ran counter to common practice.

Some companies also pressured analysts to maintain favorable recommendations on the company's stock. Aiding management in achieving this was a—was that an increasing part—in many cases, the majority part of analysts' compensation was coming from the investment banking side of the analysts' firm. Therefore, in addition to the threat of cutting off analyst communication with a company, companies could use the lure of investment banking business to have additional pressure put on the analyst by the investment banking arm of the analyst firm.

Even more damning than what happened in the late 1990s is that the companies still did not seem to get it. Investors had hoped that the actions of Enron and other abusers of the system would have led companies to bend over backward to do the right thing in accounting for their earnings and in presenting them to the public. Yet some companies continue to abuse the system.

Companies are still providing the so-called "pro forma" or "adjusted earnings" that continue to be on highly questionable footing. Even some companies that announced in January that they would no longer be reporting pro forma earnings welshed on their promise and continued to report them in their first quarter releases.

The new accounting change, FASB 142, that eliminates the amortization of goodwill requires that companies include pro forma results for any prior period cited in their 10(q) and 10(k) filings that restate the prior period earnings as if FASB 142 had been implemented before the start of those periods. Yet no pro forma first quarter 2001 results were included in the first quarter 2002 earnings releases in many companies, and some said, when called, that they would not provide them until the 10(q) was filed.

One company that had provided a pro forma result for first quarter 2001 for the accounting change when they reported last year, even though FASB 142 had not yet even been issued, chose not to report a first quarter pro forma number this year when they reported first quarter results. Doing so in the first quarter 2001 release made first quarter 2001 earnings growth look better, but doing so in the first quarter 2002 release would have made first quarter 2002 earnings growth look worse—therefore, no surprise in why they conveniently forgot this year.

Another company that omitted the pro forma first quarter 2001 number showed an earnings increase by doing so. But if the first quarter 2002 results had been compared to the pro forma first quarter 2001 earnings, the earnings were down by 1 cent, yet the

company and the analysts reports only discussed earnings as being up.

The net result of this abuse is that it is misleading investors by inflating the apparent first quarter 2002 earnings growth for many companies. Unless this practice is changed, it likely will be repeated in the next three quarterly reporting periods.

Despite some companies last year raising the assumed returns on their pension fund investments in the year when the market was down, we are not aware of any reducing their assumptions so far for this year. In the face of growing opposition to the current accounting rules on stock options, companies continue to announce repricing of options. Because the cyclical abuses were greater this time, because the analyst conflict is a new one and because some companies still do not get it, it follows that the remedies for this cycle may have to be more severe and more far reaching than those in prior cycles. We have got to knock a few more gophers down.

[The prepared statement of Charles L. Hill can be found on page 119 in the appendix.]

Chairman BAKER. Thank you, Mr. Hill.

Our next witness is Mr. Ken Boehm, Chairman of the National Legal and Policy Center.

Welcome, Mr. Boehm.

**STATEMENT OF KENNETH F. BOEHM, CHAIRMAN, NATIONAL LEGAL AND POLICY CENTER, FALLS CHURCH, VA**

Mr. BOEHM. Thank you, Mr. Chairman, and I want to thank Members of the subcommittee for this opportunity to testify.

The Global Crossing bankruptcy, the fourth largest in U.S. history, has cost investors billions. It has cost 9,000 people their jobs. It has raised serious questions about accounting practices, corporate governance and conflicts of interest in the financial services industry.

Following some recent articles in both *Business Week* and the *Wall Street Journal* and this morning's *New York Times*, a whole new controversy linked to Global Crossing has arisen. The controversy involves Ullico, formerly the Union Labor Life Insurance Company, a privately-held company owned by unions and their pension funds.

Ullico was an early major investor in Global Crossing, and its directors, who were mostly union leaders and former union leaders, used the telecom's volatile stock price history to enrich themselves, apparently, at the expense of the union members and those retirees whose pension funds own Ullico.

Gary Winnick, the Global Crossing CEO, appreciated Ullico's early investment, and he appreciated it so much he cut Ullico's directors in on purchases of Global Crossing stock at IPO prices. According to labor officials quoted in the *Business Week* account, this sweetheart deal enabled Ullico's directors to make millions of dollars personally. It also raised serious questions as to whether the stock deal was an improper inducement to Ullico investors to invest pension funds, which are supposed to be invested conservatively, in a series of dubious investments with Winnick and his Pacific Capital Group.

Many of those companies later had problems like—for example, you remember Value America, which subsequently went bankrupt. The major focus in the series of insider stock deals, though, was what allowed Ullico directors to buy and sell Ullico stock in such a way as to virtually guarantee that they personally made profits and avoided losses. The profits, they got; the losses went to Ullico, and Ullico is owned by the pension funds.

In 1998, departing from a longstanding conservative practice of giving Ullico stock a fixed value of just $25 a share, Ullico began changing its share price annually according to the value determined by an accounting review. Insiders, meaning the directors, knew in advance of the price change whether the stock would go up or down, and with Global Crossing being such a large percentage of the portfolio, it wasn't hard to follow. It was the equivalent of investing in the stock market when you knew for sure which way a given stock would go. It adds a whole a new meaning to "market timing." .

To further fix the rules, Ullico directors were allowed to profit at the expense of Ullico itself because the repurchase of stock from shareholders was set up in such a way as those who held smaller shares—the directors—could get in on some of those repurchases, while those holding the larger number of shares, which would be the pension funds, the retirees and union members, could not participate to the same degree as the directors.

Here is what *Business Week* labor reporter Aaron Bernstein describes as how this profiting worked:

"In the fall of 1999, Ullico was losing money on its operations, but earned $127 million from selling Global stock. The directors and the insiders knew that the gains would lift the annual evaluation of Ullico shares from $54 to almost triple that amount, $146, when the books closed on December 31, so in December of 1999, Ullico offered each director a chance to buy 4,000 shares at the 1998 evaluation of $54, a can't-miss proposition. The union pension funds, that own almost all of Ullico, were not given the same offer or even told about it.

"In December of 2000 and January 2001, Ullico bought back 205,000 of its 7.9 million shares at $146. The stockholders with fewer than 10,000 shares are allowed to sell all their holdings, so officers and directors can take full advantage; again, the pension funds can't. Insiders know the decline of Global Crossing stock puts the true value closer to $75."

So it is nice when you can sell shares at $146 knowing they are only really worth 75.

"In December of 2001, they bought back an additional 200,000 shares, allowing officers and directors who hadn't sold before to cash out at 75; again, insiders know that the further collapse of Global has again cut Ullico's true value, this time to $44. This was a zero-sum gain. The directors won; the pension funds lost."

Just blocks from this hearing room, a Federal grand jury is hearing evidence about the Ullico case. At the same time, the Department of Labor is investigating, as well. The board of directors were finding more and more who have personally profited. One of the directors, Arthur Coia, former head of the Laborers Union, was recently banned for life from all union positions after pleading guilty

to fraud involving failure to pay taxes on a million dollar Ferrari. A good question might be why a convicted felon is overseeing pension fund investments.

Others have been implicated as well. Marty Maddaloni, plumber's union, cashed out at a six-figure amount in terms of profit. He is under investigation by the Department of Labor for abuses related to his union's pension fund, which he also heads.

The union official most on the spot is Morton Bahr, a long-time head of the Communications Workers of America; he is a Ullico Director since 1996. Many of the workers who lost their life savings because of the Global Crossing bankruptcy were members of his own union. The emerging record shows he was intimately involved in the Ullico-Global Crossing deal from the beginning. He pushed the Global Crossing deal even though the company was not unionized at the time; and he used his authority as a CWA boss to weigh in for Global Crossing in other business deals.

The favoritism was not a one-way street. The *Wall Street Journal* recently reported that Bahr had personally profited to the tune of $27,000 in his Ullico stock deals, and a spokesman for Mr. Bahr assured the reporter that Bahr was, quote: "Concerned about the propriety of the stock trading by the Ullico board."

These are conflicts of interest on their face. Union leaders, not to belabor the point, have a fiduciary duty to serve the best interest of their union members and certainly the retirees who depend on the pensions. The big picture here is that this case is important because it involves the heads of some of the largest unions in the country improperly, if not illegally, enriching themselves at the expense of union members.

It is also important because it illustrates a growing trend in union corruption. The Department of Labor IG recently pointed out he has 357 labor racketeering investigations. Of those, 39 percent involve organized crime and 44 percent involve pensions and welfare funds. He says that the plan assets that are under risk in these investigations are more than $1 billion.

What can be done? I think the first step is to acknowledge we have got a major problem. There are trillions of dollars in pension funds, hundreds of millions and billions actually in some of these that are at risk. The public, especially union members, have a right to know what their directors have done with their money.

There are laws that have major loopholes, and one of them recently pointed out by the Inspector General of the Department of Labor is that independent accountants are not required to report ERISA violations to the Department of Labor. That is a loophole that should be closed.

Union members are entitled to know, or should be entitled to know, the sources of income of their top officials. Top union officials should disclose their outside income most probably on the financial disclosure forms they file annually with the Department of Labor.

If protecting the integrity of billions of dollars in pension funds, relied upon by millions of honest, hard-working Americans, is not an issue worth addressing, what is? Thank you.

[The prepared statement of Kenneth F. Boehm can be found on page 123 in the appendix.]

Chairman BAKER. Thank you, Mr. Boehm.

I must say each of you presents a disturbing reason for a critical analysis of our current system. As a defender of the free market, I really believe that market discipline reacting to facts is the most severe and appropriate quick remedy to abusive practices. However, it is obvious that in some instances—not in all—that the pressure on management to meet earnings expectations and to preserve shareholder value results in authorized accounting methods being used for purposes for which they were not intended. And when the losses occur, the resulting leverage brought about by the accounting misstatement causes the losses to be far more severe than had you simply addressed the fact that you have a small economic downturn in business performance, and instead of making 2 cents, you are going to make 1.

It is a result of management's intention to preserve corporate growth and to strengthen expectations that 16 or 18 percent rates of return are somehow normal. Given that and the fact that the system missed it, it isn't just the analyst, it isn't just the accountants; it goes all the way to the financial press. I mean, you can go back now and get articles written weeks before, months before the Enron debacle, where they were held out to the world as the new business paradigm for the next century. Nobody knew what was about to occur.

The big question here is—without casting blame on any particular participant, is our current system really adequate in light of the business speed with which we act? How is it possible that a statement which is based on data at least 3 months old by the time of its publication, which is a backward-looking analysis, a retrospective view of where the company was, is in any way appropriate to make a forward-looking judgment about where the corporation may be headed?

Since we have relatively few here, I am hopeful we can have more questions to follow up. But, anybody, jump in here.

Mr. Hill, you are the one who, I believe, said we may be needing to hit a few more gophers a little more rapidly with this particular set of circumstances than ever before. I have concerns about FASB's slow pace, their academic perspective and their disconnect from accounting reality to accounting philosophy.

Should we be looking at a much bigger solution here than what we have talked about in the past?

Mr. HILL. That is a tough one. In the interest of full disclosure, I should say that I am on one of the FASB task forces on financial reporting.

I think that FASB understands that some things have to change, that they have to speed up the process. That is easier said than done. It probably means more resources for FASB. There is still—even though FASB members are paid and they have a staff, there is a lot of work done by committees, like the one I am on, that volunteer. And we have plenty of other duties in addition to trying to help out with FASB. So, I mean, that is one of the things I think that slows the process down.

But on the other hand, it is good to get the input from people who are active in the industry and understand the day-to-day nature of the problems.

Chairman BAKER. And just in perspective, FASB could be a research agency to the SEC, to advise and research questions.

For example, they approved the utilization of SPEs. I don't envision anyone there at the time anticipated how the SPEs would eventually be utilized in the market, and that is the distinction between a policy and implementation. And the SEC ought to be on deck looking at those things with the capacity to respond.

And I have been informed that the Attorney General has to leave here momentarily to catch a plane. Before you depart, from your perspective, what additional advice would you give to the subcommittee in light of the structural concerns I have? Do you think we need to be looking at a broader structural remedy, or do you believe that merely additional disclosure standards and transparency is sufficient to arm you with the tools you need?

Ms. MONTGOMERY. Mr. Chairman and Members of the subcommittee, I hate to echo what you have already said, but what you have done already is a great first step. The transparency is really critical.

I would defer to some of these folks here who are more engaged in security and investment issues than I. But for an Attorney General, we need to have very clear rules with regard to self-dealing—they are already existing, but walls between accounting, doing accounting and auditing versus making some consultation, and what happens when there are accountants that do that; and certainly the self-dealing that happens on board with the directors.

Chairman BAKER. And after my slight interruption, Mr. Kanjorski had a short question.

Mr. KANJORSKI. Madam Attorney General, it is not on this issue today, but in prior testimony the Attorney General of the State of Washington mentioned that their pension funds lost $100 million as a result of Enron's collapse. But the lawsuits that she is bringing will only be able to afford the recovery about half of that amount because of the statute of limitation being 3 years, and most of these fraudulent occurrences went beyond the 3-year period, although they were disclosed just recently.

I notice that Ohio's pension funds lost $270 million because of Enron and Global Crossing. Are you running into the same problem? Does a 3-year statute of limitations inhibit your ability to get back a good portion of these losses?

Ms. MONTGOMERY. At this point, Mr. Kanjorski, it doesn't apply to us, although I will say to you in the earlier—obviously, we were a part of the Washington coalition on the Enron matter. And the statute of limitations generally is a concern to attorneys general because we always have various individual State statute limitations which can affect us.

In this instance, it doesn't affect us.

Mr. KANJORSKI. We discussed that issue in this committee before it went to the floor last week to expand the statute of limitations from 3 years to 5 years, and it is to run from the period of discovery.

Do you have an opinion as to whether or not that expansion would be worthwhile?

Ms. MONTGOMERY. Mr. Chairman and Mr. Kanjorski, as an Attorney General, I will say to you when you give us a longer amount

of time to recover, generally we are going to tell you we like that, particularly when the time doesn't run until after discovery, or when it should have been discovered or when it was discovered. So obviously that is a tool that is very helpful to us.

Chairman BAKER. Thank you very much, Attorney General. I understand the constraints of your schedule.

Ms. MONTGOMERY. I apologize.

Chairman BAKER. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, and I thank our panel.

I have to say I am reminded of when I went to Wall Street and was going through my training program, and the head of the program said, if anything goes wrong with the transaction, the first thing you do is sue everybody and then figure out afterwards what you are going to do.

I think the testimony of Mr. Holder and Mr. Hill are pretty interesting. And, Mr. Hill, I think in your opening part, you hit the nail right on the head, particularly in two out of three, and maybe three out of three, that a lot of what we have going on in this market we have seen before.

But I think you are right about the short-run aspect of management compensation which—that is just how it is, but it is one that has been short-sighted from an economic perspective and, apparently, short-sighted from a market perspective. And I think the level of exuberance, where we went through, where you ended up having to chase money—I think it was in 1987 when the UAL buyout deal was going to happen, and the pro forma said they expected the airline industry to have positive growth for the next 7 years; and somebody finally looked at that and said, that is probably realistic. And that fell apart, and the junk market fell apart for other reasons.

But the question is—and, Mr. Holder, in your testimony you lay out the issues of subjective accounting and why it has to be subjective. And I appreciate your insight on that and where there can be abuse.

I guess the question comes down to, other than some very strict standards on the market—similar to what the Congress did with respect to banks and thrifts at the end of the last bubble, where the Congress had arguably a clear line of intent because of the payment system and the Federal backstop to the banking system, whereas here we are talking about the capital markets where we do want to have sufficient protection for investors against fraud and fraudulent activity and ensure there is confidence in the market—but how far can we go? How paternalistic should we be in setting guidelines for management, setting guidelines for auditors? And to what extent do we impose, you know, the old standard of caveat emptor?

And the other question I would ask, and particularly to Mr. Hill, because you at the end say we need some tough remedies, and I would be interested in knowing what those are.

With respect to research analysts, do you think—I am not proposing this, but I am curious because we keep talking about this issue—do you think that the time has come that research analysts on the sell side should be a disclosure item for purposes of the 1933

act in the same way that an offering document is? Either one on those points?

Mr. HOLDER. Well, with respect to the earlier question you asked and sort of directed to me, I don't think there is a silver bullet to fix these problems. I think there are a great preponderance of accountants in the country who go to work and do their job in an appropriate fashion; but the weakest link fails when pressures increase, and we have seen a number of those. And in my own view, I think some fixes are necessary.

I think the FASB can become more nimble on some aspects of the due process procedure which they go on writing standards probably becomes as much a vice as a virtue. The learning curve in terms of information coming to their attention flattens out and yet there is still due process in which to go.

But if there is a silver bullet or something that comes close to it, in my own view, I think it lies in strengthening the system of corporate governance, particularly in boards of directors and, even more specifically, with audit committees. In my written submission, I suggested that audit committee Members may, for example—it may be reasonable to require them to maintain independence from the company and not be compensated through options or stock of the company in fulfilling their roles as audit committee members.

I think the whole relationship between an audit committee and the external auditors can be strengthened and made more muscular, so the audit committee has the sole responsibility and authority to retain and to discharge auditors.

I believe there are a number of promising avenues in the area of corporate governance that may bear fruit. Again, as you may have detected from my comments, because of the inherent features of financial reporting, no matter what you do in standard setting, no matter what you do in regulation, to get better accounting and financial reporting answers, the people applying those standards and rules have to be objective and have to be independent, and if they are not, bias will intrude. So it is in the area of corporate governance for a variety of reasons that I believe the greatest benefit may lie at this point.

Certainly there are other things that affect all aspects—the auditing standards that exist, the culture of the auditing profession, and the culture of the financial reporting profession deserve attention as well.

Mr. BENTSEN. Mr. Hill.

Mr. HILL. Let me first say in the comments before, about the nature of accounting being subjective, that is certainly true, and I don't think we can do a whole lot about it. We can try to tighten it up as much as we can, but there will always be judgment involved.

And a system like that only works if the conflicts are removed; and by the "conflicts," I mean the financial incentives. It is the old story, follow the money. I have said that before here.

But specifically in relation to your question, I think some sort of separation of the analysts from investment banking is probably desirable. I am not sure what the ultimate answer is. We do need, certainly, to rebuild the Chinese Wall if we are going to continue to have research be part of an investment banking firm. But to

solve that problem—I mean to be able to rebuild the Chinese Wall—we have to have compensation no longer coming from the investment banking side of the house to the analysts. There was a day when it was that way.

But, you know, the underlying problem—I mean, it is really only a symptom that the analysts are increasingly being paid by the investment banking side of the house. The underlying problem is that the research departments can't get paid for the research anymore with negotiated rates. Why, they have been driven down to the point where there aren't enough commission dollars to go around anymore for research.

Now, what is the answer to that? I don't know. We can't put the fixed-rate genie back in the bottle. Do we go to some sort of hard dollar arrangement? Maybe that is what we have to find somewhat, to incentivize or regulate; I don't know.

But, you know, the culture of the institutional investment houses has been to try to soft hour everything, even though it is a diminishing soft hour pie. I mean, if they could soft hour the janitorial service, they would.

So I don't know what the ultimate answer is, but that is the problem. I mean, until we solve the issue of being able to get paid for research—I mean, you can't. The Attorney General of New York's idea of separating research off, spinning it off as a separate thing, I mean, how are they going to get paid?

Mr. BENTSEN. I agree with what you are saying.

Would you agree with the idea, with saying that idea of a research document is treated under the law the same way as an offering document is?

Mr. HILL. Well, I think that would have a chilling effect on research. I think we have to hold the analysts more accountable, but I don't think going that far would be a good idea. I mean, it is really an opinion; it is like an opinion you get from a consultant.

I mean, there is no right answer. I mean, if an analyst could be right all the time, they no longer would be an analyst after a short time.

Chairman BAKER. In my continuing effort to be extraordinarily fair, I yielded time to Mr. Kanjorski to ask a question of the Attorney General before her departure. I then stepped over Mr. Kanjorski's time and went to Mr. Bentsen. So to kind of get us back on track, I am going to take about a minute to follow up on my questions and then recognize you for your full 5.

First, on the question of analyst disclosure, I think the rules that are now soon to be implemented, out for public comment only in the last 45 days, will go a very long way down that road in making public the intended effort to simply disclose where you have the conflict, where you can't at least trade against your own public recommendations. You can't have family and friends trading off an upgrade-downgrade price target change; you must make disclosures if you are paid by investment banking.

I think it is a good first step, and we ought to let that be operative before we go too much further in that arena. I still think the focus has to be on value added to the corporation. If, in fact, it is a subjective valuation, somehow that has got to be noted, and then you can agree or disagree with the subjective determination. But

that has got to be different than one and one equals two; that can't be subjective.

So if we have hard dollar value, and we can present that information and, in a B part, have values and subjective opinion so you can make your appropriate judgment, that, to me, seems to be the goal.

Can you comment with regard to that approach?

Mr. HILL. It is an interesting thought. I hadn't really thought it out. It is the first time I heard a suggestion like that.

Chairman BAKER. Well, what we do now is take the subjective data and put subjective footnotes; and so you scroll through the facts, and then you get influenced by what is not disclosed as being subjective. So somehow, just identifying, as we have tried to do with the analysts, where you have a conflict—the conflict may be fine and you may be managing it well within the firm, but you have to let people know that is what you are doing; you can't keep that from public light.

I think that is what they tried to do to Members of Congress. We have to disclose who gives us money, what they do, all sorts of limits and that is hopefully enough to ensure that Members act appropriately in light of the fact that they still get financial contributions from various interests. That is the whole basis on which our ethics code is structured, and it seems to be appropriate for others.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Hill, you suggested that fixing accounting problems is somewhat like beating down the gophers. I wanted to make this suggestion to you because we both love cartoon characters from our past: How about the slaughter of the Schmoos? Every time you hit them, they divide. And it seems, with this catastrophe, every time we see something, it multiplies.

The reason I opposed the legislation last week on the floor is, I do not think we have seen a real analysis of what really happened at Enron, Global Crossing, and other accounting disasters. As a matter of fact, I suspect there is almost a conspiracy of silence as to whom some of the culpable parties are by their absence of being examined and asked to testify here. And I do not want to necessarily name whom I suspect played a large part in these parties' involvement.

But, I also think you struck at something: Follow the money. We have not nearly seen where the big money was made in these transactions that were set up. This was not some lowly accountant sitting around a corporation, or even their accounting firm, that sat down at a low, tertiary level coming up with these gimmicks. This was real, extraordinary brain power that came out of the sharpest minds in the accounting field and the investment field in the United States of America.

And to a large extent, I do not think the accounting firms reaped all these benefits of extraordinary amounts. I think there are other parties out there that reaped incredible sums and created this activity. And I am disappointed that the Congress has not gotten to these parties yet. We have not asked any of these people to testify.

I mean, who wrote these documents? Who came up with these ideas? Where are the notes? What did they anticipate? Why did

they not see conflicts of interest, violations of the law, lack of standards, criminality?

Quite frankly, I have talked to some of the people that have participated in the writing of these things, and there is a great deal more for this Congress to learn, which we have not yet learned. And yet, we are out there trying to thrash around making a decision. I am disturbed because I am wondering whether or not this is something more than just the excess at the end of a bubble. It may be an infectious disease of greed and inability to contain oneself in their lust for using the system and abusing the system to earn money.

There was a column by Mr. Samuelson in the paper this morning that really strikes home. It goes to financial literacy. I am still confused in my mind about his conclusions. Forgetting the average investor, who gets snookered all the time, let us take a look at the sophisticated pension fund investors, the real corporate investors, the people that are paid and supposedly have all the genius to come up with the right answers. Why are they buying stocks 100 times over earnings?

When Samuelson analyzed the market today, he said—I think—one of the price-to-earnings figures, on average, was 45-to-1. I don't know. Maybe I slipped off the cabbage truck or something, but I do not ever recall companies profits alone going to inflate the stock. To a large extent it used to be that stocks' prices were calculated on what was their payment, what was their dividend, what was their revenue. These institutions seem to have lived on that "profit" mentality.

It does not surprise me that this mentality has filtered down into the union pension funds and everything. Those guys are peripheral actors. We are talking about a guy making $27,000 on stocks. That is a joke. There are people that made billions upon billions of dollars on these transactions, and they took it out of the pension funds. And we were conspirators in that, the Congress.

I just remember a few years ago in this Congress when we passed legislation in the height of the interest bubble to allow the corporate pension funds to calculate the value of the pension funds based on the capital market value of their stock and investments, and if it was in excess of a certain amount, they could start withdrawing funds. And I have not seen any writers talking about how many crippled pension funds there are out there that in 1999 and 2000 had huge amounts of these funds drawn out by companies, and utilized for company purposes. And now, with the market having fallen, I wonder what those funds are worth out of those pension funds.

I just reviewed one report the other day. In 1999, the pension fund was, I believe, in the vicinity of about $100 million. Today, it is worth less than $30 million on a market cap basis and it cannot really cover its long-term obligations. And there is nobody responsible under the law to step up and fill that void, so ultimately it is going to go to the Government under our pension guarantee program, and the taxpayers are going to pick up the shortfall.

But where are the people writing about these things, analyzing these effects? When $54 billion disappears, it is a paper loss. But there are many sets of papers that will get reflected in that loss.

And I am worried about the financial literacy of our geniuses on Wall Street and around the country. Maybe we have to go back and reeducate these people or restructure how they get paid. We are always talking about how the analysts get paid.

I just want to bring up another point. In Pennsylvania we used to have a process where the most junior judiciary—the justice of the peace—was paid on a per case. If he found the defendant guilty, the defendant had to pay him a fee for the justice's time. It was amazing how any charge led to a conviction. If you went to a justice of the peace in Pennsylvania at that time, you were about 99 percent certain that you were going to be found guilty.

Chairman BAKER. Maybe that is how we ought to prosecute these guys.

Mr. KANJORSKI. Talking about how people get paid, in tort law, the judges sitting in the common pleas level of court systems were paid a percentage of the recovery in a tort case. I can just imagine how much evidence would go to the jury and how much material would go to allow a higher verdict for a higher payment.

These are solvable things.

I guess my question is at what point should Government step in? Have we stepped in enough? Have we stepped in not enough? What we have already done—last week in the House—I think, is superficial. I do not think it solves the problem. I do not know where the measure is as to how far we have to go, but I hope we have hearings to determine that.

I think professionally you have your hand in it. I do not care what we do on subjective rules. If we have avarice, greed, and malcontents in the professions and in the leadership roles of these corporations, they are going to find a way to accomplish their fraud. We can pass all the statutes we want, they are just going to find another way to commit fraud. My experience with good lawyering is that you get what you pay for. Someone will find a way around the barrier we construct, and generally, good lawyers do that all the time.

I am wondering whether we need some basic public discussion in this country as to the nature of this problem. Does this situation reflect something of far greater concern to our society, a far greater threat to our society than just the loss of some stock value, or just the loss of some money or just, sometimes, limited abuses. I think it may acutally indicate that we have much more serious systemic failures in the overall system that are merely being reflected by what has happened in the last several years in our corporate governance.

Chairman BAKER. If anybody wants to respond, Mr. Hill.

Mr. HILL. I agree with most everything that you said.

And as far as the cultural aspect of it, I think it is this instant gratification that pervades our culture these days; and as a result, why everything has become so short-term oriented. I mean, you ask why a pension fund manager was paying 100 times earnings. Well, I will tell you why. Because the pension fund managers, the outside ones, are measured every quarter. They have maybe five different institutions managing their pension fund. Every quarter they kick one out and add a new one.

Everywhere you turn, the pressure is on short-term performance. I mean, the mutual funds, individuals don't have any patience. This one is down this quarter, they sell that one and try another one.

Why did the managers then buy this stuff? Because to keep up with the guy that was buying the junk and having better performance, he said, well, I have to, too. I know a lot of portfolio managers who were buying stocks that they knew were questionable, but they felt they had to play the momentum game.

So you are right. We have to find some way to get away from this short-term orientation and get rid of these incentives that encourage it, like company management compensation, which is so short-term oriented.

I mean, I think the regulations that come out of Congress should be of a more positive nature. How can we incentivize managers, analysts, and so forth, to do the right thing rather than saying, well, you can't do this because as soon as you say you can't do this, as you pointed out, there are going to be some smart guys to figure out how to get around it. So we have to change the incentives.

Chairman BAKER. Mrs. Jones is next.

Mrs. JONES. Thank God for that rule.

Couple of questions. I am going to stick with you, Mr. Hill. Are you aware that last week, the SEC issued a new rule—number 8K—with regard to disclosure of certain management transactions?

Mr. HILL. I am aware of it, but that is not one that I have looked at really.

Mrs. JONES. The purpose was to—in Enron and Global Crossing, the testimony was that everybody—all the CEOs and the directors were able to have a way of relieving themselves of their assets while the value was very high, while the rest of the employees were stuck with what they had when they finally got to their dollars; and they were at nothing.

Is this one of the things that might assist us in getting where you are suggesting that we might go?

Mr. HILL. That is certainly a positive step, but it is a drop in the bucket.

Mrs. JONES. I believe this rule change actually came as a result of some conversations that we had with Chairman Harvey Pitt, Chairman of the SEC Harvey Pitt that we had at an earlier hearing. Because there was in place a rule that would allow directors and managers to have a plan in place to dispose of their assets, and then they could be shielded from quote/unquote, "any insider trading."

Let me ask you another question in that line, and I will get to the other witnesses. With regard to your whole conversation about compensation, I was just stunned, based on the arrogance of the Enron and Global Crossing CEOs that came in before this hearing in response to our questions about what their compensation was and what their—and unwillingness on their part to even, A, tell us what the compensation was publicly; and B, to say in response to some of my questions, "I didn't set the salary," and, "You don't know how busy I am as a CEO," and so forth.

I have come to the conclusion, based on the short time I have been in the Congress, in going through this process, that we real-

ly—no matter how much legislation we pass, no matter how many rules we put in place, to—like they just started doing in law schools about 15 years ago, requiring that ethics be a part of the curriculum for lawyers—that each year they would be required to do an ethical—I think every 2 years in the State of Ohio lawyers are required to get 2 or 3 or 4 hours of ethics training.

But also just to put out in the world that, hey, that right is right, and you can't misuse people, it seems to me is one of the things we need to look at.

I am going on for a little while, but I am going to ask you a question at this point. I guess all of my colleagues and I do that.

Anyway, though, what do you think, where do we need to go first in trying to resolve this situation that we find ourselves in in terms of accounting principles? Where do we strike first?

Mr. HILL. I think you strike for the low-hanging fruit first.

Mrs. JONES. And the low-hanging fruit is?

Mr. HILL. Well, I think the NASD and NYSE proposals that were are alluded to earlier, that will presumably be OKed pretty much in their original form a week from today by the SEC, and will presumably go into effect pretty quickly.

There is a max of 90 days, a 60-day and a 30-day, but I think they will go for the short end of both of those. That is a tremendous step. If you look at that and divide it into three parts—one is the conflict issue that I talked about, the compensation issue.

They only did a few perfunctory things there, and I am glad, because if they had tried to solve the problem which—as I mentioned, the underlying problem really is getting paid for research, but things would have been so bogged down that we wouldn't have gotten to the other good things that were in there.

So I am glad that in round one they didn't try to solve that problem.

Mrs. JONES. On that point, let me ask you this: Do you believe that CEOs and directors ought to stand behind the representations that they make about the financial condition of their companies?

Mr. HILL. I agree with some of the proposals that Chairman Pitt has put forth in that line. I think there should be more responsibility and penalties for CEOs if they are pushing the envelope, and obviously, if they are cooking the books. But fraud provisions take care of that.

Mrs. JONES. Mr. Chairman, could I ask unanimous consent for him to finish the answer to that last question?

Chairman BAKER. We have been very liberal with the use of time today, so please proceed.

Mr. HILL. The other two parts of the NASD and NYSE proposals were the disclosure and the recommendations.

Now I think probably some of the discussions in this committee last year set the stage for what came out of that—I think they really hit a home run in what they have done in terms of the recommendation issues.

I mean, there were two things that—Congressman Kanjorski is gone, but we joked about that you needed a decoder, a two-level decoder, to figure out what was going on with the recommendations. One was to put everybody on a common standard, you know, buy at one firm that was at the top category on a 5-tier basis, and sec-

ond tier at another and third tier at another. So you had all these different terminologies and scales.

The other problem was that there was this extreme optimistic bias in the recommendations, over 100 to 1 in terms of buys and strong buys, to sells and strong sells in the most commonly used terminology. But the NASD proposals, I think, really go a long way to solving that.

As far as the first problem, you can still have your proprietary recommendation scale, but it becomes supplementary because you are going to have—at the end of the day, in that report, have to say it is a buy, a hold, or a sell. So there will be a common scale and everybody's recommendations can be compared against each other.

The second thing is on the optimistic distribution. Every report is going to have to show the firm's number of recommendations in each of those three categories and what percent of those are investment banking clients. In addition, the analyst has to put in a price chart of the stock with his or her recommendations superimposed on it.

Chairman BAKER. If I may jump in on that point, given Mr. Kanjorski's reference to the cartoon, this is the coloring book chart, so any consumer, a Member of Congress I think can understand this.

You have the price target and the line goes down away from the estimate. I think that is a very persuasive tool that anybody can use to get an understanding of what the analyst is doing in relation to the real performance, and it is historical over a 12-month period.

Mr. HILL. And I think it will force the analysts to say what they mean and mean what they say.

I mean, if the reports are going to come out for the year or whatever, and every analyst's report coming out of that firm is going to be showing that 80 percent of their recommendations are buys and all their investment banking clients are in the buy category, pretty soon they are going to have a reputation as a shill. And we have seen Morgan Stanley come out with a change in their recommendation system that was obviously in anticipation of what they saw coming; and their distribution initially—I don't know what it is today, but initially 22 percent were sells. That is a reasonable distribution. The highest we had seen for any broker prior to that was 8 percent. And there were damn few, you know, that were more than 1 or 2. Sorry, I shouldn't have said that.

Chairman BAKER. Mr. Sandlin.

Mr. SANDLIN. Thank you, Mr. Chairman, for calling this hearing. And we thank the panel for appearing today.

Professor Holder, I wanted to ask just a brief few questions to understand what you are saying about the intangibles and goodwill. I noticed in your written testimony, you indicated that AOL-Time Warner wrote down intangibles and according to the information we have here, is about $54 billion in intangible assets. Is that correct?

Mr. HOLDER. That is my understanding, yes.

Mr. SANDLIN. That AOL-Time Warner merger was in January, 2000, would that be correct?

Mr. HOLDER. I have that general understanding, yes.

Mr. SANDLIN. And from what I understand in your testimony, the goodwill write-off merely reflects the decrease in value of the stocks since that merger in January of 2000; would that be correct?

Mr. HOLDER. It is a little more complex than that, I think. But basically, yes, the standard requires a fair value test for potential impairments of goodwill.

Mr. SANDLIN. So the drop in the value of the stock directly affects the value of the goodwill?

Mr. HOLDER. It certainly can and, in that case, did in a profound way.

Mr. SANDLIN. With the changes in the stock market since that time and particularly in the high tech area and the internet area and things like that, I think you would logically expect a fairly significant write-off, wouldn't you?

Mr. HOLDER. I am sorry, sir. In general, you mean?

Mr. SANDLIN. Yes, sir.

Mr. HOLDER. Well, a stock value is diminished and there is goodwill that is on the books of companies from acquisitions of other companies. While not axiomatic, that would certainly be the relationship you would expect.

Mr. SANDLIN. And there have been particular problems in the area of high tech stocks. And I guess that is what I was saying.

Mr. HOLDER. Yes, sir.

Mr. SANDLIN. Obviously, this is a very huge merger, and so while 54 billion is clearly a very large amount of money, it is not unusual in a transaction of this size, would you say? Does that seem to be proportionate to you?

Mr. HOLDER. $54 billion write-downs, in my experience at least, would not be unusual in the accounting term of our sense, but it is a very large loss.

Mr. SANDLIN. It is large, but these are huge corporations.

Mr. HOLDER. Indeed, they are, and the dollars that are involved in those mergers lead to those kinds of valuations of assets acquired certainly.

Mr. SANDLIN. Correct me if I am wrong. Previously companies amortized a portion of their goodwill each year; is that the way it worked?

Mr. HOLDER. Yes, sir, with the exception of some pre–1970 goodwill that wasn't subjected to that standard, that is generally the case.

Mr. SANDLIN. And you refer in your testimony about FAS 142, and my understanding is that intangibles acquired after June 30 have to be annually reviewed with a charge against the earnings if the market value of the assets drop, or if there is an impairment, as defined by FAS 142; is that correct?

Mr. HOLDER. Very generally, I think that is a fair statement, yes, sir.

Mr. SANDLIN. I am not an accountant. I am just a country lawyer.

Mr. HOLDER. I will accept your characterization. I am a simple teacher.

Mr. SANDLIN. So in my reading of your testimony, you analyze this transaction and talked about this write-down of intangibles,

but you are not indicating under the rules, under FAS 142 or any other rules, that that write-down was handled improperly, are you?

Mr. HOLDER. No, sir. The description that I tried to write in here, based upon publicly available information, would lead me to believe at least that this is unremarkable, at least in a couple of senses. A business decision got made leading to the acquisition of a company with certain consideration involved. That decision was predicated upon expected outcomes, how successful the combined entities would be.

When that business decision, through hindsight, didn't come to pass in the way that was anticipated, then the accounting implication of that is the—and I will say routine application of that accounting standard to value goodwill in light of a possible impairment.

So in that sense, I think the accounting model—and this is a rather new standard, but the accounting model in that sense works and achieved what it was designed to do.

Mr. SANDLIN. Right, and I think that is my point. The rules seem to work and flow naturally from the transaction that happened, correct?

Mr. HOLDER. That certainly is my understanding at this point, based upon the publicly available information, sure.

Mr. SANDLIN. Thank you for coming today. I appreciate your testimony.

Chairman BAKER. Thank you, Mr. Sandlin.

Just to follow on Mr. Sandlin's line of questioning, one point of clarification, the 10K restatement on the $54 billion write-down occurred and was made public December 31 of 2001. Since that point until now, there has been an additional $10 decline in stock value.

Based on your comment earlier about the not-necessary-but-likely correlation between stock price and deterioration of goodwill, one might not be surprised to see an additional restatement in some future months, given the current stock deterioration. Would that not be expected?

Mr. HOLDER. To the extent further impairment occurs, according to the accounting standard, one would expect to see those losses being reported as of the time the deterioration takes place, yes, sir.

Mr. HILL. Could I just jump in on that for a second?

Chairman BAKER. Sure.

Mr. HILL. Here is an example, though, of the subjective nature of accounting. Typically, in the kind of transactions we are talking about, it is saying that you paid too much for this because it deteriorated in value and didn't perform as you expected.

But you also can have a situation where a company acquired somebody with stock and now is subject to this—or in the past, even when we had pooling, didn't qualify for a pooling—but you took our overvalued stock, and you knew it was overvalued, and you went out and acquired somebody else's stock that may be overvalued and incurred some goodwill in doing it.

Was that a bad decision? No. You used your funny money to take advantage of it at that time. But it shows up here eventually as a write-down of goodwill or impairment. But that is why—you know, it is not just the numbers, you have to look at what is behind them.

Mr. HOLDER. Could I just add one bit of perspective?

Chairman BAKER. Let me just recognize Ms. Hooley.

Ms. HOOLEY. I would like to hear the rest of his answer, and then I will go on.

Mr. HOLDER. Well, all I was going to say is the accounting standard on how valuations and how acquisitions get recorded is really pretty clear that what one looks to is the fair value of shares in the market. So whatever that market value is generally would be the number that an accountant would use to record the acquisition. And while you might personally believe that that number is greater than the actual value, you are still basically obliged to use that number because it represents the most objective evidence of value that is attainable. That is all I wanted to say.

Ms. HOOLEY. Thank you, Mr. Chairman. Thank you for testifying.

One of the things that I think has been fascinating and interesting with the debacle of Enron, you have now seen several other things happen across the United States, whether that is with analysts and who is paying them and that whole situation.

There is another thing that is happening which is—for some of us finding out about it is relatively new, and this is the corporate-owned life insurance that they take out on employees. And we have a situation where Enron took out corporate-owned insurance, life insurance, on PGE employees who—this is an Oregon company, about 2,000 men and women. These are people who virtually lost all of their retirement savings when Enron imploded. In the case of Portland General Electric, more than $78 million in such benefits have been set aside for long-term compensation for managers and directors and supplemental retirement and bonuses for its top executives. And I understand that life insurance has a legitimate role in our economy.

And FASB rule 106 requires any publicly traded company that has an unfunded liability such as retiree health care plans to account for it in the annual financial statement, and life insurance is often used as the source of that funding.

And the IRS can find out about the COLIs policies directly from the companies, but there aren't tight requirements, and this makes it hard for others to determine just how much money is squirreled away in the insurance permitting employers to use COLIs to pay for lavish retirement benefits for executives, such as the situation at PG&E and Enron. This is because current disclosure rules don't require them to distinguish between the executive life insurance and rank-and-file life insurance.

First of all, do you think these disclosure rules should be amended to require companies to distinguish between the two types of insurance?

Mr. Holder.

Mr. HOLDER. As far as financial reporting goes, the financial statements generally have been viewed, historically at least, as providing an overview of the enterprise and its past ability to generate earnings and cash flows from various sources and its general financial structure at a particular point in time. So to require that kind of a distinction would certainly deviate, I think, at least from the

historic general purpose of financial reporting in accordance with Generally Accepted Accounting Principles.

I certainly recognize that the information you describe would have relevance to a good number of people. Rather than require that kind of information as a function of accounting principles, I probably would advocate that it be provided through other communication mechanisms required by the Securities and Exchange Commission.

I think that vehicle of additional information outside of the financial statements is well understood, and you see a lot of information of that type contained in official filings, 10-Ks and certainly other documents filed. To the extent that information was considered to be sufficiently useful, that is where I would recommend it be provided.

I am shooting from the hip here. I would like to think a little bit more about it, but I don't have that opportunity. That is my immediate reaction.

Ms. HOOLEY. Well, when companies report all of their life insurance in an aggregate, accounting rules require that they report the increases in the aggregate cash value of those life insurance policies, and only if the increases are material. But material is not defined. So do you think we need to define materiality?

Mr. HOLDER. I think the SEC has done a pretty good job in Staff Accounting Bulletin 99, I think, if I recall correctly, in tightening what materiality means and reminding the accounting profession generally that there are qualitative aspects as well as quantitative aspects to materiality. The FASB has declined to do that beyond providing very general guidance.

I believe the staff accounting bulletin has had a substantial affect on the way materiality is viewed. It is rather recent. But I would be content at least myself, to see, you know, the effect that it has had before I would propose at least additional information.

I believe that was the extent of your question. There may have been something on the cash value side of it.

Ms. HOOLEY. No. I think you have answered the question. I have just one other quick question, and this goes back to private companies and what Mr. Boehm was talking about in terms of some of the pension funds. Certainly we have had some problems in my State again with this issue.

Private companies generally aren't required to make public filings with the Securities and Exchange Commission. Why do we treat them differently? Should they make filings with the SEC? Would that be helpful, not helpful?

Mr. HOLDER. Private companies or employee benefit plans?

Ms. HOOLEY. Well, employee benefit plans, pension funds, should those be reported to the SEC? Just sort of what are your thoughts on that?

Mr. HOLDER. Well, certainly there have been some problems in that area, as you know. Most employee benefit plans have reporting obligations to the Department of Labor and to the IRS generally if they are subject to ERISA, the Employee Retirement Income Security Act.

Anyway, those two agencies, I believe, are charged with oversight of financial reporting by pensions and have specified rules over the

years. At this point I wouldn't be inclined to recommend transferring that responsibility to the SEC.

Certainly financial reporting by employee benefit plans can be improved, and certainly there are incentives for bias and for self-dealing that exist anywhere economic resources are probably aggregated. So many of the things we have said about business enterprises and the issues that need addressing there would certainly apply to employee benefit plans generally, I think.

Ms. HOOLEY. Mr. Chairman, can I ask one more question?

If there was one thing and only one thing that you would do to change the law or change reporting or change what we do so that—you know, I don't know that you can ever stop what happened with Enron, but what is the one thing that you would have the most—you think would be the most significant change we could make?

Mr. HOLDER. I would empower audit committees. I would act to make them independent of the companies that they serve. I would make their relationship with the external auditor far more muscular and robust. I would also make that same relationship more muscular and robust with the chief accounting officer, the chief financial officer of the company.

Ms. HOOLEY. Thank you very much.

Chairman BAKER. Thank you, Ms. Hooley.

Gentlemen, you have done such a good job. The bad news is the committee is going to do a second round. We have more questions, so I am going to start off.

First, for the record, I want the subcommittee to know that subcommittee efforts were made to secure comment on these subjects from AOL Time Warner, from Xerox, from Dynegy, from CALPERS, and from various pension union management representatives. All, at least for purposes of today's hearing, declined to appear, and I think that unfortunate because not every action taken was necessarily taken for untoward purposes. It may have been legitimate business management decisions that simply turned out, in retrospective analysis, not to be good judgment.

But I think it important that we do get before the subcommittee at some appropriate time representatives of market participants to explain how special purpose entities, IRUs, goodwill, all of those various accounting methodologies are utilized for valid business purposes that do, in fact, result in shareholder value being enhanced.

Yesterday, I understand that the SEC has released for public comment a new standard of disclosure requirement, specifically in the management discussion and analysis section of annual reports that relates to critical accounting policies. In summary, as I understand it from reading it this morning, it requires in that section management to describe the assumptions used to arrive at values. For example, if we are back in our widget manufacturing mode, we are assuming widget market price will be $10, and that the pricing for construction and delivery of the widget will be 5. All of those things are based on certain assumptions: That the cost of raw materials won't be adversely impacted, that market price will actually be sustained at $10. And there must be some discussion in a simplistic way of how management came to represent the net value after expenses of $5 per widget.

Are any of you in a position to be able to comment as to the adequacy of this new disclosure standard and your view of its appropriateness?

Professor Holder.

Mr. HOLDER. I just received the document that you referred to myself last evening and got a chance to read it. I think as far as accounting standard setting goes, I tried to be inclusive of—there are lots of ways to improve the system, and standards is one of those. In recent years you have seen the FASB, as they have produced standards, rather routinely requiring, when accounting estimates are required, that companies disclose the estimate of the requirement for making the estimate, the methods used to make that estimate, and the significant assumptions that were adopted in the application of that method.

A couple of years ago, I and a colleague of mine published an article calling for the generalization of that kind of disclosure. And as I read the—because right now the disclosures are inconsistent between different estimates, and, you know, it has been done on a rather ad hoc basis.

This seems to be consonate with the belief that I have had for some time that where you have ambiguous accounting numbers, subjective accounting numbers, that one pathway to transparency is revealing the methods used to make the estimates and the significant assumptions that were adopted in applying those methods.

So I would wholeheartedly support this type of an initiative. As I understand it, most of this would go at MD&A, in management's discussion and analysis. And, as I testified earlier, I think this stuff might well—I know the SEC doesn't like to set accounting standards because it is FASB's province, and there are features like that. But I think this kind of information, I would advocate it becoming an integral part of the financial statements.

Chairman BAKER. Mr. Hill.

Mr. HILL. I would agree with all of that. I think though, that—I mean, the SEC can kind of get the word out of how they are going to interpret some of those things, and I would hope that that interpretation would include that in this kind of discussion, which is really, I think, taking the footnotes stuff and putting it into layman's language here, but I think it should include things like, you know, what percent of our earnings this quarter came from the pension fund. And, you know, but—and also this—this pro forma aspect. I think that companies have the right to say this—this is the way that we think our earnings should be valued, but I think somewhere they should have to spell out what each of these items are and defend why they think it should be counter to what common practice is.

So, I don't know. We will have to wait and see what the SEC interpretation is and how they enforce it, but I think it certainly is a good step forward and hopefully goes as far as what I am suggesting.

Chairman BAKER. Mr. Boehm.

Mr. BOEHM. My background is as a prosecutor and ethics lawyer, not an accountant. I will pass.

Chairman BAKER. Thank you.

Mr. Bentsen, another round?

Mr. BENTSEN. Thank you, Mr. Chairman.

Although the prosecutors and ethnics lawyers are getting a lot of work right now.

Mr. Holder, I want to go back to—and Mr. Hill actually—back to the Enron case, because we looked at that more closely than others, and with respect to both the use of SPEs, which in and of themselves I don't think are particularly evil instruments, but obviously can be overused and misused. In the case of Enron—also I wanted to talk about management compensation.

There has been a lot of discussion about the issue—about whether or not and how options should be disclosed, whether they should be treated as an expense, whether or not shareholders should have the right to approve options for management officers and directors. In addition, in the case of Enron, we saw, I believe, if I recall correctly, that in a number of financing vehicles, SPEs and I guess some others, Enron put a pledge behind or guarantee behind it, which they guaranteed that they would—they pledged stock that would be—to be issued later, which would have the effect obviously of diluting the stock that had already been issued.

Are those disclosable events, or is it a subjective call on the part of the company or the accountants as to whether or not that dilution of the stock or potential dilution of the stock would be disclosable?

Do you think that it is a good idea that Congress should require public companies to expense options once they are issued? And do you think that we should beef up the disclosure particularly—and also have shareholders approve options extended to officers and directors?

Mr. HOLDER. With respect to the options, I have—in fact, I signed a letter addressed to Congress along with several hundred or a couple hundred other professors advocating that the fair value method of accounting for stock-based compensation, particularly options, be the only method allowed under Generally Accepted Accounting Principles, and that the intrinsic value method of Opinion 25 be discontinued.

So I do believe that that is the appropriate accounting solution here, because options generally do have a cost. They are a mechanism to a company. And it dilutes the value of shares. And in addition to that, we have empirically demonstrated metrics, options pricing models, that, in my view, at least sufficiently value them with sufficient precision and reliability to warrant their recognition in financial statements.

As it relates to the Enron commitments, we do have an accounting standard that requires that guarantees of the indebtedness of others be disclosed, even if the possibility of a loss resulting from that is remote. I have struggled to understand why there was—and I have not found it—but why there was no disclosure of those guarantees, why there was no disclosure of those commitments. Using my own reasoning, I can start to develop pathways for why it may have been believed that the disclosure standard I just referred to didn't apply in that circumstance, but it gets rather speculative. And so I just—I haven't seen enough facts in the public record for me to dispositively say, here is why they did what they did or didn't do what they did.

Mr. BENTSEN. I would just add, in our hearings, the Chairman may recall, when we had the dean of the University of Texas law school testify on his report that a number of these options to issue that were written as a form of a guarantee were also not approved by the board. It would seem to me again that you are extending a lot of credit on behalf of the company and thus on behalf of the shareholders with one or two people apparently making that decision. Is that something where you would see a board function come into play?

Mr. HOLDER. I don't understand what you just said. All I said was, based on what I have seen in the public record, I can't explain from a financial reporting standards perspective why a disclosure wasn't made. As it relates to the authority to issue or to engage in such contracts and so on, that is a feature of corporate governance, and I mean—if a company has policies that require a board approve a particular type of transaction, then that is how that company should operate, I would think. I mean, I am probably missing——

Mr. BENTSEN. Well, I guess the question is if you are providing a guarantee using the ability to issue stock in the future to fund that guarantee, is that a function—if the shareholders aren't approving the option, should at least the board of directors be approving that option since it is very likely that this action will dilute the value of the stock that has already been issued? And do the board of directors have a responsibility to the shareholders to give that approval?

Mr. HOLDER. In all honesty I am, like I said, I am an accounting person. You are speaking now of corporate governance and where the authority to issue stock should be vested. You know, my sphere of competence, I have an idea, and I have thoughts, but, I mean, I don't have particular expertise there that would inform a judgment that might result in legislation. I am happy to give you my view, but I just feel uncomfortable venturing onto that turf as to how corporations should operate, what rules should I evolve on them for issuing the stock.

Mr. BENTSEN. Mr. Hill, if I could you get your comments on the question of disclosure, shareholder approval of the issuance of options. You raised management compensation as an important issue and cause. Do you think we need to crack down on the use of options in this respect?

Mr. HILL. Well, I do think there needs to be more control over them, and I think that shareholder approval of officer and management options is probably a good thing. It has kind of been open season. But, you know, even if you had that, the problem is if it is essentially an inside board, why is it going to matter?

But I think it would be a good step, and hopefully the shareholders themselves would step up and actually take a look at the proxy and vote accordingly. But you know, on the option expense issue, I kind of—I guess I am going in dangerous ground here to take a different position than the professor, because I am just like the Congressman from Texas, a poor country boy here. I know more about milking than I do about accounting.

But I think we need to think something—on the earnings statement here, we are getting too complex and getting too many what-

if things in there, whether it is the market ruling—I forget the FASB number, but if you can help me out there.

Mr. HOLDER. On derivatives? 133.

Mr. HILL. Thank you.

But, I mean, this is distorting earnings. It is going to render them meaningless. People can't make estimates. What is going to come on the future on these things? Is it really representative of what the company is earning? No. Does the issue need to be raised? Yes.

But I think—again, I am thinking off of the top of my head here, but maybe we need to do something where you take some of these things out of the income statement and you have sort of a risk category where you have the what-ifs. And maybe that is the answer to it.

But I think, you know, when we—on the option issue, if we are going to expense them, I think it ought to be when they are exercised, because that is when the lost opportunity cost is for the company, whatever the difference is in the stock price and the exercise price. Essentially if they had sold that to an outsider, they would have had full price, but with the option holder, they are foregoing some of that. So I think even though it is kind of not when the option was granted, obviously, but that is when the company really incurred the cost and lost the opportunity to have gotten full value for that share.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BACHUS. Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman.

Mr. Holder, I am going to ask you questions this time around since I asked Mr. Hill before.

And, Mr. Boehm, don't think we aren't happy that you are here.

With regard to Time Warner, Mr. Holder, Professor Holder, excuse me, the write-down of Time Warner as you speak to in your statement is that they are complying with this FASB 142 or FAS 142.

Mr. HOLDER. Yes.

Mrs. JONES. So that was appropriate conduct for them to—understanding the rule—to then do the write-down. Is that a fair statement?

Mr. HOLDER. Based on the public information that I am aware of, yes, that the accounting was called for in that circumstance.

Mrs. JONES. They stepped forward and did what they were supposed to do?

Could you tell me, do you believe this standard should change at all or that it should be modified any more than it has been?

Mr. HOLDER. It is a very new standard. Certainly it is having an effect, as we can see. The issue of how to account for goodwill has been around for a long time and has been controversial in the——

Mrs. JONES. What did they use to do 20 years ago, if you have been around that long?

Mr. HOLDER. Unfortunately, I have. Sadly, I have.

When the predecessor standard, APB Opinion 17, was written, somewhere around 1970, the treatment of goodwill was, subsequent to its recognition in a purchased business combination, simply one

of amortization, and the standard then said over a period not to exceed 40 years.

My own sense is, and my understanding of some experience from long ago, were that the accounting for goodwill subsequent to its acquisition at that time was a systematic and rational amortization of that total amount over some future period, and many companies were using 40 years. As time passed, that period shortened, and challenges were raised about things that were becoming goodwill. People were attempting to take what perhaps earlier would have been recognized as goodwill and recognized it as other types of intangible assets.

Certainly I am not a tax expert in any sense, but the tax law intruded here because some things would be amortizable and deductible, but not goodwill during periods of time.

But there really was an impairment test for goodwill until rather recently. There certainly was not one contained in Opinion 17. And so this standard is sort of a fresh way to look at accounting for goodwill subsequent to it—and other intangibles for that matter—subsequent to its acquisition. And it is an impairment-based, not an amortization or a spreading of cost-based accounting standard.

You can build a case for either, depending upon what your view of a measure of earnings ought to be, but I believe the new standard is certainly much more aligned with the conceptual framework of financial reporting that has been developed also over the last 20 years.

Mrs. JONES. It is fair to say that it is a lot easier for you as a professor, and Mr. Hill as an experienced accountant, and Mr. Boehm coming from lawyer ethics, for us to sit in and, for lack of a better term, pontificate about all of those issues. It is a lot easier for us to do that than individuals coming from particular companies to come to this subcommittee and in 5 minutes tell their whole company history and to be able to make some sense of it.

It is a lot easier for us to do that than for an AOL or a Dynasty or Dynegy or whatever it is—excuse me, anybody here from Dynegy, I don't know the name correctly—than for us, in this circumstance—I find myself as a former trial lawyer, 5 minutes to ask questions, I am just getting rolling before the time is up. So the forum of congressional hearings, it is a difficult format to present a situation. Would you agree on that?

Mr. HOLDER. I myself had difficulty trying to confine my remarks to that period of time. I would suspect that others would be.

Mrs. JONES. Thank you.

Let me, Mr. Boehm, give you the last few minutes of my time just to speak on anything you would care to speak on, just so we didn't bring you here and you don't feel that you were part of this.

Mr. BOEHM. No. I appreciate that. And I am sorry the Congresswoman from Oregon isn't here. She alluded earlier to a situation in her State involving pension funds. What had happened there in Oregon is that $100 million in pension funds belonging to union members was lost through racketeers, and that is money that is lost. And I viewed this case that is developing on Ullico, as there is a duty that is owed to the retirees, to the people whose money has been put at risk.

And in my exhibits, I have 25 recent cases, these are all cases in the last year or two. Some of the numbers are staggering. When the FBI swooped down on the Lucchese family in the year 2000 on the scheme they had, they were on the verge of transferring $300 million from union pension funds into a management company controlled by the Lucchese crime family. I think it is fair to say that this particular entity did not have the best interests of the union workers, the retirees, at stake.

I appreciate the opportunity to answer a question, too. I have a problem with the 5 minutes and so forth, but I realize the constraints of time, but if I had one thing to leave folks with here, it would be this: That you have 7 trillion in pension funds in the United States. You have literally billions of dollars in what they call those Taft-Hartley funds that are union pension funds. There are some of the same issues that affect Enron and affect Global Crossing, which are transparency, accountability, and that the stakeholders, whether it is a shareholder or a retired union member, ought to have more quality information, accurate information, as to how their assets—they own the pension fund just as the shareholders own the corporation—how they are being protected or not protected.

So you had asked earlier what is one thing that could be done. The one thing would be laws and policies that have a stronger emphasis on disclosure, because the time-honored saying is sunshine is the best disinfectant. That is how we prevent these things.

Mrs. JONES. Thank you.

Chairman BAKER. In today's hearing I will say that no one has been constrained to 5 minutes.

Mr. HILL. I just was going to add something to your first question about AOL Time Warner. What we are seeing this year is sort of a one-time event. I mean, there will be impairment of goodwill as we go forward in future years, but because of the implementation of this new impairment test, why a lot of—I mean, yeah, there was probably some impairment last year, but we are going back and applying it to all of those other periods. So you are going to see some big hits at a lot of companies, whether they are old-line companies or whether they are new-line companies, this year.

Mrs. JONES. So it is magnified.

Mr. HILL. It is magnified this year. But it will subside in future years.

The other thing in relation to the history is if you go back 10 or 20 years, most of the goodwill was created by a company paying cash to buy another company, paying a modest premium over the value of that company. So a fairly reasonable amount of goodwill was created and amortized over 40 years.

But what has happened with the information age is that we had these companies that—as I mentioned before, that go out and make acquisitions with their highly valued stock, so a huge amount of goodwill is created. And on top of it, given the nature of these companies, they say you have to amortize it over 3, 4, 5 years. So that changed the whole situation with goodwill here in recent years and was one of the reasons why—of moving to—the current system where we do away with the amortization of goodwill, but have tougher impairment tests.

Chairman BAKER. Mr. Sherman.

Mr. SHERMAN. I have quite a few questions.

I see that we have a professor here from USC. As one of the few CPAs to come out of UCLA long ago, I may have dreamed of this situation.

Mr. HOLDER. That bodes ill for me.

Mr. SHERMAN. No, I think we will get along fine. Let's first take a look at Enron. Let's assume that those who were putting this whole thing together hadn't been so sloppy or so cheap or so unable to get Barclay's Bank to loan them $15 million when they needed to borrow $15 million. Let's assume that every one of the special purpose entities met the 3 percent capital test, so that those who wanted to prop up this $100 billion house of cards actually had the few additional million dollars in that that they should have.

Under those circumstances, could Arthur Andersen have legitimately stated that, or even arguably stated, that the Enron financial statements were within the range of materiality, within the range of possible interpretations of GAAP? Could they have given them a clean opinion?

Mr. HOLDER. Let me try to answer the question this way. If the SPEs had complied with all of the requirements that would avoid their consolidation, then I think not consolidating them would have complied with Generally Accepted Accounting Principles as a general matter.

My view is reinforced by the belief that professionals need clear and unequivocal standards to the extent they are possible. And as I have said earlier, there is great subjectivity in this area that standards can't remove. But to the extent that clear, unequivocal standards could be produced, they should be, and if one complies with those, then one should be comfortable their conduct is——

Mr. SHERMAN. I couldn't agree with you more on the need for clear standards. There are those who have come before this subcommittee or my colleagues who have said, if we could just get together and sing Kumbaya, if we could just tell people in the business world, do the right thing, then they all would. The fact is that businesses are run by the people who have the best records, and they get there by being aggressive. And then companies competing for capital on the stock market, the edge goes to the most aggressive company run by the most aggressive people that run the most aggressive company.

And to think that long term, because short term everybody remembers Enron, everybody is quaking in their boots, that will last another 6 months, maybe a year, and then if we don't—the idea that those who are singing Kumbaya as they drive to work are going to be running the most aggressive companies with the highest stock performances kind of ignores our culture.

But I want to get back to the need. Let's go back to Enron, because what I have said in this room before is that it appears that this is a company that got a ticket for going 101 miles an hour in a school zone, but the posted limit was 90. That is to say, if they had just gotten—put in that extra money to reach that 3 percent, as you said, Enron, I don't know if they would be selling for, you know, 80 bucks a share, because their stock had started to go down for a number of other reasons, but they would be a happy company

selling for 20, 25 bucks a share. Someone would be buying their shares today, and that person would be making a mistake.

My concern is go back to the—if we don't consolidate the SPEs—the SPEs, as I understand it, borrowed money from the investment bankers, and so it looked like the investment bankers were taking the risks. And if you don't consolidate the SPEs and you issue those financial statements, aha, the risk has been borne by those who lent money to the SPEs.

What concerns me is that the SPEs, as I understand it, had received assurances from Enron—not the SPEs, but the lenders to the SPEs had received assurances from Enron that if those loans ever went in the tank, Enron would issue them a line of Enron stock. It is as if I go to my accountant and say, my factory burned down, but don't worry about it, I have an insurance policy. And he says, well, yeah, but didn't you insure your insurer? Well, that doesn't count because I am only going to give stock to my insurer.

Under the most liberal reasonable interpretation of today's Generally Accepted Accounting Principles, and assuming the SPEs are independent, not only do we not consolidate the SPEs, but do they achieve the result that the derivatives provided by those SPEs are recognized and the assurances given by Enron to the creditors of the SPEs are not reflected in the financial statements?

Mr. HOLDER. Your general question is, is that appropriate?

Mr. SHERMAN. Yes. Within the most reasonable definition of GAAP.

Mr. HOLDER. It is a very difficult question. The temptation is obviously here to say, obviously not, that there should be greater disclosure and so on.

If I may for just a moment, I think it is probably axiomatic that the evolution of business transactions and events will exceed even the most nimble of standard-setters. And so in order to—there are a whole host of other reasons that I believe as I do, but that is certainly one of them.

Are there deficient standards, standards that may have been acceptable in yesteryear that today aren't, because transactions are being written to which those standards apply, that didn't even envision the——

Mr. SHERMAN. The people looking for loopholes in either Generally Accepted Accounting Principles or in the Internal Revenue Code will always find them. If you go to sleep for 50 years, you will collect no revenue, and every company will be reporting higher earnings every year, because you can't go to sleep and let the loophole finders get a 50-year head start.

Mr. HOLDER. As unfortunate as it is, that is an abiding feature of the way financial reporting, the way a lot of things, the rulemakers write rules. Those subject to them craft transactions, sometimes to try to avoid those rules, and I can't think of a way to stop that.

But in addition to better standards——

Mr. SHERMAN. Professor, with all due respect, I can; that is, be as nimble as you possibly can be, and as quick as you possibly can be. This Congress has passed quite a number of loophole plugs to the Internal Revenue Code. And now and then there is a loophole that some who disagree with a tax prevent us from plugging. Like

there are those who are opposed to a corporate income tax, so there is a gaping loophole in the corporate income tax. They say, don't plug it.

But while there is disagreement in this House as to whether we should have a corporate income tax, nobody disagrees that we should have accurate financial statements given to shareholders, and the way you get there is you plug the loopholes and also have a general overarching standard that financial statements should accurately reflect the situation.

What I am asking here is, is there a loophole that the FASB did not plug that a reasonable, though somewhat liberal, accountant could allow a company to exploit that allows the reliance on a derivative issued by a genuinely independent SPE whose creditors have received assurance from the Enron company that if those creditors lose money on the loans, they will get Enron stock? Is the speed limit here 90 miles an hour?

Mr. HOLDER. Hindsight would suggest that is certainly the case, sir.

Mr. SHERMAN. I mean, my image of the accountants at Arthur Andersen is not that they were idiots, delusional, or viewed themselves as intentionally committing a crime. They thought the company had found a loophole that worked, and they only gave the company a ticket leading to that company and their own demise when they realized they were doing not 90, but 101 miles an hour. And I have been pressing the FASB not only to deal with the SPE issue, not only to deal with the mileage above 90, but to deal with the derivative issue, to deal with the issue of what if you go to a genuinely independent company and they insure you, but you insure them. What if your factory burns down and you have fire insurance, but, oh, wait a minute, you owe a whole lot of stock to the fire insurance company?

Mr. HOLDER. Sure.

Mr. SHERMAN. Can you identify other areas where the FASB has allowed a loophole of this magnitude to exist?

That will have to be my last question. Perhaps other members of the panel would be allowed to comment on it, but the Chairman has been incredibly generous with time.

Mr. HOLDER. Adopting your view of loopholes and so on, over the years a great many accounting standards that have been produced have been produced in response—at least in the eyes of some as a response to an accounting abuse. You can go almost as far as back as accounting standards have been crafted and see that thread of logic. I think of leases, I think of accounting for leases. I think of accounting for pensions.

It was earlier a Congresswoman alluded to the other postemployment benefits standard, 106, that was produced. In many cases there are unanswered questions that require a standard to be produced. FAS 133 on accounting for derivatives is one of those. Certainly the future will reveal instances where accounting standards need to be created, and if we had the ability to foresee that need, certainly they should be crafted and produced today.

Accounting standards can be written better. There is no question about that. There are a whole lot of structural issues, some of which I relate in my written testimony, on how to improve the

standard-setting function. And certainly we should try to anticipate unfolding transactions, and certainly we should be nimble in responding to those that arise, and we can get better at it, I think, as a profession, and should, and should be provided the tools to do that.

But I continue to say, I don't think that is a complete answer, because no matter how nimble you are, you can't be that nimble. And the people implementing and applying, even if you have got the best standards, have to apply professional judgment in areas of great subjectivity, unless you just wring out of the standards almost every aspect of relevance.

Chairman BAKER. Thank you, Professor Holder.

Let me maybe add on just one comment to that of Mr. Sherman's relative to FASB. Let's make a grand assumption, Mr. Sherman, that you and I are both qualified CPAs in business together. We are monitoring this SPE transaction over at Enron. We consult. We can't get to the right determination as to what we should do, so we flip over to our FASB home page and turn to the technical inquiry service where we find a helpful suggestion that the FASB will—in response to an inquiry we might make, the FASB will not issue a written response to any technical inquiry; that the staff recommendations are only those; that the only font of authority on all of this would be an official position by the Board; that we can only respond to inquiries that relate to an applicable FASB pronouncement.

But listen to what they cannot pontificate on. I shall read. The FASB staff cannot answer questions in the following areas: Auditor independence; audit procedures or related auditor reports; compilation and review procedures of related accountants reports; SEC filing requirements; Federal, State or local income tax issues; legal or contractural issues; structuring of transactions; materiality; detailed, fact-specific questions. And here is the one which I found of particular interest, which I think is the only appropriate exclusion from response: research for school assignments.

Now, if that is what our regulator of accounting practices can do for a CPA in distress in this marketplace, gentlemen, we are in serious difficulty. And I just only learned of that helpful page just a few moments ago.

We have to have a clear, concise, nimble response someplace where an inquiry can be made where you know when you get the answer, you can rely on it. This basically says, we can give you advice, but it doesn't matter, because if the Board decides otherwise, you are still in trouble. I think the IRS technical helpline is a pillar of exemplary service compared to this.

We have a real problem. And let me add that next week we will have another hearing on this matter at which time we will hear from the Chief Auditor of the SEC and other interested parties. This is not the end of our process, this is merely a step in the right direction.

Did you wish to make further comment, Professor?

Mr. HOLDER. Only if you have an interest. I would react to what you said.

Chairman BAKER. Certainly. Yes, sir.

Mr. HOLDER. In my written testimony I said additional steps can be taken about the standards-setting and regulatory function. As the current time many of the things you mentioned are not part of FASB's charter. They have no authority to speak on auditing issues. They are confined just to financial reporting. That may not be the right way for it to be. And certainly we need to be responsible and responsive to inquires from practitioners. SEC filings, I mean generally you would ask the SEC about those.

So I clearly understand why you would see many of the limitations of what the FASB——

Chairman BAKER. But on the areas of questionable advice, it ought to be understood, let's help you comply with the SEC filings if we can, but this clearly is outside of our bailiwick. On areas which should be our responsibilities, you ought to be able to get a definitive response within a few days on which you base a professional judgment and not be held liable. Why would any CPA step out and advise a client with the presumption that at a later time they would be found guilty of non-professional performance?

Mr. HOLDER. Mr. Baker, I think that absolutely makes a lot of sense. In order to do that, the resources available to FASB to provide responses to the kinds of inquiries they would then expect to get would be extraordinary relative to what they have today.

They also will have to change some of the Financial Accounting Foundation's due process requirements, because once you begin to provide those kinds of authoritative answers, you would run afoul of the current due process through which the FASB is supposed to go before they establish authoritative standards. And so additional steps need to be taken.

Chairman BAKER. We don't have a place where the buck stops. Everybody points at everyone else, and it is not my fault. Accountability is the only answer to this. If you know you are the one at the end of the game who is going to be held accountable, you have a tendency to be a lot more critical in your casual assessment.

Mr. SHERMAN. Mr. Chairman, if I could comment on this.

Chairman BAKER. It would be unusual if we had any panel that even got remotely close to 10 minutes.

Mr. SHERMAN. I want to thank my many colleagues who aren't here, thereby giving us more time to talk.

Chairman BAKER. We have, by the way, dissolved our partnership example for the moment.

Mr. SHERMAN. I was looking forward to it.

Chairman BAKER. Well, if there is profitability there.

Mr. SHERMAN. As long as I was the first-named partner.

I would point out that when it comes to independence issues and especially audit issues, that the AICPA is supposed to fill the function that the FASB fills for Generally Accepted Accounting Principles. Whether that is the right way to do it, whether they do a good job I will put aside. Likewise the SEC answers some of those SEC questions. But the most interesting part of your litany, when the FASB says, we don't want to deal with fact-based issues, hello.

Chairman BAKER. If it can't be fact-based, I am going to make up something here and see if you can answer this one.

As I say, I think that we have a real policy discussion ahead of us on all of these matters. I do very much appreciate each of your

long-standing participation in the hearing. It has been productive for the subcommittee's understanding, and the written record will remain open for an additional 5 days for Members to forward any written questions they may have or further materials provided by you.

We appreciate your courtesy, and our hearing stands adjourned. Thank you.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

# CORPORATE ACCOUNTING PRACTICES: IS THERE A CREDIBILITY GAAP?

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**TUESDAY, MAY 14, 2002**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Kanjorski, Gillmore, Castle, Royce, Lucas, Weldon, Hart, Sherman, and Lucas.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order. This hearing today represents another step in the subcommittee's continuing effort to properly assess the reporting of corporate financial condition to the market.

It appears, in the aftermath of Enron, Global Crossing, and others, there is a need for the subcommittee and the Congress to carefully review all of the elements that bring about market discipline and to ensure that shareholders and investors are getting concise and accurate reports on the companies in which they are invested, or in which they are considering making such investment.

Over the past few months, there have been many troubling revelations, and I wish to make it clear that I think our system by and large works very well, and that it is, in the aggregate, a system that is conducted by professional people trying to do a professional task. And it is unfortunate that the inappropriate conduct of so few has brought about such broad-based market dislocation. Nonetheless, it is our responsibility, I believe, to fairly assess where there may be inadequacies, and for the subcommittee to act appropriately based on the best counsel that we can receive.

I am pleased today to have the participants that we do have for our hearing. I think all of them will be very helpful in helping the subcommittee arrive at appropriate considerations and recommendations for future committee action.

At this time, I would recognize Mr. Kanjorski for any opening statement he might make.

Mr. KANJORSKI. Thank you. Mr. Chairman, I ask that my full remarks be made a part of the record.

Chairman BAKER. Without objection.

Mr. KANJORSKI. Mr. Chairman, I want to congratulate you, first, for having this hearing. I then want to address some of the things that have happened over the last 6 months, and their relationship to some of the groups involved in today's hearing.

Certainly, Enron's collapse and at least some of the other recent earnings restatements that have occurred in corporate America over the last year, and which will continue for a short period in the future, are disturbing. More disappointing, from the standpoint of

the world's wealthiest, freest economy, is that excess sometimes drives good, reasonable people to unacceptable extremes.

Even though I am a lawyer and I have gotten used to the legal profession being kicked around in my life, I have to say that I have great sympathy for the accounting profession. In a broad sweep, they seem to be being painted with the primary responsibility for Enron's collapse and these other weaknesses in our system. They have been burdened with our unwillingness as a society and as an economy to decide whether we are going to use principle-based or rule-based accounting systems. The excesses in our capitalistic system that have occurred over the last 8 or 10 years could have driven the weakest among us to steer away from our values or basic principles.

In terms of the accounting profession, they do not need a defender, but I will try to defend them a little bit. I hope that we as a committee, a Congress, and American people do not castigate the profession unduly, or fail to recognize the importance of the profession and their incredible contribution to the free economy of the United States over the years. It is only through their very professional activity that the economy of the United States has gotten to the point it is now, which is the greatest economy in the world.

There seems to be a problem with some management in corporations. There seems to be a problem of corporate governance in some corporations. There seems to be a problem with some accountants that work for some corporations. And as a lawyer, I have to say, there seems to be an awful lot of questions as to whether the legal profession has risen to the occasion.

But I do distinguish in our society the difference between people that are in business to do things, and people in the professions to maintain standards. I hope that we do not discourage the future students of this country from entering the honorable profession of accounting because of what has occurred. The behavior of a few represents a very, very small portion of the accounting profession. Those accountants that I have had the pleasure of knowing over my lifetime and doing business with, I can say have acted with incredible ethics and proper conduct within the system. I want to make that point as a matter of record.

We have also had in this situation a merging of the question of what is a professional and what is a businessman. As I was coming back to the hearing today, I was thinking—not to further alienate another group—about investment bankers. I sort of thought: Maybe we could say that investment bankers are businessmen, and businessmen are to a large degree salesmen; these investment bankers are salesmen in Brooks Brothers suits.

But, there is a difference between them and a lawyer and an accountant. The latter are professionals. They really deal with such substance, and have had such high credibility, that even raising a question about them injures them and injures our society.

I think this hearing today can be very productive, and I think we should look into what new rules have to be put in place and what can be done to tighten the accounting system. The new economy is so significantly changed. We have moved from accounting for the production of screwdrivers, which was rather easy, to trying to figure out the value of derivatives, which is not easy. But we should

not just find a target defendant, if you will, and castigate them because of some of the failures of this system. Instead, we should concentrate on the positive. What can we do for better governance? What can we do to make sure that management is more responsive to the marketplace and to the shareholders? What can we do to the professionals that step out of line? We should also ask whether or not the free market system or the profession can respond appropriately, or whether there is need for new rules and regulations?

But, by no means should we run down this path with tremendous speed. I think the fear I have now is more that we can injure the system and have unintended consequences come out of our acts, than if we act deliberatively. We must study what has happened, and try and only be as responsive as absolutely necessary.

So I look forward to the very competent list of witnesses we have today to give us the proper map to follow on that course.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 148 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Lucas, or Ms. Hart, either one have an opening statement?

[No response.]

Chairman BAKER. Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman. I regret, I think my statement will have a slightly different tone than that of my more senior, more learned, and more knowledgeable colleagues.

I don't think that we can say all is going well, and we just had a problem with one company due to the moral failings of a few individuals, and now that those individuals are no longer making important national economic decisions, everything is fine. And I realize that is not what my colleagues have said, but to the extent anybody would exaggerate their comments to reach that conclusion, I would respond that instead, the markets don't think that way.

The market value of what is being traded on Wall Street has not just dropped by a few tens of billions of dollars representing the overstatement of the value of the stock of Enron, but rather our markets are selling for perhaps a trillion dollars less than they would be if, in virtually every company, but especially those that deal with derivatives or those that deal with energy—but across the board, people did not factor in as bigger than any terrorism risk, as big as perhaps a recession risk, an accounting risk.

In our first set of these hearings, we discovered—at least a USC accounting professor told us, and I am not blinded by my UCLA loyalties to the wisdom of that professor—that if only the Enron folks had dotted their i's and crossed their t's, perhaps any one of several different accounting firms would have blessed, correctly—or at least arguably correctly—what they did. If only they had put up a few additional millions of dollars to make sure that their special-purpose entities reached that glorious 3 percent independence level, then they would have been allowed to use those special-purpose entities for covering the billions of dollars of losses through the appearance of being insured against those losses by derivatives, and without the accounting system taking into account the fact that they had, in effect, insured the creditors of their insurer, and, in fact, had no insurance against the losses which they chose not

to state; and this whole house of cards came tumbling down not because it was a phony house of cards that the accounting profession would never allow to stand, but just because it didn't meet those independence standards that could have been met for a few million dollars of additional capital.

We have had a rules-based system and a principles-based system. The principles are always there. They don't need to change, but they are never enough. They weren't enough for Enron, they weren't enough for the accounting scandals of ten or 20 or 30 years ago. You, in addition, need rules, and the rules do have to change, because there are two accounting systems that we have in this country, and we can compare them. We have a tax accounting system and a financial accounting system.

The tax accounting system, we know we have to plug new loopholes every couple of years, because the tax lawyers come up with new loopholes every couple of years. And if we still had the 1939 code, we wouldn't be collecting any taxes at all, at least from more sophisticated taxpayers.

And we need to also plug loopholes in the accounting principles promulgated by the FASB. And I would hope that you are moving—and we have talked about this privately—very quickly—not precipitously, but very quickly—toward special rules dealing with derivatives, dealing with a company's own stock, and dealing with, especially derivatives on and dealing with the company's own stock.

I think the SEC and FASB have failed us to some extent up until now in allowing smart people to logically talk to other smart people in one of the most respected accounting firms in this country, and convince each other that they were in compliance with the rules. If only a few million dollars had been there, as they thought it had been—if only these SPEs had really been independent—when, in fact, the rules should have prohibited them from getting anywhere close to where they were.

I would add that we also, perhaps, need to look at—and I brought this up in legislation, but I know that was just the first piece of legislation—the fact that the AICPA, in its governance of the ethics of accounting firms, allowed a situation where David Duncan was the final decisionmaker as to whether Arthur Andersen would sign an opinion, when, in fact, it ought to be the Quality Review or Technical Review department of any accounting firm that makes that decision.

So I do think we have some changes to make—SEC, FASB, AICPA—and that not only was there an Enron problem, but the market perceives a great risk, and I think correctly, that perhaps to a less than Enron extent we have problems with other companies being traded on the exchanges.

Thank you.

Chairman BAKER. Thank you, Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, if I could also honor Mr. Jenkins in his last month of service with the FASB. It is my understanding that after many years of outstanding service, that he will be leaving.

Chairman BAKER. Absolutely. If there are no further opening statements, I would like to recognize our panelists.

We have with us today Mr. Robert K. Herdman, who is the Chief Accountant for the Securities and Exchange Commission, and appears before this subcommittee for the first time. Welcome, Mr. Herdman—second time? Welcome here. Glad to have you, sir. Your full testimony will be made a part of the record, but feel free to proceed as you choose.

**STATEMENT OF ROBERT K. HERDMAN, CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION**

Mr. HERDMAN. Thank you, Mr. Chairman. Chairman Baker, Ranking Member Kanjorski, and Members of the subcommittee, I am pleased to appear before you on behalf of the Securities and Exchange Commission to testify concerning the roles of the SEC and the Financial Accounting Standards Board in establishing generally accepted accounting principles, and questions that have arisen with respect to the relevancy of generally accepted accounting principles in today's business environment.

I know that all of the Members of this subcommittee have worked diligently over the past few months, and I would like to commend the leadership shown by you, Mr. Chairman and Ranking Member Kanjorski, as well as Chairman Oxley and Ranking Member LaFalce of the full committee, in exploring these important issues and working to maintain investor confidence. I would also like to add that the SEC has appreciated the opportunity to work with you and your staffs, and we look forward to continuing that cooperation.

Recent events and press articles have raised questions about the transparency of the accounting and disclosure practices of some companies. While our financial reporting system in the U.S. continues to be the best in the world, certain aspects of the system can and should be improved. In particular, the Commission believes that the process for setting financial accounting standards must be enhanced so that changes to accounting standards can be implemented more quickly, be more responsive to market changes, and provide more transparent information to investors.

The SEC has a unique position in the financial reporting process. The Commission not only has authority under the securities laws of the United States to set accounting standards to be followed by public companies, but also the power to enforce those standards. Practically since its inception, the Commission has looked to the private sector for leadership in establishing and improving the accounting methods used to prepare financial statements. The body currently performing that function is the FASB.

With this context in mind, I would like to share with the subcommittee the SEC's insights into the standards-setting process, and the reforms needed to continue to support our capital markets. The SEC is on the front line of financial reporting by virtue of its day-to-day activities, and often is among the first to identify emerging issues and areas of accounting that need attention. On issues already identified, such as revenue recognition and accounting for business combinations, the staff refers them to the FASB for guidance. As the FASB conducts its deliberations, the SEC staff monitors the project to ensure that any final standard improves financial reporting for investors.

The SEC staff should not dictate final standards, but rather we should allow the private sector standard-setting process to work under our oversight. Once a project is completed, the SEC staff should evaluate the final product taken as a whole, and only if the product taken as a whole is not in the best interest of investors would action on our part be necessary.

As companies adopt new standards, the SEC staff also monitors implementation, addresses additional questions, and refers unique issues to the FASB's interpretive body, the Emerging Issues Task Force. Through this cycle, many EITF issues that have been addressed were done so at the request of the SEC because of implementation problems it observed in practice.

In light of the SEC's unique role, it is critical that the SEC work closely with the FASB. However, no matter how good accounting standards are, there always will be instances where some answers will not be clear and additional guidance will be needed. In these instances, we have encouraged companies and their auditors to discuss the issue with the staff on a so-called pre-clearance basis. The cooperative efforts between the public and private sectors has given the United States the best financial reporting system in the world, and the Commission is working to make it even better.

In this day and age, one cannot talk about standard-setting in the United States without discussing international convergence. While convergence can have a variety of different meanings, it is generally assumed that ultimately all standard-setters should agree on a single high-quality accounting answer. To this end, the SEC has encouraged both the IASB and the FASB to re-examine their agendas in order to speed up their short-term convergence efforts.

I would also like to address another critical and related part of the financial reporting process, which is the oversight of the accounting profession. Auditing provides credibility to financial statements and comfort to investors. Accordingly, the Commission is actively exploring ways to strengthen the system of overseeing the work of the accountants that perform audits of public companies. In my written testimony, I have outlined the model we are pursuing, which is similar to the CARTA bill passed by the House last month.

In summary, even though our system is the best at present, there is room for improvement. Recent events have been a catalyst for reform, and the work related to implementing needed reforms. While it is imperative that the criticism of the accounting standards-setting process be addressed, we should not abandon the system that has allowed us to achieve what we have to date. Instead, we must take the opportunity to make fundamental improvements to standard-setting and oversight.

Thank you for your interest and having scheduled this hearing today, and inviting me to participate. I am pleased to answer any questions that the subcommittee Members may have.

[The prepared statement of Robert K. Herdman can be found on page 152 in the appendix.]

Chairman BAKER. Thank you, Mr. Herdman.

Our next witness is Mr. Edmund L. Jenkins, Chairman of the Financial Accounting Standards Board, and certainly no stranger to the subcommittee.

We have worked with you over the years, Mr. Jenkins, on a number of topics, and I know that retirement plans are in the offing. My best to you in whatever the future may bring, and we certainly have regard for your years of work and contribution. Please proceed as you choose.

**STATEMENT OF EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD**

Mr. JENKINS. Thank you very much. Chairman Baker, Ranking Member Kanjorski, and Members of this subcommittee, I am pleased to appear before you today on behalf of the Financial Accounting Standards Board. I have brief prepared remarks, and I appreciate your entering my full testimony into the record.

The FASB is an independent private-sector organization. We are not part of the Federal Government, and we receive no Federal funding. Our independence from the Federal Government, reporting enterprises, and auditors, is fundamental to achieving our mission to set accounting and reporting standards to protect the consumers of financial information, most notably investors and creditors. Those consumers rely heavily on credible, transparent, and comparable financial reports for effective participation in our capital markets.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public companies, ultimately the SEC.

The FASB also has no authority with respect to auditing, including auditor independence and scope of services. Rather, our responsibility relates solely to establishing financial accounting and reporting standards.

The title of this hearing, "Corporate Accounting Practices: Is There a Credibility GAAP?"—with two A's—might be read to imply that generally accepted accounting principles, or GAAP, are the main contributor to what many perceive to be the growing lack of credibility of corporate financial reports.

I strongly disagree. U.S. GAAP, when properly applied, still produces the most transparent financial reports in the world, financial reports that are an essential element of an efficient capital market.

Should U.S. GAAP be improved? Without question. And as part of the Board's ongoing process, the FASB is actively working with our constituents, including the SEC, as Mr. Herdman mentioned, to continue to make necessary improvements to GAAP. In addition, the FASB—and our financial accounting foundation, which has oversight over us—is reviewing and modifying our due process procedures and taking other steps to improve the efficiency and effectiveness of the standards-setting process. Those actions are described in detail in the full text of my testimony.

In my opinion, the most efficient and effective accounting standards-setter imaginable, and the highest quality accounting standards conceivable, could not have prevented the Enron bankruptcy;

could not have prevented the many corporate restatements of recent years; and could not alone improve the credibility of financial reports.

Remember that restatements, including the Enron restatements, are done to bring financial statements into compliance with existing accounting standards. By working together, standards-setters, reporting enterprises, auditors, and regulators share the responsibility for a credible and transparent financial reporting system. Each party must carry out its responsibilities in the public interest.

Reporting entities seeking to access the capital markets for financing are responsible for preparing the financial reports and presenting those reports to investors. Those enterprises must apply GAAP in a way that is faithful to the intent of the standards. Unfortunately, the far too common practice of seeking loopholes to find ways around the intent of the standards obfuscates reporting and does not result in a transparent and true reflection of the economics of the underlying transactions. That practice must end.

Auditors examine the financial reports of enterprises to determine that GAAP has been fairly applied. Auditors also must assure that the stated intent of the standards are followed, and not accept facile arguments that the reporting is acceptable because the standard does not explicitly say that the reporting is unacceptable.

Auditors have a primary responsibility to the public, since consumers do not have the same access to the underlying facts about an enterprise's operations and transactions. Auditors must end the practice of accepting "Show me where it says I can't do this" accounting.

Finally, regulators, principally the SEC, are responsible for protecting the investor. Through their oversight and enforcement activities, regulators assure that enterprises report their financial statements based on GAAP, and that auditors are independent and examine financial statements using accepted auditing standards. The SEC must have the resources that it needs to fulfill that important role.

Thank you, Mr. Chairman. I very much appreciate this opportunity and your courtesy, and I would be pleased to respond to any questions.

[The prepared statement of Edmund L. Jenkins can be found on page 164 in the appendix.]

Chairman BAKER. Thank you very much.

I would like to start with the announcement made today by Standard and Poor's to go to a "core value" reporting assessment methodology where, for example, one-time non-recurring revenues are not booked as operating profits in a quarterly statement—from a sale of an asset, for example. Have you had a chance yet, Mr. Jenkins, to be familiar with those, or do you have some opinion about what they are doing?

Mr. JENKINS. I have only seen the reports in the media about this, and I just, prior to this hearing, did receive the news release from Standard and Poor's, which I have quickly read. But I am generally familiar with what Standard and Poor's is trying to do. They announced a couple of months ago that they were going to look into this area.

And I believe that they are doing what analysts truly should do—analyze the financial statements. I believe it is the role of financial reports and financial statements to provide the information that is necessary for analysts to do their job. And that includes providing good information that they can use to make adjustments.

The core earnings approach is one that is an important approach, because it is designed to provide the information that is most likely to be replicable in the future—and, after all, it is future operations that form the basis for investment decisions. But it is all based, as Standard and Poor's acknowledges, on the underlying information in financial statements, reported earnings.

I wouldn't want to, without further study, get into the individual adjustments that they are making. But I believe that this approach is entirely appropriate. It is very consistent with the AICPA's Special Committee's report on improving financial reporting, that recommended that we try to do a better job of displaying information that is recurring from that that is non-recurring.

So I think this is—as long as it is based on information that comes from audited financial reports, and the items and the amounts that are used to come up with the core earnings are clearly displayed, so that investors can make their own determinations on whether those adjustments are the ones they would make, I would support this effort.

Chairman BAKER. Well, I only have concern with regard to the possible creation of another set of accounting standards with which businesses have to comply and still have to meet the generally accepted standard, which, of course, FASB generates.

What was of interest to me is that from their statement of a couple of months ago, that they were able to move so quickly to the presentation of these standards in such a short fuse, realizing the potential consequences of this announcement for capital formation generally. Which gets to the question that is obvious and evident of concern: why does it take so long to go from an Emerging Issues list to a final statement that changes, ultimately, market compliance with a new standard?

Almost any subject—we can even go back to the SPEs themselves—from the initial authorization to the statement issued last—well, this April—relative to the committee's work. What is it that can be done to expedite a more prompt reaction to evidently market difficulty?

Mr. JENKINS. Well, one very significant and important difference, particularly for this subcommittee, I believe, between Standard and Poor's and the FASB is that they have no responsibility to carry out any open public due process with respect to what they are doing. And I, for one, believe that our open due process—an opportunity to listen and hear from all of our constituents before we make decisions—is central to the credibility of the FASB. And I believe that Congress, as well, wants to be assured that constituents have adequate opportunity to weigh in on our decisions. So that is at the core of the difference between, I think, between Standard and Poor's and the FASB's activities.

We also undertake really fundamental changes. Standard and Poor's approach—and this isn't to denigrate it in any way—is going to take information that comes from our accounting standards to

come up with the amounts that they are going to use for these adjustments. But without the standards that we have, they wouldn't have reliable, consistent information, perhaps, about unrealized gains or losses from hedging activities, for example. So those complex issues do take time to research and study.

Still, there is no question that we need to move more rapidly in establishing standards. And we have undertaken some efforts, even before Enron, to do that. Most recently, as you perhaps know, the voting majority required for issuing a standard has been changed from a supermajority to a simple majority. That, at the margin, will help speed things up.

We are changing our internal process. We intend to go more toward a principle-based approach to standards, as Congressman Sherman mentioned. We have principles in our standards. It is trying to answer every conceivable standard that, as a part of setting standards, that gets into overly detailed rules. We do this for the benefit of our constituents, but it takes time and it increases the complexity. So we are going to try to cut down on the number of detailed questions that we answer as a part of our approach. Internally, we have undertaken new internal plans with respect to how we approach projects.

We accept the criticism that we need to move more quickly. But it is also essential that we end up with high quality standards, and that they have been subjected to open due process.

Chairman BAKER. Thank you. We will, I am certain, come back for an additional round of questions, given the number of Members here. But I do want to give other Members a chance to proceed.

Mr. Sherman.

Mr. SHERMAN. Yes, Mr. Chairman. I am a little less sanguine than the other Members of this subcommittee. We are told over and over again that the U.S. accounting system is the best and the most transparent in the world. I would add that Nero fiddle as Rome burned, and as he was fiddling he would have been justified in singing along with the fiddled that Rome, even after the fire, was the most powerful city in the world. We do need to do more than just say we are better than other systems, such as the Russian business system.

There is a huge credibility gap. And even Nero, I think, ordered that the fire be extinguished before due process was fully carried out. We do have a fire going on here.

Now, Mr. Jenkins points out that the SEC is responsible for enforcing FASB standards with regard to publicly traded companies. Mr. Herdman, I am told that during all of 1999 and 2000—roughly 730 days—that not a single hour of SEC professional time was spent with regard to looking at or enforcing the FASB standards on the Enron financial statements, even though those statements included absolutely incomprehensible footnotes. Can you tell me that that information is wrong?

Mr. HERDMAN. No, I believe that is correct, Congressman.

Mr. SHERMAN. So Mr. Jenkins tells us that the SEC is supposed to enforce, and in this case—even on my quiet, residential street, a policeman comes by, you know, more than once every 2 years.

I think that we have also left out one element of the enforcement, and it is, in fact, the primary element of enforcement, and

that is the trial lawyer system, the civil bar. In fact, if any company's stock drops according to a variety of formulas, you can count on a lawsuit.

And what worries me, Mr. Jenkins, is if we go to a system that says, we are not really relying on specific rules, we are relying on principles like "do the right thing." First, if we could really rely on such principles, we wouldn't need auditors at all. Shouldn't businesspeople just do the right thing? Why do we have to audit them to make sure they do the right thing?

But putting that aside, if we rely just on relatively simple principles, could you ever get summary judgment against a plaintiff who sued, noting that stock had declined significantly and that other people applying those same relatively vague principles would have provided a much less rosy picture of the company the investor invested in?

Mr. JENKINS. Well, I am not an attorney, so I am not going to opine on whether you could get summary judgment on anything.

But I think it is a matter of finding the right balance. I agree with you that it is not enough to say look to our rather complete conceptual framework, for example, on which we start when we develop a standard, because it doesn't address the specific issue that is under consideration. We need to develop the principles that come from that conceptual framework that are relevant to the particular issue at hand.

Then I think it is not enough, either, to quite stop there. We need to make sure that there is sufficient guidance as to how to implement those principles to a reasonable extent to assure that people will generally apply those principles in a consistent way.

Mr. SHERMAN. If I can cut you off, what if we went with a simple income tax law? Just a dozen pages, basically, and then at the end we just say, "Pay your fair share"? Do you think Federal revenues would go up or down?

Mr. JENKINS. I don't have an opinion on that, either.

Mr. SHERMAN. Let's face it. They would go down precipitously, and this country would not be a superpower anymore.

Mr. JENKINS. Well, I think there is, though, in fairness, the purpose of the Internal Revenue code and the purpose of financial reporting, I think, are significantly different.

Mr. SHERMAN. They are somewhat different and somewhat the same. You go to an accounting firm; you pay that accounting firm. They complete your income tax statement, and you will be most happy with their services if they report the lowest possible earnings to the Federal Government. You go to an accounting firm; you pay that accounting firm. And you will be most happy with their services if they report the highest possible earnings to your shareholders.

Now, the only difference—and it is a difference none of us delight in—is that the second kind of accounting activity can result in a civil lawsuit against the accountant. There are some other differences as well. But to say that the pressure on the financial accountant is less than on the tax accountant; to say that we accept as a society that the tax accountant will do everything legal to report the lowest possible earnings to the Federal Government, but that the financial accountant will somehow be immune from the

same principle, from the same fact that they are being paid by the client, I think, asks us to substitute wishful thinking for an examination of the economic structure.

Tax accountants are professionals, too. Yet, if we were to discover that tax accountants tried to come up with the lowest possible reported earnings, we wouldn't have hearings here. We wouldn't be surprised. We would have hearings if a tax accountant wasn't doing that.

And I don't think that we can rely on general principles, enforced not at all by the SEC—at least with regard to Enron during 1999 and 2000—and enforced chiefly by a civil bar. But I shudder to think what the civil bar will do if the standards are made, are replaced with principles.

But I get your point; you are trying to do both. And I think I have run out of time.

Chairman BAKER. And if I can, just for the record, if the IRS is listening, my tax accountant always makes me pay the higher amount.

[Laughter.]

Mr. SHERMAN. He will be losing all of his clients, except one.

Chairman BAKER. Yes, but I won't be audited.

I think for the moment I will start with another round while we are waiting for other Members to return. I want to get back to this timeliness question, and how we can construct a system which gives opportunity for public comment, but draws a more narrowly defined constraint around that activity.

For example, if a problem would come up through the Emerging Issues Committee, as of that date when it is on that agenda—sort of a starting gun—that within a year, if there hasn't been some resolution or final statement issued—there may be work documents, there may be some other background that has been assigned to get us close to a position, but yet not yet there, as in the case of SPEs—shouldn't there be some other mechanism—perhaps throw it over the fence at the SEC shop and have them, with some time obligation come up with the resolution? In other words, a predetermined series of steps that lead us to a judgment?

It is like a court proceeding. Sometimes you don't get all the stuff timely filed; sometimes it is not admissible—whatever the case may be. But ultimately, you have to deal with a certain set of facts and reach the best judgment you can within the constraints in which you operate. But I think in this instance, our constraints are so difficult we can't get there. And I think the cost of that is worse than not having ample input from all parties concerned.

Would you like to respond, Mr. Jenkins, to that approach or concept?

Mr. JENKINS. Well, I think it is fair to say that we ought to set appropriate goals in terms of timeliness for each individual subject that we take up. But I don't think that those goals would be the same in each case; it would depend on the complexity of the issue.

But I think it is fair to set some goals and to stick with them. That means, particularly, I think—and this is something else that we are working on—is making sure that the scope of the issue is narrow enough, that we get the inadmissible stuff out at the front

end, so that we have a good shot at reaching a conclusion on what we do undertake to address in a relatively short period of time.

Chairman BAKER. Let me jump in on that goal description that we are talking about. What troubles me is rules that are not intended—that are perhaps manipulated by smart individuals for a specific unintended consequence—which create the difficulty. But if we go at it with the view that ultimately an accounting activity is—two things in mind: one is to give a fair snapshot of true financial condition at the time of its preparation, which is always understood; but two, it is an activity which will enhance the ability of the corporation to succeed, in a very broad statement. In other words, if we do it this way, we are likely to be successful.

What troubles me about—let's take indefeasible rights of use. And looking at a particular statement—I don't remember the corporation at the time. But they were booking revenue in a current quarter from the prospective sale of a telecommunications service for which the network did not yet exist.

Now, I don't know how that could possibly be held up to be a measure that adds value to the system. And from my limited understanding of how these things should work, that ought to be a prohibited activity. Perhaps you can book one-time sales, or one-time events, or aberrant activity in revenue, but it certainly ought to be noted, so that if you are in the business of making shoes, and you happen to have a rich uncle who passes away and you get a $500,000 life insurance benefit and you put that in the business, you have got to show that that is $500,000 of Old Uncle Joe, and not sales of shoes.

We are not there. I think my problem with the current system is when you look at a statement, you can't determine, from the current reporting requirements, what their underlying business activity is generating.

Mr. Herdman, you want to jump in on any of this?

Mr. HERDMAN. Thank you, Mr. Chairman. I think, on the example you just cited, on the indefeasible rights of usage, that there needs to be some real care taken here between what was being done in the financial statements prepared under generally accepted accounting principles and filed with the SEC, as opposed to what was being disclosed in earnings press releases using alternative measurement sources commonly referred to as pro forma earnings, and certainly the kind of thing that Standard and Poor's action today is intended to prevent.

And while we have some investigations in process with respect to some of the companies that engaged in the Indefeasible rights of use-types of transactions—and I can't get into specifics—I do think that it is very important to—and I hope you get some comfort from the fact that the Commission has put out some advice, some cautions to companies with respect to their earnings press releases, that the minute they depart from generally accepted accounting principles in those press releases, they run the risk of violating the Anti-Fraud provisions of the securities laws.

And we also have pointed out to them that when they do present these alternative measurements, that the only way that they in effect have what you might call a safe harbor from violations of the securities laws is to present a clear, specific, itemized reconciliation

between the results under generally accepted accounting principles and under this alternative measurement that they have forwarded to the public through their press releases.

Chairman BAKER. Well, I will press it just a little bit further. Let's assume for the moment that it is clear, at least from the outside looking in, that the corporate structure was intended to obfuscate debt, or to create revenue. When you ask the individuals involved in the creation of these accounting methodologies, "What was the business purpose for doing this?" there ought to be a rational explanation as to the public benefit or shareholder benefit that accrued from that activity.

Where that is absent, and it appears to be obfuscating true financial condition, some sort of liability ought to attach to that effort. And that, I think that is my frustration, is it appears that people are saying, well, this complies with GAAP. Well, if that is complying with GAAP, we need to make it clear that GAAP provides for honest disclosure of true financial condition.

Is there a question about that? I mean, when somebody says it is GAAP-compliant, does that obviate you from any criminal liability?

Mr. JENKINS. Well, I think that the whole goal of presenting financial statements is to provide transparency of information, which is another way of saying what you have just said, I believe. And we need to do that. That has to be our goal. That is why financial statements and financial standards need to be continually improved.

Chairman BAKER. Well, it is a fine point. But for me, it is important anyway—if you are GAAP-compliant——

Mr. JENKINS. Yes.

Chairman BAKER. But, the consequences of being GAAP-compliant in some circumstances lead to a hiding of true financial condition, that still should be a violation of something. Is it?

Mr. JENKINS. Well, I think that gets to the issue of how the GAAP information is displayed in the financial statements. And that gets to your question of putting the proceeds from a life insurance policy in revenues; I don't think that that is in compliance with GAAP. I don't think that that should be done. I am not aware that it is done.

And there are some fundamental rules of what goes into revenues and what is other kinds of income. But we need to have disclosures when we have these unusual or one-time revenues.

Chairman BAKER. Yes, sir?

Mr. HERDMAN. And there are a couple of cases that are very much on point. In the late 1960s, one of the Federal courts handed down a decision in a case called *U.S.* vs. *Simon*, in which the decision was that just because financial statements comply with all of the measurement requirements of generally accepted accounting principles is not an absolute defense if the result is misleading, and the disclosures about it are misleading.

And the SEC has, I think, a very instructive enforcement case from the mid-1990s against Caterpillar Corporation, in which the company had a huge increase in sales in one of its foreign divisions as a result of basically putting a big sale on toward the end of the year. And it was accounted for, it was all accounted for correctly.

These were valid sales, there was nothing wrong with them. But their management discussion and analysis, which is intended to be an adjunct to the financial statements and through which management is supposed to explain through its eyes to the investors what is happening with the company, what has happened, and what has happened in the past that may not be repeated in the future—and in that particular case, there was no mention of the fact that the huge increase in sales in the fourth quarter—and I believe it was a Brazilian subsidiary—was entirely due to a very unusual event that didn't have a chance of being replicated in the next year.

And so there are indeed strictures against providing a misleading picture, even if the underlying financial statements are presented in accordance with GAAP.

Chairman BAKER. I will follow that up with a more detailed written inquiry. But it is a point around which I think there is some considerable difficulty.

Mr. ROYCE. Mr. Chairman.

Chairman BAKER. Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I had an opening statement that I would just like to introduce for the record, if that would be all right.

Chairman BAKER. Without objection.

Mr. ROYCE. And then I would like to go to Mr. Jenkins, as Chairman of the Financial Accounting Standards Board, and ask him a question about a 1994 report which he directed. He wrote about special-purpose entities in that report, "Users are concerned that current rules may permit companies to exclude from their balance sheets rights and obligations that make companies appear to be less risky"—less risky—"than they are"—of course, that is exactly what Enron did. Yet FASB did not issue a definitive statement on these special-purpose entities, other than two short letters, one in 1990 and one in 1991. And the 3 percent rule in those letters was what Enron, in fact, abused.

And so my question would be, couldn't FASB have possibly reduced the risk of the abuse by acting decisively at that time? I mean, the problem had been identified, but there wasn't decisive action taken. And that is my initial question.

Mr. JENKINS. Well, as you know—and this isn't an answer to your question directly, but I will get to that—we are working to provide guidance specifically on accounting for SPEs, and now on an expedited basis. I know that that sounds a little bit like closing the barn doors after the horse is gone, and I accept that criticism.

We at the FASB have been working over the years to try to come to some acceptable decisions with respect to accounting for special-purpose entities. But it is not sufficient to simply say that every special-purpose entity should be consolidated, because special-purpose entities have a variety of purposes, and it is only where the special-purpose entity does not have sufficient independent purpose, and/or is not capitalized sufficiently by an independent third party, that consolidation should really take place. And the devil is, we found, in the details of defining those particular circumstances.

We at the FASB have tried twice since 1994 to issue guidance on consolidations. And in each case, the concerns raised about our proposal, and how those proposals were overreaching, from both

the business community and the accounting profession, caused the board to conclude that it could not go forward and develop a standard that would be generally accepted.

Mr. ROYCE. Which of the major accounting firms opposed that?

Mr. JENKINS. All of them.

Mr. ROYCE. Every one of them?

Mr. JENKINS. The 3 percent rule was designed to address a particularly unique circumstance involving a single type of a transaction. And through practice, it was probably appropriate for that particular transaction—it got extended in practice to apply to some other transactions. Of course, the essence of the Enron situation as I understand it is not the 3 percent rule per se—in some cases, apparently, they didn't have 3 percent; in other cases they didn't follow the 3 percent rule because the 3 percent had to be maintained throughout the life of this entity, and it went down, and they didn't replenish it, so to speak. So they apparently didn't follow the rules.

It also had to be independent, and there couldn't have been any other guarantees or support, nor could the 3 percent have come through the back door as being provided by Enron or one of the affiliates, apparently, in some of the transactions that part of the requirement wasn't followed as well.

So that is why I said in my opening remarks that the standards, even if they are minimal, and perhaps need to be improved, if the standards aren't followed for whatever reason, the best standards in the world aren't going to solve these issues.

Mr. ROYCE. No. But I think they did cite this rule as their argument.

Mr. JENKINS. Yes.

Mr. ROYCE. I mean, they attempted, at least, to attach their line of reasoning to this rule.

Mr. JENKINS. I believe that is correct.

Mr. ROYCE. I was going to ask Mr. Herdman if he thought that FASB could have taken better measures to reduce the risk of abuse of special-purpose entities. I know this is in hindsight, but what does the Securities and Exchange Commission think now about that?

Mr. HERDMAN. Congressman, I think this is an example of what Mr. Jenkins was alluding to earlier when he talked about the size of projects and the scope of projects that FASB undertakes. The particular subject matter where this was being considered was the Board's project on consolidations.

The proposals that Mr. Jenkins referred to were not focused solely, or even principally, on special-purpose entities. They were focused on the question of consolidation of subsidiaries more broadly, and proposed sweeping changes to that particular practice, which many accountants felt had not been controversial.

And so, when something like that occurs, it occurs to us now, that that is the time when it is important for the Board to re-examine the scope of its product. In other words, if they have a project, they come out with a proposal that would attempt to deal with four or five things. And if there are one or two that there is general agreement should be done and it is important to get them done, but the other two or three have failed yet to capture the imagination of the audience, we think that it would be better for the Board

to go on and fix the one or two things that everyone is in agreement need to be fixed, and work harder on the others or reconsider whether they need to be done.

And so that is, I hope, a lesson for all of us for the future in terms of how this agenda can be better managed to make sure that the pressing issues do get dealt with promptly.

Mr. ROYCE. Are you familiar with Arthur Andersen or Enron marketing their unique interpretations of how to utilize special-purpose entities in order to boost earnings per share, and basically going into the market and saying let us work with you, with other companies, to show you how we can do this? Are you familiar with a history of Andersen doing that?

Mr. HERDMAN. Congressman, we are still investigating Arthur Andersen and Enron, and I can't comment on that.

Mr. ROYCE. Can't comment on that? OK. Thank you again. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Sherman.

Mr. SHERMAN. Yes. I would hope that the FASB would be closing this barn door, because I think you have got tens or hundreds of billions of dollars' worth of horses that still haven't escaped the corral.

I do think there is a legitimate purpose for special-purpose entities—for example, in my hometown it is not unusual to legitimately shift the risk that a particular movie or group of movies is going to be successful or fail to a group of investors. While the studio does the work of creating the movie, other people can take the risk and place their bets as to whether the latest film will be successful.

The Chairman puts forward an interesting idea, and that is that there be a business purpose doctrine, and those transactions that have no business purpose not be recognized. That is an interesting part of tax accounting. Is that part of financial accounting as well?

Mr. JENKINS. Well, I think we try to understand the business purpose of transactions and, as I say, develop standards that do the best job they can of displaying that purpose.

Mr. SHERMAN. If there is a transaction that has no purpose other than causing the recognition of income or deferring the recognition of loss, does that transaction give an effect in preparing financial statements?

Mr. JENKINS. Well——

Mr. SHERMAN. Is there a clear yes or no? Or is that one of those hazy things?

Mr. JENKINS. I think it is pretty hazy, but——

Mr. HERDMAN. Well, Congressman, just like under the tax law there is a concept that if the only motivation for a transaction is to reduce taxes, then as I understand it, it is not lawful.

Mr. SHERMAN. Yes. I am familiar with it in tax law. I am asking whether there is a similar principle——

Mr. HERDMAN. However, certainly when we look at transactions with companies, if it is clear that the only reason they entered into a transaction was to achieve a particular financial statement result that would not have been attained had they not entered into the transaction, then we would generally disagree with their proposed accounting.

However, I will caution you, just as in the tax area, that it is very difficult to find a transaction that can be characterized as solely being done to achieve a particular——

Mr. SHERMAN. It is always possible to find a tail, even if that tail isn't big enough to wag the dog.

Mr. HERDMAN. There are always other motivations, absolutely. So that is not a very good principle.

Mr. SHERMAN. It is not a bad principle. It is helpful.

Mr. HERDMAN. It is not a very effective one, though, perhaps.

Mr. SHERMAN. Speaking of effective enforcement, and the whole idea of enforcing general principles—not numerical principles, where we can say, oh, here is this exact rule, but rather, the general principle that, for example, the prose in the financial statement and in the report to shareholders be accurate—you pointed out the Caterpillar example. But it is my understanding that in Caterpillar, with its failure to tell shareholders about the Brazilian situation, that not a single day of jail time was done by a single executive, accountant, or auditor. Can you tell us how large a fine—or let me know if I am wrong on the jail time. But also, can you tell us how large a fine was imposed on Caterpillar?

Mr. HERDMAN. I don't recall, Congressman.

Mr. SHERMAN. Could it have been that no fine or a fine of just $50,000 or $100,000 was imposed?

Mr. HERDMAN. Since I can't recall, it could be.

Mr. SHERMAN. So even the preeminent example of enforcing vague principles, we are not, we don't have a specific level of punishment? I would hope you would furnish that for the record, but it is my understanding of SEC general practice that they might have gotten, you know, a really tough letter in their file. And given what is at stake in these transactions, perhaps the only enforcement we really have, much to our own chagrin and not to our joy, is the trial bar.

I would like to posit—we have talked about special-purpose entities, which is part of the Enron problem. And I have asked the FASB on more than one occasion to expedite a review also of another part, and that is, even if you are transacting with a fully legitimate entity, the transaction in derivatives may be misstated.

I would like to conjure up the idea of a Genron Corporation that wants to state the largest possible earnings per share. It has two portfolios of investment securities. One is in the restaurant industry, where they have gained $1 billion and they have recently sold at a $1 billion profit. And, of, that is a $1 billion profit. They have another portfolio that they haven't liquidated their position in of high-tech companies, which on a mark-to-market basis has declined by $2 billion.

But they don't want to recognize a $2 billion loss, because they have a derivative issued by the Kiticorp—not to be confused with Citicorp—but a large, completely independent, very financially sound corporation. And this derivative says that if you lose any money, up to $2 billion, on your high-tech portfolio, we will give you the money. So you haven't lost anything; it is like your factory burned down, but you have perfect fire insurance.

But then there is a provision that says, to the extent that Kiticorp has got to give money under this debenture, Genron Cor-

poration must give shares with a value of, in this case, $2 billion to Kiticorp's parent corporation, so that in effect, they owe something—they have insured their insurer.

Is it clear under FASB pronouncements that under these circumstances the $2 billion loss must be recognized, because although it is in effect insured by a completely independent, highly creditworthy company, the provisions of that derivative or insurance policy, if you will, require Genron to issue stock to Kiticorp or its parent?

Mr. HERDMAN. We are investigating that company, Congressman.

Mr. SHERMAN. Well, I am asking what—this is not something you are investigating. This is Genron Corporation; I just made it up.

Mr. HERDMAN. But the facts are——

Mr. SHERMAN. Do we know what accounting principles call for? Or is the accounting result of this transaction unknowable at this time?

Mr. HERDMAN. It would depend, I believe, on the terms of the equity derivative, and whether it could be settled net or would require the outlay of cash or the distribution of shares.

Mr. SHERMAN. In this situation, Genron Corporation is to receive $2 billion in cash to make it whole from its $2 billion of investment losses in high-tech stock. And Genron Corporation is to issue $2 billion worth of Genron shares for no additional compensation to the parent company of Kiticorp, of the company that is giving it the cash. Under those circumstances, must the $2 billion be recognized as a loss?

I mean, it is either "yes," "no," or "we don't know."

Mr. HERDMAN. I would have to consult further with—there are some very complicated requirements that need to be looked at with respect to equity——

Mr. SHERMAN. In fairness, this is a question I have asked behind closed doors two or three different times. I am not completely sandbagging you, although I guess you didn't know I would be asking it quite this way at this time. I wonder if Mr. Jenkins can give us an answer; what does the FASB have to say about this transaction?

Mr. JENKINS. Well, I think, first of all, I would say that there needs to be disclosure of these arrangements in the financial statements. And we are issuing shortly some clarifying guidance of existing literature to make it clearer than it should have been in the past, apparently, that disclosures with respect to guarantees, even if they are remote or not likely to be called, need to be disclosed.

Mr. SHERMAN. Well, this one is clear. I mean, they owe the $2 billion worth of stock. They have a right to receive the $2 billion in cash. Both of these are triggered the moment they sell their high-tech portfolio at market. This isn't a remote contingency like "what if our factory does burn down?" The factory has burned down. You have a right to cash from your insurance company, and under my example, you have an obligation to give that insurance company $2 billion worth of your stock.

Mr. JENKINS. I didn't understand your example to say that the loss had incurred, and under the insurance policy the money was now due.

Mr. SHERMAN. Well, it would be due upon the liquidation at market of a portfolio of publicly traded corporate stock that is usually mark-to-market. So if you are going to mark-to-market under ordinary circumstances, the sale transaction of the stock is thought to be irrelevant.

Mr. JENKINS. Well, again, you understand——

Mr. SHERMAN. OK. Well, let's put it like this: it is not a remote contingency that you would choose to sell a stock on which you have lost $2 billion, losses that have already—would have been recognized on a mark-to-market basis.

Mr. HERDMAN. I would start with the presumption that the loss needs to be recognized. But I would need to consult further very complicated accounting rules that pertain to the issuance of so-called equity derivatives.

Mr. SHERMAN. OK. I would hope that—it is my understanding—I mean, I didn't make this one up completely. I mean, this is the loophole that Enron thought they found. They think it works. They think they didn't dot their i's and cross their t's. There are a lot of other companies out there who are capable of dotting i's and crossing t's. And I would like to know whether this loophole exists. And that is why I would ask each of our two witnesses to furnish for record an answer to this excessively complex question.

And so I will ask you to do that in the future.

Chairman BAKER. Thank you, Mr. Sherman.

Mr. Royce, did you want another round?

[No response.]

Chairman BAKER. Mr. Herdman, before we conclude the panel, do you have a position on behalf of the SEC relative to where we might go with regard to shortening time consideration for development of financial accounting standards? Have you arrived at any recommendations yet?

Mr. HERDMAN. We have. We have spoken with the FASB about this issue at some length, and we believe that—of course, it is a mixture of things. It is scope definition. We believe that the move toward a more principles-based approach, and not needing to attempt to answer every question that comes along the way, should enable the Board to move faster on its projects.

It is very time-consuming to try to come up with the definitive answer for every question that comes up. And they should really need only to answer enough to make sure that the principle that they have in mind is operable in the real world. And I think that that is something that can be done.

We believe that the recent decision by the FASB trustees to change the voting requirement from 5 to 2 to 4 to 3, if implemented aggressively, should enable the Board to move more quickly because, to the extent that there are minority views, at some point in time it will be possible for the Board, presumably through its Chairman, to say, we have heard enough and now we need to proceed and get this thing done. So we think that is positive.

We also think that it is positive that the board of trustees has asked the question about whether the size of the Board should be reduced from seven members to five. It has concluded at this point to leave the size of the Board at seven members, but it has charged Mr. Jenkins's successor, Mr. Herz, with the task of conducting his

own study over the next few months as to what he believes needs to be done to increase the timeliness and efficiency of the Board, and report back to the trustees with a view toward they would implement whatever changes he recommends, that they believe are reasonable.

So I think that it is a combination of factors, Mr. Chairman. And I think that the Board and its oversight foundation show all signs that they are working to improve in this regard. And over the next 6 months or thereabouts, hopefully they will be able to demonstrate the improvement in terms of the projects that they are working on.

Chairman BAKER. Well, just, again, without having the competency to make the judgment, I make it anyway. It seems that a principles-based value reporting system, some of which we will hear about in the next panel, offers a great deal of appeal. I don't know, frankly, other than marketing purposes and to show that you are running faster than you were a year ago, that historical 90-day-old data, at best, really tells you about what the company is doing tomorrow—especially in light of the apparent use of accounting methodologies which do not result in an accurate financial picture being portrayed even of the historic data.

Now, I don't ascribe that to the fault of FASB, because in good intent, with arduous and lengthy study, the rules have been developed for what we believe to be the best public policy. And they have been misused. It would seem, at the end of the day, if we are building value and we want to encourage corporate CEOs to invest for the long term and not worry about the next quarterly earnings report, that there are some simple principles we could outline, and that if you were consistent with those principles—until we catch you otherwise—that the core reporting that maybe Standard & Poor has talked about is a good place to start, and move from there.

But the current system, I think, given the speed with which technology enables businesses to develop new product and new business structure—we are trying to regulate traffic on the interstate while we are still hooking our horses up to the wagon. And they are running by us. And I think we have to be more nimble in our ability to respond to identifiable problems in a short period of time.

No response needed, but if you would like, please.

Mr. HERDMAN. That is the danger of the cookbook-style of standards, that while it appears to close off all possible avenues of different interpretation, the people who are out there creating transactions are always going to be way ahead of those who are writing the rules, the detailed, loophole-closing rules intended to try and close off their initiatives.

And so accounting principles that are more principles-based will be simpler. And a principle is not to say "pay your fair share" or "do the right thing." The principle has to be expressed in the context of the particular area that is being addressed. For example, the Board's recent standards on business combinations, I think, are a real positive step in the right direction, in that they really did approach this whole area in a very principled basis, and there are implementation details that need to be applied by individual companies.

But the principles are clear, the objectives are clear. And while there will be some differing interpretations on some of the implementation details, I believe that the resulting reporting will be comparable, and the product will be useful to investors.

Chairman BAKER. I think it is certainly worthy of pursuit. I thank you. Mr. Castle, I know you have just arrived, but did you have a question for this panel?

Mr. CASTLE. I do, Mr. Chairman, if I may take a moment.

Chairman BAKER. Certainly.

Mr. CASTLE. I am sort of starting from scratch, and I guess my question is of Mr. Jenkins.

But I am interested in—and I guess concerned; but in all candor, I don't really know enough about it to express my concern, articulate it as well as I should—with the stock options situation and the accounting side of it. And I am worried about it from an executive compensation point of view, but I am not too sure we can legislate in that area, so I won't ask you questions about that.

But it is my understanding that FASB had some sort of an expense option on this—I am not sure I understood exactly how that was going to work—and I think backed off at some point, maybe under congressional pressure or whatever the reasons may be. But I am interested as to the status of that now. I realize that as the value of companies was growing, it was a valuable tool. And I am not even suggesting options are not a valuable tool, and I am not even saying they should not be part of executive compensation.

But I am just amazed in my reading about it that there is not an accounting entry at some point or another. It obviously has to dilute capital. I mean, it just automatically has to at such time as it is exercised. And at such time as it is granted, it essentially is giving a right which could dilute capital, which greatly impacts stockholders and can impact the entire valuation of a company. In fact, there have been studies showing that some profits would be losses if this was properly accounted for.

And if you could just give me the rationale of FASB now—or is it changing again, and you are about to look at it again and have some sort of firm accounting practices with respect to stock options?

Mr. JENKINS. Let me first describe where we are today.

Mr. CASTLE. Thank you.

Mr. JENKINS. Our standards require that the use of stock or stock options for almost every transaction would result in an expense charge. So if you issue, if you give stock to an employee—not a stock option—you expense it. If you give stock to pay your attorney or to buy a truck, you recognize it either as an expense or an asset.

We have one exception, and that exception is the employees—certain types of employee stock options that you have referred to. Not even all employee stock options. That is an exception.

Our standard says that even those—it is preferable that those options be expensed at their value determined at the date they are granted. Our standard—it is preferable, but it is not required. And the reason that it is preferable but not required is, as you also suggested, the Board received intense criticism and pressure from Congress in 1994, leading to a sense of the Senate resolution requiring

us to stop work on stock options, and proposed legislation that in effect would have put the FASB out of business.

Mr. CASTLE. Well, let's look at it in the year 2000. And I thought it was actually later in 1994 that all that pressure occurred.

Mr. JENKINS. No.

Mr. CASTLE. But let's look at it in 2002, maybe with the advantage of hindsight. I mean, I would hope that Congress wouldn't feel quite the same way it felt in 1994—perhaps none of us individually do; perhaps FASB does not, I don't know. My sense is that a lot of wise heads around Washington and economists around this country are certainly thinking the other way now.

And to me, it just seems absolutely apparent. I mean, I don't know how the heck you can have an entry, a numerical impact on a corporation of such magnitude, and not somehow or another do something with it at this point. Is there a change going on? Is FASB looking at it differently? Can we put all this pressure from before behind us so we can go forward with doing something?

And I want to do the right thing. I am not trying to——

Mr. JENKINS. Yes.

Mr. CASTLE. And I realize it is extraordinarily difficult to determine the actual value at the time of issuance. But to me, it just seems completely wrong to ignore it.

Mr. JENKINS. That is one of the principal arguments that is used against recognizing the expense. We do require disclosure of the amount. We require that in diluted earnings per share, that the impact of these options be reflected so the dilutive effect is shown. There is work going on internationally in the International Accounting Standards Board. Their goal and their objective is to expense all share-based payments. The circumstance outside of the United States is significantly different than it is here in the U.S., in that virtually no share payments or share-based payments, even the ones I described that are getting expensed here, are expensed outside the United States. So they have a longer way to go than we do.

My belief is that if the international board is successful in meeting their objective, that consistent with our pledge at the FASB to work toward convergence of standards around the world, that the Board at that time—I won't be here, or be at the Board, but at that time I believe it would be incumbent upon the Board to consider then whether or not it would undertake a project in this area.

Chairman BAKER. If I could also add, too, Mr. Castle, the Standard and Poor's announcement today on the core valuation does require the expensing of the stock options as an element of their reform. It is probably the most controversial part of their package. But that was announced earlier today, Mr. Castle.

Mr. CASTLE. As something Standard and Poor's is going to require?

Chairman BAKER. Right, in their valuation on the companies on which they report.

Mr. CASTLE. On their ratings?

Chairman BAKER. They have a new core value assessment they are going through, which basically gets rid of any non-related revenues, requiring disclosure of certain types of debt structures, and part of that is requiring the expensing of options for employees.

And that is the basis on which the S&P will now rate the productivity of companies. And it was just announced this morning.

Mr. CASTLE. Well, Mr. Chairman, my time is up, and I will yield back. But I would just like to close by saying—and I appreciate your answers on this, Mr. Jenkins. I realize the political circumstance, although I thought it was later. But my own judgment is that out of all this Enron mess and Andersen mess, what we really need are clear rules and laws with respect to this.

And if there is anything that is ambiguous to me, it is stock options. If I look at a report, a quarterly report, and I see that a million stock options were issued—and again, to the executive compensation, particularly when it is issued by a company which has lost money the year before, so they rewrite it, but it is with a lower ceiling or whatever the effect is where it would take hold, so that the corporate executive can take advantage of it. To me, that is a corporate compensation, executive compensation issue of huge magnitude we need to consider.

But having said that, I just think there is also an accounting entry, automatically, that needs to be looked at. I think it is really unfair, frankly, to the companies as well as the stockholders, and even to some of the executives who would take advantage of it. I think a good executive would tell you do it in such a way that it measures our worth in terms of what we are doing, and show it in some way or another. And I just feel that something should be worked out on this.

So I hope that FASB, working with the international folks, and Standard and Poor's, anyone else who is discussing this, will come up with some common standard so all of us, as just average poor investors out there, can figure out what is happening.

I yield back, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Castle.

Mr. Weldon, do you have a question?

Dr. WELDON. Yes, thank you, Mr. Chairman, I just have a couple of quick questions. Sorry I missed your testimony, gentlemen.

But for Mr. Herdman, I had a question about FASB's sources of funding. As I understand it, their sources of funding are publication sales and contributions from accounting firms and companies. As I understand it, there has been some recent debate about securing a constant funding source for FASB. Can you give me the SEC's view on this issue, or do you have a view?

Mr. HERDMAN. Well, there are a couple of things that have been happening historically. The first is that the FASB has been engaged in deficit spending for the last 4 or 5 years, I believe. Its funds today come from a combination of—I think it is very clear from Mr. Jenkins's testimony—two-thirds of their revenues come from the sale of their publications, their standards and what have you. The other one-third comes from contributions from the business community and from the accounting profession.

And we think that it would be beneficial if FASB could get a broader source of more assured funding in the future so that there no longer are questions about whether the fact that their support comes from those who must abide by their rules creates the impression that somehow that impacts the quality of their rules. And also, just because it is a tough world out there, and if the way that you

are getting your support is to go around and solicit contributions, when times get tough that is often one of the first things to go.

So we believe that as we consider what needs to be done with respect to oversight of the auditing profession and the ways to achieve funding for that, that there are some very promising ideas with respect to how the FASB might be included in that type of funding—broad-based, private sector funding that would be an assured source of funds for the Board and for any organization, assuming that there isn't a legislated organization that would have a different source of funding. But as we think of alternatives and what we must do from a regulatory standpoint, if there was not a legislated organization to oversee the auditors, we have to create funding ideas there. We think that the same ideas ought to be applicable to FASB's support.

Dr. WELDON. Thank you very much. I just had a quick follow-up question. Maybe it is not a quick question. Mr. Jenkins was referring to international accounting standards, and I understand that you in your testimony provided some mention of the convergence of international accounting standards with U.S. standards. We were talking a few minutes ago about expensing share-based payments.

Did you want to elaborate on that a little bit more? I have got a few minutes left here. Did you want to say anything more?

Mr. HERDMAN. I would be glad to.

Dr. WELDON. Where is that heading?

Mr. HERDMAN. The SEC's mission is really twofold. The first is to protect investors. The second is to make sure that American markets stay competitive with the rest of the world. And for a number of years the SEC has had rules on its books with respect to foreign companies that want to list their shares on U.S. exchanges or otherwise register them with the Commission. And those rules pertaining to filing requirements—taking into account, from the time that they were written, that there are many countries out there and a great diversity of quality of accounting standards—have required from the outset, and continue to require today, that those so-called foreign private issuers either prepare their financial statements for U.S. filing purposes using U.S. GAAP, or reconcile from their home country GAAP to what the results would be under U.S. GAAP. And that is done for net income typically as the principal reconciling item.

There has been a lot of staff work done by the SEC over the years looking at the quality of so-called international accounting standards written by the International Accounting Standards Committee initially. And now for the last year-and-a-half that has been reformed, restructured into the International Accounting Standards Board. A couple of years ago, the European Union decided that all 7,000 listed companies domiciled in EU member countries, starting in the year 2005, would have to use international accounting standards as opposed to French or German or Spanish standards in their annual reports that get filed with the various exchanges in Europe.

A combination of the two things, the restructuring of the IASB and the step taken by the European Union, really makes the IASB a major player in the development of accounting standards around the world. They have a lot of work to do to go back and improve

the quality of some of their older standards. They are very much engaged in that right now. We have encouraged both the IASB and the FASB to take a single-minded approach to trying to achieve convergence with one another—approximate convergence—by the year 2005. We recognize that there are going to be huge efforts underway by the IASB and by European companies to convert to these international accounting standards, and we think—I personally think that the time is right for the Commission to consider whether the confluence of those events and the continued improvement in the international standards is such that they should be permitted for U.S. filing purposes by these foreign private issuers.

Chairman BAKER. Thank you, Dr. Weldon. Mr. Sherman, you had a wrap-up?

Mr. SHERMAN. Yes. I think we have loophole-ridden financial accounting standards; that we are painfully slow in plugging those loopholes; that we have a system for financial accounting standards publication which, if we applied it to tax accounting, would cause this country no longer to be a superpower in the world because it wouldn't have the revenue. And the argument against all this is, well, principles—no matter—will be enough. We don't make anybody do anything, but ask them to—just give them some vague guidance.

And one illustration of whether this works or not is in the area of putting a charge to earnings when you issue a stock option. The FASB has indicated that it is preferable to have such a charge to earnings. But that is a principle; the rule is you don't have to do it.

Can either of the witnesses identify any of the Big Four-and-a-half accounting firms that has as its uniform policy that a charge to earnings must be made by its clients, when material, when they provide an employee stock option? Can you name any of the firms?

Mr. HERDMAN. Congressman Sherman.

Mr. SHERMAN. A simple question. Can you name a firm?

Mr. HERDMAN. But the accounting firms don't make those decisions for clients. When the rule is as explicit as it is here, companies have a choice, and——

Mr. SHERMAN. OK, companies have a choice. And if they don't—can you name a single company that follows the preferred standard, or a single auditor who has failed, who has issued an adverse or qualified opinion because the company has failed to follow the best principle as stated by the FASB?

Mr. HERDMAN. Two companies that follow the preferred approach out of the Fortune 500. Boeing is one of them, and for the life of me, I can't recall who the second one is.

Mr. SHERMAN. So that would be one half—no, that would be less than a half of a percent.

Let me shift over to something else, and that is I know the wringer that a small company goes through to go public with their initial public offering, IPO. And sometimes they are trying to raise $10 million, $20 million in assets. How many accountants reporting to you, Mr. Herdman, work on these initial public offerings, as compared to the number of accountants that you have deployed to read and ensure at least the completeness, if not the accuracy, of statements filed by the thousand biggest companies in the country?

Mr. HERDMAN. None of those accountants actually report to me. They are all in our Division of Corporation Finance.

Mr. SHERMAN. OK. How many at the SEC?

Mr. HERDMAN. I believe the number of accountants in the Division of Corporation Finance is approximately 100 people.

Mr. SHERMAN. One hundred people. So you have 100 accountants that can look at both the new small companies and the big established companies. Now, of those 100, how are they divided between those two tasks?

Mr. HERDMAN. It depends on the volume of IPO transactions. In the current environment, virtually everyone is looking at filings of established public companies. A couple of years ago, when there were a lot of IPOs, then those have to take precedence.

Mr. SHERMAN. Those take precedence?

Mr. HERDMAN. Because they are new to the system. And so it depends on the relative volume of what is going on at a particular point in time.

Mr. SHERMAN. So if a company is trying to go public and raise $20 million, they are guaranteed to have a careful SEC review of their filing, and a comment letter that requires that they provide supplemental and corrective information necessary to make everything clear and up to spec. Is that a——

Mr. HERDMAN. For a company undergoing an IPO, they are guaranteed they would have a review. They are not guaranteed they would have a comment letter, but they can be pretty assured they will get one.

Mr. SHERMAN. OK, so they will get a comment letter. So you are trying to raise $20 million, you are pretty sure you are going to get a comment letter, guaranteed review. And yet if you are Enron, a company that was accused of fraud by the entire California Democratic delegation back a couple of years ago—so not a company with necessarily the highest business standards, or at least not in the opinion of the Democrats from California—you could go a couple of years without a review at all?

So you could be one of the ten largest companies in America, no review; trying to raise $20 million, guaranteed review? Maybe that is one of the reasons we have got a problem.

Mr. Chairman, I yield back.

Chairman BAKER. Thank you, Mr. Sherman. That is, I think, why some Members have a bill in to make sure that some of those big corporations file appropriately with the SEC. I think they are called GSEs, something like that. That is another whole subject matter.

Mr. SHERMAN. I think that would not include Enron, would it?

Chairman BAKER. No. I was making a very small joke about the volatility of the reporting issue.

Mr. SHERMAN. I would agree with you. It is a small joke.

Chairman BAKER. I want to thank the Members of the panel for their courteous use of time today and their participation. Your insights have been helpful to the subcommittee. We know we have a long road ahead of us and a lot of work to do in this area, and we look forward to working with both FASB and the SEC in the future in resolution of these important matters. Thank you very much for your participation.

Mr. HERDMAN. Thank you.

Mr. JENKINS. Thank you.

Chairman BAKER. At this time, I would like to call the members of our second panel to the witness table at their convenience.

I would like to welcome each of you here this afternoon. We thank you for your time and willingness to participate.

Our first witness to be heard from is the Co-Director of the AEI-Brookings Joint Center for Regulatory Studies, Dr. Robert Litan. Welcome, Dr. Litan.

**STATEMENT OF ROBERT E. LITAN, CO-DIRECTOR, AEI-BROOKINGS JOINT CENTER FOR REGULATORY STUDIES**

Mr. LITAN. Thank you very much, Mr. Chairman, for inviting me here today to summarize some of the key conclusions of a book called The GAAP Gap, a book that I recently wrote with Peter Wallison at American Enterprise Institute about the future of corporate disclosure in the internet age. In brief, I think we will agree with a number of panelists today—and I am guessing here—that corporate reporting needs to be updated to fit with modern business realities.

One of the purposes of disclosure rules is to help investors make informed judgments about the future, because equity prices, after all, embody the collective judgment of investors about the future prospects of companies. Current GAAP-based financial statements, even if they are clean as a whistle, only go so far toward meeting this objective, for four reasons.

Number one, recent financial reports inherently are backward-looking, especially so because, for the most part, assets and liabilities are recorded at historical cost, not current market values.

Number two, much of the value the market assigns to many companies cannot even be found on their balance sheet or income statements. That is because this value is intangible and cannot be easily bought and sold on the marketplace independent of the value of the firm.

Number three, non-financial information relevant to price in the future that may never directly show up in any financial report, such as the gain or loss of new customers, insider stock sales or purchases, is constantly being generated—and in any event, much more frequently than quarterly. To its credit, the SEC has recently proposed that more such information should be disclosed in such 8-K filings by companies, and more rapidly than ever before.

And finally, the development of new computer-based technologies may soon make it possible for investors, on their own or through independent advisors, to manipulate company-specific information so that they don't have to rely on GAAP-based financial statements that companies now produce. Specifically, I refer here to a new computer language, Extensible Business Reporting Language, that allows firms to place what are called "tags," or identifiers, on all kinds of financial and non-financial information. Investors and analysts can then easily manipulate and compare these data, which is not possible with financial reports that are now available on the internet in the language HTML.

These four conclusions have several policy implications.

Number one, while it is tempting to solve the intangibles problem by having firms place values on those assets, this is not generally appropriate, in my view, because it puts auditors in an impossible situation, especially in the wake of Enron. There are few if any organized markets for intangibles, so auditors have no objective benchmarks for verifying those values. The better approach, and one which addresses the need for more forward-looking information, is for firms to disclose more non-financial information that may give rise to intangible value, such as employee turnover, product return rates, measures of innovation and so forth. The SEC can and should accelerate the disclosure of such information by convening working groups of experts from different industries to identify which of these measures are most helpful and to publicize the results, so that investors, analysts, and other professionals can begin demanding to see such data.

Second, the SEC should encourage more frequent internet-based reporting, not only of non-financial information, but even financial data. Companies already balance their books and compile information internally much more frequently than quarterly. If investors had access to real-time data, it is conceivable—not certain, but conceivable—they would place less emphasis on the quarterly earnings figures with which markets and firms are now obsessed. In turn, this could reduce incentives for firms to manage their quarterly earnings to hit expected targets.

Third, the SEC should encourage the use of XBRL, and thus give powerful tools to investors, by perhaps requiring Electronic Data Gathering Analysis and Retrieval System submissions to be in XBRL by a fixed date.

And finally, the movement toward a new reporting model will not, in my view, eliminate investor demand for having financial reports comply with a certain standard, whether it be U.S. GAAP or the international accounting standards that you just discussed. In my written testimony, I argue that it is highly unlikely in this country that we will ever replace GAAP with IAS. Instead, I try to make the case for allowing all firms—not just foreign firms, but all firms listing their shares on U.S. exchanges—to choose between GAAP or IAS without necessarily having to do reconciliation, as is now required for foreign companies, as was just explained.

Competition between standard-setters would encourage both standard-setters to respond to market developments more rapidly, and thus solve a problem that you, Mr. Sherman, identified, which is the slowness of FASB. It may also—that is, competition also may reduce some of the political influence that has affected FASB rulemaking in the past, since firms choosing what is perceived by investors to be the weaker standard would be punished by the markets for doing so.

Thank you, Mr. Chairman, and I look forward to answering your questions.

[The prepared statement of Robert E. Litan can be found on page 248 in the appendix.]

Chairman BAKER. Thank you very much, Dr. Litan.

Our next witness is Mrs. Ellen Masterson, Partner-in-Charge of Global—lost my glasses, wait a minute—in charge of Global Audit Methodology and ValueReporting, PricewaterhouseCoopers. And for

the record, I have read ValueReporting about a half-dozen times trying to absorb it all, and I think it is an excellent piece of work. And the conclusions reached, I think, are excellent in the publication.

Ms. MASTERSON. Great. Thank you, Mr. Chairman.

Chairman BAKER. You will need to hit that little button.

Ms. MASTERSON. Oh. Thank you.

**STATEMENT OF ELLEN H. MASTERSON, PARTNER-IN-CHARGE OF GLOBAL AUDIT METHODOLOGY AND VALUEREPORTING, PRICEWATERHOUSECOOPERS, LLP**

Ms. MASTERSON. Thank you for those kind words, and thank you for the invitation to speak with you today.

When we wrote The ValueReporting Revolution at PwC in the fall of 2000, the topic of transparency was not as in vogue as it is today. Our book captures the results of our research into the effectiveness of corporate reporting in meeting the needs of investors around the world. Based on surveys of thousands of investors, analysts, and managers, there were several consistent messages that came out.

One, at the time surveyed, more than a third of the companies believed they were undervalued in the marketplace. Second, few investors regard corporate reports as very useful. Third, the market is excessively focused on short-term earnings; we can all agree on that. And finally, it was clear that companies could benefit significantly by improved transparency, including higher share prices where warranted.

From our research, which is ongoing today, we have defined certain communication gaps that drive the difference between the way management values their business and the market value today. The most significant of those communication gaps are three that I would like to discuss with you. One we call the information gap: investors need information they don't get. Second, there is a reporting gap: management agrees information is important and that they are not reporting it. And thirdly, the quality gap, where management simply doesn't have all the important performance information they need.

This quality gap often underlies the reporting gap. Management doesn't have all the information; they don't report it because they don't have it. And that gap is by far the most troublesome.

We group the kinds of information that investors want into four categories, fairly simple: market information, company strategy, and the key information used to manage the company; finally, the value platform, measures of the real drivers such as innovation and brands, people and customers, as Dr. Litan just mentioned.

Many of the elements underlying the four categories will differ by industry sector, but the four categories hold true for all companies. Investors and analysts and managers all agree this is the information that is important and that they need.

So if all agree, why doesn't management communicate more? There are likely many answers, some of which we have heard—it is not required, it is competitive, it is not reliable, we don't want to go first, there are no standards. And the more we disclose, the more legal liability we have.

And yet we haven't met a CEO or CFO who doesn't basically agree that eventually the market will approach a new model for communication similar to our ValueReporting framework. Many companies are leading the way on a voluntary basis.

In the spirit of transparency, we have no conclusive evidence that better disclosure will actually lead to accurate share prices. But our survey respondents did indicate the benefits of greater transparency to companies would be increased management credibility, more long-term investors, improved access to capital, and more accurate share prices.

There are benefits to investors as well. Simply put, value reporting would give investors the information they need to make better investment decisions.

ValueReporting requires dramatic changes in management and board attitudes toward corporate reporting. In recent hearings, I understand, the subcommittee has looked at the role of the board and the audit committee in corporate governance. Boards of Directors need the information embodied in ValueReporting to properly evaluate management, and they have a responsibility to make sure that investors get such information as well.

We encourage the creation of new venues for reporting, beyond the boundaries of traditional financial statements, to give investors more information about the real sources of value in the business. Thus, we don't propose to make traditional financial reporting less relevant, or to replace it, or to put lots of intangibles on the balance sheet.

Thinking in terms of the balance sheet probably misses the point. Companies should give the market reliable and relevant information, and the market will figure out what to do with it.

I appreciate the opportunity to be with you today, and look forward to answering questions.

[The prepared statement of Ellen H. Masterson can be found on page 259 in the appendix.]

Chairman BAKER. Thank you very much.

Our next witness is Professor of Accounting, The Wharton School, University of Pennsylvania, Dr. Robert Verrecchia.

Welcome, Doctor.

**STATEMENT OF ROBERT E. VERRECCHIA, PUTZEL PROFESSOR OF ACCOUNTING, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA**

Mr. VERRECCHIA. Thank you for inviting me.

In the brief time that I have to testify, I would like to offer the perspective of someone who wears the proverbial "two hats." That is, first I would like to offer the perspective of someone whose instruction material touches on many of the issues that are central to the debate about the process that promulgates accounting standards and firms' adherence to those standards. Later, I would like to offer the perspective of the researcher who has attempted to document the economic benefits of increased disclosure and greater transparency.

With regard to pedagogy, it is at least a partial indictment of the financial reporting process that one of the most popular elective classes in the Wharton MBA program is an accounting class whose

chief purpose is to discuss how firms gerrymander their financial statements to conform to the letter of various U.S. generally accepted accounting principles, U.S. GAAP, but not necessarily the spirit. Further, one of the most popular executive education programs sponsored by Wharton is one in which the financial reporting peccadilloes of firms are brought out into the open and put forth for ridicule.

Many of the instructors at Wharton are sensitive to the concern that in regaling students with tales of financial reporting chicanery, we may also be promoting this behavior on the part of our graduates. In our conceit, we rationalize our way around this dilemma by arguing that in any accounting Armageddon, it is important for our students to be better-armed than the students from our peer institutions.

In short, viewed from the rarified air of academe, the accounting standard process appears structured in such a fashion as to produce the occasional accounting debacle. Industry and financial groups, and their auditors, sponsor a private sector agency, the Financial Accounting Standards Board, to offer accounting pronouncements and guidance from which the very same corporations and their auditors will either benefit or suffer. In other words, it is a process that, at best, seems fraught with moral hazard problems, and, at worst, results in accounting opinions that appear to pander to the worst aspects of corporate America.

These problems are only exacerbated when auditors who lobby the rule-making process in behalf of their corporate clients are then asked to implement these rules. In an environment like this, should we have expected anything less than the occasional Enron/Andersen misadventure?

Part of the problem with the rule-making process is the failure to be guided by two broad principles. One, wherever practical, all publicly traded companies should be required to adhere to a regime of full and fair disclosure. And two, whenever effective control is exercised over an entity, financial results of that entity should be fully consolidated into the controlling firm.

Unfortunately, all too often in the rule-making process, corporations, through their lobbyists, appear to employ a variety of self-serving arguments to circumvent these principles. This problem is further exacerbated by the fact that the rule-making process itself seems more absorbed in the detailed minutiae of accounting transactions than in the economic substance of those transactions.

Opponents of the recognition of substance employ these arcane debates to frustrate rule-making at all levels. No better example of this exists than the treatment of employee stock options.

But from a research perspective, the real tragedy of recent financial reporting deficiencies is the failure of all representatives in this debate to recognize the clear and obvious economic benefits of increased disclosure and greater transparency—lower costs of capital for firms, increased liquidity for firm equities, greater participation in the capital generation process by the public, and so forth. Recently, contemporary accounting research has attempted to document these benefits. While somewhat nascent, this research nonetheless is consistent with prevailing notions that increased disclosure is beneficial to the capital generation process.

Commitments to increase disclosure on the part of firms do indeed result in lower costs of capital, increased liquidity, and so forth. The research results are clear and compelling, and buttress traditional claims that greater transparency enhances access to capital markets.

But if contemporary research can document the benefits of increased disclosure, why do publicly listed corporations not embrace it to the fullest extent? One rationale for less than full disclosure is that disclosure may require disseminating information about a firm's proprietary business model, proprietary management expertise, proprietary technology, and so forth. This, in turn, may work against the interests of a firm that reports publicly, and to the benefit of firms that compete against it.

To the extent to which these competitors are based outside the U.S. or report under accounting standards other than U.S. GAAP, this provides powerful political leverage for less disclosure. But in a sense, a call for greater disclosure is no different from a variety of welfare arguments. While full disclosure and full consolidation may lead to both winners and losers in capital markets, indisputable increased disclosure serves the greater good.

In short, the thought with which I would like to leave the subcommittee is that the rule-making process be governed by an ideal of full and fair disclosure and full consolidation. Perhaps stated differently, arguments in favor of anything less than full and fair disclosure and full consolidation should require a high burden of proof. While full and fair disclosure and full consolidation will not eliminate failures that result from fraud, flawed business models, and/or unexpected industry and economic downturns, they will work to ensure that failures are not the results of a reporting system that gives firms and their managers unwarranted discretion to obfuscate an entity's overall financial condition.

Thank you very much, and I will await any questions.

[The prepared statement of Robert E. Verrecchia can be found on page 285 in the appendix.]

Chairman BAKER. Thank you very much, Doctor.

Our final witness on this panel is Mr. Steven Wallman, CEO of FOLIOfn, and a former SEC Commissioner from 1994 to 1997. Welcome, sir.

**STATEMENT OF STEVEN M.H. WALLMAN, CEO, FOLIOFN, INC., AND COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, 1994-1997**

Mr. WALLMAN. Thank you, Mr. Chairman. And today I am representing only myself.

Our capital markets are clearly the means pursuant to which capital flows from those who have it to those who need it. I don't think there is any proposition that can be gainsaid other than that our capital markets do, in fact, work better than anybody else's. They work better now than they have in the past. But the recent events of the last year have also shown how much more we need to do in order to make them work even better.

Capital markets rely on public disclosure to work efficiently. Financial statements, along with other mandated and voluntary dis-

closures, are, if you will, the bedrock of that system. And they are what allow investors to make efficient resource allocations.

Generally accepted accounting principles are the language of financial statements. More than half-a-dozen years ago, it was apparent that GAAP was starting to fail in one of its most essential purposes, which was to be able to provide useful, timely, and relevant disclosures to investors. About 6 years ago, we commenced a study at the SEC looking into these issues. At that time, the whole proposition that there might be something failing with regard to GAAP was viewed as somewhat heretical. I think today, in hindsight, it is not quite as heretical.

Let me explain five ways, sort of the normal who, what, where, when, and how, where GAAP is currently having some difficulties in fulfilling its purposes.

First, in connection with sort of what is measured, accounting principles are geared to measure bricks and mortar—basically a tangibles-dominated world from the past. Increasingly today, the drivers of wealth production are intangibles. They are generally created internally, not acquired, but GAAP generally measures them only when acquired, not generally when they are created internally. So we have a sort of what is measured inconsistency.

Who is measured has been brought to light in connection with what we are seeing now with special-purpose entities and other arrangements, where the boundaries of a firm are increasingly difficult to discern. It used to be you could tell where a firm began and where it ended, and what business it was in. But derivatives today, SPEs, off-balance-sheet activities, partnership arrangements, and other kinds of things have blurred that boundary quite considerably.

A third area obviously is timeliness of measurement. Things move more quickly now than they have in the past. Financial statements clearly are generally backward-looking, even though there is forward-looking disclosure embedded in financial statements—reserves, for example, are clearly forward-looking. Yet the concept of a forward-looking financial statement is one that is hard for some to discern.

Access to information is another. GAAP is its own language at this point. Those who wish to understand what is truly going on in a financial statement have to spend some significant amount of time investigating it. And in fact, there are people who spend their careers taking the aggregated information in financial statements and then disaggregating it in order to understand what is really happening.

Moreover, the language of GAAP is now sufficiently esoteric and specialized in many cases that it has even its own dialects with regard to specific industries and different instruments and circumstances within those industries. And even though financial statements increasingly, I think, fairly put, are beyond the comprehension of the lay person, and even many professional investors, we continue to require their distribution to all, maintaining the to-some-degree fiction that they should be useful to all. At base, I think we in a sense almost mislead people when we suggest that financial statements should be distributed widely because they are widely understandable. They clearly, at this point, are not.

Finally, how things are measured; accounting requirements clearly, in my view, have become very rules-oriented. You heard earlier somebody talk about them as sort of a by-the-book type of check-the-box type of accounting, and I think that that is a problem. We need to have more goals-oriented, more principle-oriented approaches. We will not be able to close loopholes, but one of the most effective, one of the most overwhelmingly effective standards in the securities laws for the last three-quarters of a century has been one very simple concept, the notion of 10(b)(5). And that is in essence a very broad-based principle with regard to disclosure, and it has been, if you will, one of the most effective means for ensuring appropriate disclosure ever created.

The current scandals clearly indicate, I think, how outdated GAAP can be when people stretch it to the extreme. Let me talk about a couple things that might be useful to try to address some of these concerns.

One is, FASB and the SEC have already taken important steps to address some of the intangibles deficiencies. And they are doing more, and I think that is worthwhile, in terms of general principles there. In addition, Chairman Pitt and the SEC have already asked for further disclosure with regard to the principal accounting judgments that are currently being made by accountants and issuers. I think that is a very important thing to get out into the public disclosure.

In addition, there are other incremental steps that I think are worthwhile to take. One is the idea of re-educating the profession that the overall principle of financial statement reporting is that they have to present a true financial picture of the company, and not basically what is in accordance only with respect to generally accepted accounting principles, but whether or not the overall presentation is in accordance with generally accepted accounting principles and a fair presentation.

And finally, there are some other suggestions that one could explore, such as requiring a second firm to provide a review of the more important principles and judgments being made by an auditing firm, at least in connection with the largest corporations, so that there is a means for some double-check with regard to the very broad-based and important decisions that are being made in connection with major firm audits.

Thank you.

[The prepared statement of Steven M.H. Wallman can be found on page 289 in the appendix.]

Chairman BAKER. Thank you, Mr. Wallman. You were discussing a point which I had raised with the earlier panel, with regard to the obligation to present an accounting methodology that reflects true value, and that where the utilization of an accounting mechanism is not for the purpose of building value or enhancing shareholder perspective, that that be questioned or noted in some special way. Is it your view that that is not the underlying principle of compliance with GAAP today, that we are so technically focused on the construction of the rule that bright people spend a lot of time trying to figure out how to comply with the rule and become, therefore, GAAP-compliant, but by so doing obfuscate the true financial condition of the company?

Mr. WALLMAN. I think there are two points in what you are bringing up. One is the question of whether there are transactions engaged in that have no true business purpose, but which are being done in order to take advantage of a rule. And the second is whether or not, even when that is not being done, are the rules such that the presentation to investors that is generated by the operation of those rules is such that it does not fairly present the overall financial picture of the company?

With regard to the latter, I think the answer is clearly yes. I think people who read financial statements today, unless they are well-endowed with an interest in financial reporting and accounting, must have difficulty understanding the true nuances of what it is that is being described. The descriptions are no longer in plain English. The words that are being used, whether it is net income or something else, clearly have at this point a whole language behind them that is far beyond what the assumption is when you look at the word, from an English standpoint.

With regard to the first, whether or not there are those who attempt purposefully to obfuscate, it is a large world. I am sure the answer is that there are those who do, and there are, I am sure, those who get away with it as well. There are those who, I think, could be caught, if you will, by having a simple principle that says if the accountants cannot be convinced that there is a business purpose for something, regardless of what the accounting is, there should be disclosure of the fact that it appears that there is no business purpose for the transaction. That obviously would stop those transactions from going forward. And I am not sure there is anything negative with regard to that conclusion.

Chairman BAKER. Thank you.

Did anybody want to jump in on the topic, with regard to—and I know your general views about what the current deficiencies are of the rules. But I am getting at the consequence of the current rules. Even when you comply, you may not be presenting a clear picture of financial condition. Certainly with regard to forward-looking statements or identifiable business risk or new market development, or whatever might be the thing of value down the road that you are not disclosing, but I am even worried about the accuracy of the historical statement that is GAAP-compliant, in light of the technicalities in which the rules are constructed. They are very difficult for anyone to understand, and more FASB tries to define it, the more complicated the system becomes that they are trying to fix.

I don't know how we get out of this. I don't think we can go from a historical-looking current system to a forward-looking internet-based system overnight. But certainly there has to be some force in the market to bring about these changes—and I don't know that the Congress is the appropriate forum for that to occur. But what are your recommendations about how we get where we need to be? What is the first next step?

Dr. Litan.

Mr. LITAN. Well, I think there are several steps. On the forward-looking information question, which relates to all these non-financial indicators that several of us talked about, as well as to moving to the internet, the prime mover, in my opinion, has to be the SEC.

It shouldn't do it by mandate; it should do it by encouragement, arm-twisting, if you will, education. But it has to be the agency out in front helping to create a demand among investors—working through the media, because once people know that this information is out there, or capable of being produced, then sophisticated investors, namely institutional investors, I think, will begin to demand it. And you will see a virtuous cycle. But somebody has got to start the cycle, and it has got to be the SEC.

Now, the second point concerns the existing GAAP-based system, not the forward-looking information. Now you get into this debate which has no clear resolution, where you have GAAP, which has highly detailed rules versus international accounting standards, which are basically principles-based, and much more general in nature. But, as Congressman Sherman pointed out, the international rules may allow too much discretion. So you're damned if you do and damned if you don't.

There are problems with each approach, which is why I end up recommending competition. Rather than give a monopoly to one rule-setter in one geographic area, I would like at least to see some marketplace competition. Firms choose among the standards, and then what the media will do and the analysts will do is they will write about which standard, on the whole, better serves investor interests. And you will get investor demand, I think, for the better standard. And let them go at each other, head to head.

But I think in the absence of competition, you are going to be beating a dead horse.

Chairman BAKER. Ms. Masterson, or Dr. Verrecchia? Can you comment on the subject?

Ms. MASTERSON. Yes, I would. I think there is a lot—as you said, this is not a one-step process. In fact, it is probably a longer process than any of us wants to think about.

But certainly one of the outcomes of the system we have today is this, I think several of us mentioned the obsession with earnings, with current short-term earnings. And the earnings game is very real. We see that; we got a lot of information about it in our research.

And the fact is that those short-term earnings pressures don't really turn into that long-term investor value in many cases. And so where we get the rules that are so focused on short-term wins and companies feeling that it has got to be this quarter over last quarter, and immediate results, and not an ability to really talk with investors about what they are doing to build long-term value—I think that is where, whether it is rules or principles, we just get caught in that same old cycle.

So getting more information about the long term—I agree that the SEC is a main player here. I think industry-driven initiatives have got to come into play, and the FASB has actually sponsored some of the industry-based coalitions. We do have early adopters in the marketplace today, and hopefully there will be some pressure to follow them.

But giving investors more information about the long term can hopefully balance out that obsession with short-term earnings, which I think is at the heart of the manipulation, whether there are rules or principles.

Chairman BAKER. Right, thank you.

Mr. Castle, did you have a question?

Mr. CASTLE. Thank you, Mr. Chairman. I want to sort of start where I stopped before. And I am delighted that you gave me the information about Standard and Poor's beginning to bring stock options into their corporate reporting. Maybe they heard I was going to ask questions about this today or something like that.

I would like to really, I think, ask all of you this question. And you all were in the room when I asked questions about it before. But I am a little hung up on this subject, admittedly. I know it is a smaller part of the transparency issues, and I agree with the Chairman, I think accounting methodology which reflects true value is what we are all after. I think we all would basically agree on that. And I agree with the short-term earnings pressures that Dr. Litan and Ms. Masterson have both talked about. If there is some way to spread it out so we didn't always look for it, I think it would be helpful indeed.

But stock options in particular do trouble me. I have seen all kinds of opinions on it. I have seen expensing options when granted, expensing options when they are actually executed, or just leaving it alone and doing it in the footnote. I see here from an article in *Business Week*, which I clipped out, the boards make matters worse by so lavishing options on executives they now account for a staggering 15 percent of all shares outstanding—whether it is true or not, if it was even remotely close to true, that is an astounding number, a percentage of the capital of any corporation which exists out there.

And I don't know what the right answer is. And as I said at the beginning—and I am not getting into this—I just think executive compensation has perhaps gotten out of hand in this country. And that is something that I think the corporations are going to have to look at in terms of their own management. And their directors—although the directors benefit from all this as well—and everybody else.

But from an accounting point of view, it seems to me that all of us who are interested in this have a responsibility. And I can't imagine you haven't thought about this issue in some way or another, even though some of you didn't speak to it directly here today. And I would be interested in your views on it. What are your views on what we should do on the accounting entries on stock options?

And you can do whatever you want. You can duck and say, "I haven't thought about it." You can say we should expense it when they are granted, or expense it later, and the methodology by which that would be done. And you will probably have about a minute apiece, when it is all said and done. But I would just be interested—you are four diverse people, even though you have commonality in terms of the area you look at. And I would just be interested in your views on this. Apparently, everybody seems to have different views—the President and Mr. Greenspan differ, others differ. And I am just interested in what the wealth of good, valuable opinion on this subject is.

So maybe we could just go across the table and start with Dr. Litan and go from there.

Mr. LITAN. I will side with Chairman Greenspan. He said that the one thing we know is that the right answer is not zero. The stock options are valuable; we know that, and they are valuable at the time of granting.

Now, the people who oppose assigning a value say the so-called Black-Scholes method of valuing options is not perfect because the options have all kinds of restrictions; a lot of times the stock isn't well-traded, so you don't have the data to do the precise Black-Scholes valuation. My answer to that, and I think Chairman Greenspan said the same thing, is you do an estimate off that, and even if it is arbitrary, it is better than nothing.

We do it all the time. We have depreciation schedules which are arbitrary. We have loss estimation for bad loans, which is not a science. It is more an art than a science, but we don't just simply pretend the loan is good when it isn't and put a 100 percent value on it. I think an estimate here is better than zero. And so yes, I think there is a right answer. It may not be the perfect answer, but we know that the current system is not the right answer.

Mr. CASTLE. Thank you. Ms. Masterson?

Ms. MASTERSON. I think I am going to take Steve's line and say I am going to speak for myself and not my firm on this one, if I may.

Mr. CASTLE. I actually was only asking you, not for your firm's opinion.

Ms. MASTERSON. Because I am not here to make a statement on behalf of PricewaterhouseCoopers about the accounting for stock options. So I am going to take a little bit different tack, if you don't mind.

But I think you have hit the point on the head, and that is executive comp in general. One of the things that all investors really want more information about is the quality of management. And management, by and large, is what they are investing in. And whether it is in the income statement, on the balance sheet, in the notes, the information needs to be there about management, the quality of management, the compensation of management, the value that the board has placed on management and where the incentives are leading management behavior.

So I think that fulsome disclosure—with all due respect, if I can dodge the placement of that, I would appreciate it.

Mr. CASTLE. Thank you. And Dr. Verrecchia, I will throw a kicker in on yours, because I think you said in your testimony, and I think I saw it in your writing, that you actually think this has enhanced value to the corporation, if stock options are correctly reported. Maybe I am mis-stating that. I would be interested in that as well as the other question.

Mr. VERRECCHIA. Well, I think any disclosure enhances. But I think that specifically with regard to this, this strikes me as so straightforward and obvious that I think it speaks very much to the controversy about rule-making in general. Obviously they should be an expense. It is probably much easier to measure, through Black-Scholes or otherwise, the value of that expense, than it is a whole bunch of other things that are synthetically amortized.

So in a way, what has happened is people have used this measurement issue to, if you will, put forth an agenda that nothing be

recognized at all in the form of an expense, without recognizing that something like that option, like in very sophisticated communities, can be valued with a high degree of accuracy. And so I think most of the arguments are totally disingenuous, that suggest somehow it should not be recognized as an expense because of measurement issues. And if we can't see through this issue, then there is no hope for rule-making in general.

Chairman BAKER. Thank you.

Mr. Wallman.

Mr. WALLMAN. The measurement issue, I think, is a red herring. And I don't think the argument has really been on that since it was first raised in the mid-1990s. I think everybody understands that issue, both sides.

The question is how best to present the information, and what is—in some cases, the perception of broader-based impacts. And you have had the argument for quite a number of years that expensing it would be something that could deter the use of stock options. As a society, is that something we want or not? Should accounting be neutral or not? These are a number of interesting and important policy decisions that transcend the mechanical questions of whether or not you can come up with a value. The answer is, of course you can. The question is really how best to then use that information.

Some have suggested that there be additional disclosure of the actual calculated expense, and that can be a disclosure. Others have suggested a separate line-item in the financial statements that would break this out, because you get one of the other confusing aspects, as you mentioned yourself earlier, that operating profits, for example, in some companies could be wiped out by showing expenses which are not cash expenses and which could be, therefore, quite misleading to investors looking at the financial statements, wondering how it is that this company can keep making a lot of money in the traditional sense of making a lot of money, but keep reporting losses because the stock price keeps going up.

And you do get very strange anomalies where the more the stock price goes up, the more there could be an expense; the more the stock price goes down, the less of an expense. Yet management or the employees haven't changed. So you get some very interesting circumstances as to how best to describe, disclose, and present this information.

So I don't think the focus ought to be on the measurement issues. Clearly, that is inapposite, and I think everybody understands that. The real issue or debate has been for the last decade how best to present this information, both to investors so they understand what it is, to managers so it can be used, and also how do these factors implicate themselves in more broad-based societal issues that people have been arguing about for a long time.

I think we should remember this whole debate started in part when managers and others used to get a lot of cash. And there was an awful lot of movement on the corporate governance side to start paying managers not in cash, but in stock and stock options, in order to better align their interests with the corporation. And the view was that we needed to have some way of trying to convince

companies and managers to take equity-based compensation so their interests would be aligned with shareholders, as opposed to simply taking cash from the company.

Mr. CASTLE. Are you willing to opine how you would do it, if you were doing the accounting?

Mr. WALLMAN. Actually, I am happy to, because I was on the record as proposing an answer that was in between. And I would be happy to pursue that in detail if you would like. But in essence, it was a hybrid that came up with the equivalent of a charge in terms of coming up with the amount, the measurement amount, but showing it on a separate item, so that it was fully disclosed and people could understand what it was, as opposed to mixing it into an overall cash, otherwise understood compensation expense.

Mr. CASTLE. Thank you. I appreciate all of your answers, which I think were clear and helpful, and I yield back, Mr. Chairman.

Chairman BAKER. Mr. Castle, on that subject, the Chairman wrote on October of last year to FASB relative to the expensing of stock options. And in the response that FASB gave to the Chairman, they arrived at a disclosure regime, not requiring expensing. But they got to this point in a rather convoluted way, because their preference was to expense, but because of the divisiveness of the subject matter, I quote, "the Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on the issue, not because it believes that solution is the best way to improve reporting."

So our non-political board happened to make a political judgment, I guess, which gets me to the next difficult question that none of you have spoken to yet. Can we get where we need to go with FASB as the accounting regulator, centered on a rule-based system? Aren't we looking at a very—this issue itself presents evidence of the difficulty. With regard to derivatives treatment, there was a 10-year debate. With regard to SPEs, there was a 10-year debate and then a statement issued saying we have decided not to take a position.

In the world in which we live, it may not be the fairest, but we need decisive response to inappropriate market conduct, so that investors at any time and moment are getting access to clear-cut, helpful, usable information. We are trying to put a horse and an automobile together here, and I think that we maybe better advised to go get us another mechanic. What is your view about the viability of reform versus a whole new approach?

Yes, sir?

Mr. LITAN. Well, I think, as I said in my written testimony, a second-best solution to the slowness problem is to have the SEC threaten to step in and set a rule with some kind of deadline. I want to be clear, I don't think that is a perfect solution, but it is better than where we are now.

Now, the problem inherently, both as to slowness and to political influence, is that ultimately FASB can, at any moment, be influenced by the Congress. And it will be as long as FASB reports to the SEC. It is inherently a political creature. I think the only way to reduce political influence is to have competition in standards, as I said before.

Now, you could imagine replacing FASB with IAS, international standards. But that would just move the politics to some other place, it would move it to London. And then it would dilute American interests, obviously. We would have to compete with overseas interests. But I am not sure that would be a necessarily better answer. London may be even slower than Greenwich, Connecticut.

And, by the way, I am not sure IAS would be a stable solution. I think we would end up, over time, having national accounting bodies potentially interpret IAS to apply to specific countries. And so we could end up right back where we are now, with different flavors of different accounting standards.

Chairman BAKER. From your perspective, is FASB asset-limited? If they have been operating in a deficit posture for the past 4 years, they obviously can't be adding on any large numbers of staff. Is it advisable to consider a federally based support system for FASB to break the tie between the industry and the FASB regulatory body, and to give them pay parity in order to do the work they need to do? Is that an element of the delay, or is that a factor at all?

Mr. LITAN. Well, I will give my opinion, and then I don't want to monopolize attention. I think that a more stable funding source could help reduce the perception that FASB is in anybody's pocket. But it doesn't solve the political problem that I put my finger on, because you can still get political interests working through the Congress who don't like stock option expensing, and they can still stop FASB in its tracks.

So I don't think the funding thing, while it may be meritorious, is a perfect magic bullet. I think the only chance you have got is competition, and let the market pressure both FASB and IAS to come up with more rapid standards, and also to do so in a way that is in the investor's interest.

Chairman BAKER. Any differing opinions?

Mr. WALLMAN. Yes. I mean, I think competition is an interesting idea, and people have suggested it a number of different places. It is not a panacea, though, and it will not, in my opinion, I think, do much other than create two fora where politics can be brought to bear in various respects. And I don't think you are guaranteed a better result out of either of them just because you now have competition between them.

I think we also end up with the potential issue for there to be misunderstandings. It obviously becomes somewhat more confusing for investors who now have two different sets of standards. It is already confusing for investors in trying to figure out what GAAP is meaning; forget trying to figure out what two different kinds of GAAP mean. I mean, there are a number of different issues.

On the other hand, I think the convergence that has been talked about is also happening, and I think on most issues you end up with people who are intelligent concluding reasonably the same thing with regard to how to try to do something. The problem is that the world is very complex, and the problem is that when you continue to try to come up with specific rules that cover things, it becomes increasingly like the tax code.

And like the tax code, we don't have people out there who decide that they can intrinsically and inherently understand it just by sort of looking at a bunch of books. There are tax lawyers who are paid

to do nothing but try to figure it out, and we have courts that are specialized in trying to understand it.

We are in a position here where we are looking for something that is useful for the marketplace as a whole and for investors generally speaking. And in order to provide something to them that is useful, it needs over time to be something that has more and better disclosures with respect to it. And to some degree, we create, I think, a problem by trying to roll things up to specific numbers.

I think Standard and Poor's is a great example of an entity that has attempted at this point—in part because there were concerns about whether or not the numbers it is using are useful for what it is trying to do—to now itself try and analyze it better, and to come up with its own view of core numbers, separate from what FASB and what the SEC and others think are the generally accepted accounting numbers that ought to be suggested to the public, and different from what it is that we will have the public see in audited financial statements. S&P will basically use its own.

That is an interesting opportunity, if you will, for competition. We already have competition there, if you will, and we will see whether or not people prefer to see what S&P produces versus what it is that somebody else produces.

I think it was said earlier in the previous panel, too, that you can end up in a position where as long as you have got full information out there, and the line items are clear and the disclosure is obvious, you can end up with others—whether they are analysts, whether they are entities like S&P or others—creating, if you will, their own view of what financial statements are like.

So I think that we, in essence, end up with sort of the competition, if you will, for ideas and thoughts through that means, without trying to come up with multiple places to have influence peddled with regard to politics and financials.

Chairman BAKER. Do I take from that, then, you do not believe that a regulatory restructuring makes any sense? That it is pressure to get the current structure to move in the disclosure regime that you see as appropriate?

Mr. WALLMAN. I think that whenever there is a failing, there is a question of whether or not there needs to be a change in the overall structure. And I think it is a worthwhile question to ask. Personally, I think that to some degree the failing has been in the approach. It has been too much of an attempt at, if you will, closing barn doors after horses have escaped, trying to come up with the next rule to take care of the last problem. And what we need is a more forward-looking approach, if you will, to regulation.

I think that the people are in a position to be able to exercise that, and to do it appropriately, if one can step back and take a more general approach to rule-making. And I think the SEC has begun to do that, and has done it in various instances. And I think the FASB, with its new business combinations approach, has done that as well. So I think you are starting to see that, and I think people have recognized that that is a necessary element to appropriate rule-making going forward. That, I think, is the restructuring.

There is a separate set of issues, which is whether or not there is a sufficient level of resources both at the Commission and at

FASB, whether or not the funding really ought to be something where the private sector has to step up to fund this, which necessarily entails the question of where is influence coming from with regard to that.

But I think stock options is a worthwhile point in case: the pressure there came not from the private sector suggesting they were going to withdraw funds from the FASB if it went forward with the project; the pressure there came from Congress suggesting that FASB was doing something inappropriate if it were to expense stock options.

Chairman BAKER. Thank you.

Mr. Castle, did you have any further questions?

[No response.]

Chairman BAKER. I don't know if anybody wants to make any further comment on the Standard and Poor's approach that was issued today, if you have any degree of familiarity with it. But if, after review, you find it of interest, or if there is comment worthy to send to the Committee, we would be appreciative for analysis and comment as we move forward.

This is a very meager beginning to a very long process, but I want to express my appreciation to each of you for your time in being here today. Your insights have been very helpful to us, and I am certain we will be working together over the coming months toward the goals we all have in mind.

Thank you very much. Our hearing is adjourned.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]

# A P P E N D I X

May 1, 2002

**Opening Statement**

# Chairman Michael G. Oxley

## Committee on Financial Services

**Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises**

**Corporate Accounting Practices: Is There a Credibility GAAP?**

**May 1, 2002**

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Good morning. I want to thank the Chairman of the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Congressman Richard Baker, for holding this important hearing.

Last week, the House overwhelmingly passed H.R. 3763, the Corporate and Auditing Responsibility, Transparency, and Accountability Act of 2002, or CARTA. Chief among the provisions passed by a strong bipartisan vote were mandates for increased financial disclosures by publicly traded companies. We also set forth a new regime for tough oversight of the accounting profession by the creation of a new board under the Securities and Exchange Commission, which is the only legally recognized authority over this important function of our economy. We look forward to the Senate leadership's swift and bipartisan passage of CARTA.

However, our responsibilities for protecting American households, public pension funds, and private investment accounts cannot end with CARTA. We must continue to review the generally accepted accounting principles and discretionary accounting practices that American companies use every day to report on their operations.

During the initial phase of our CARTA hearings, the Committee publicly discussed the complex principles involved in the accounting for financing tools such as special purpose entities. We disclosed that those principles had not been clearly stated by the Financial Accounting Standards Board and the SEC, and that Enron clearly and continually abused these principles.

We also discussed the principles involved in accounting for sales and swaps of fiber-optic cable capacity among telecom companies such as Global Crossing, Qwest, and WorldCom. After a change in the principles in 1999, companies increasingly turned to unaudited "pro forma" statements to better explain the cash flow in their business. There is no guidance on the consistent preparation of those statements, however, which leaves investors, and even seasoned professionals, unsure of a company's or industry's results or direction.

Clearly, there are plenty of other events that we should also review. Accounting principles and corporate practices for reporting revenue from the sale of a business, changes to accounts receivable, company loans to corporate insiders, special accounting mechanisms designed to minimize taxes, and pension fund transactions have all been raised in the financial press and have been the subject of SEC reviews.

There have been too many restatements of financial statements, too many SEC investigations, and too many pension plan losses for us to not dig further into this area.

Our witnesses today will give us their perspectives on the problems in accounting principles and practices and the impacts on different sectors of American life. I am especially pleased that Betty Montgomery, the distinguished Attorney General of Ohio, has taken the time from her extremely busy schedule to come to Washington today in order to discuss how she is trying to recover losses suffered by public employees. Attorney General Montgomery and the other expert witnesses will, I'm sure, advise us of ways by which we can help investors and employees by encouraging more informative and updated financial information by publicly traded companies.

As I said at our Global Crossing hearing on March 21, it is only by reviewing these practices that we can help investors to base their decisions upon a company's real financial condition.

That concludes my comments, and I will now yield to the gentleman from Louisiana, Mr. Baker, for what I anticipate will be a very interesting and illuminating hearing.

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May 1, 2002

Congressman Paul E. Gillmor
Opening Statement
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Corporate Accounting Practices: Is There Credibility GAAP?"

Thank you, Chairman Baker for holding this important hearing today and allowing this committee to further our investigation of the collapse of both Enron and Global Crossing, and most importantly, the negative impact these events have had on states and local communities across the country.

The House of Representatives has clearly taken a great step forward in addressing the systemic problems in the accounting industry that engendered these corporate abuses by passing the Corporate and Auditing Accountability, Responsibility, and Transparency Act, but given the 230 million dollar loss by the public employee pension fund in Ohio alone, further scrutiny of these particular business failures is necessary.

I would like to thank all the witnesses for joining us today and to extend a special welcome to a native of my congressional district, Ohio Attorney General Betty Montgomery. In January of 1995, Ms. Montgomery was sworn in as Ohio's first female Attorney General and saw her hard work on behalf of all Ohioans rewarded with her election to a second four-year term in November 1998.

A graduate of Bowling Green State University, soon to rejoin the Fifth Congressional District of Ohio and the University of Toledo College of Law, Attorney General Montgomery began her distinguished law career as a criminal clerk for the Lucas County Common Pleas Court. In 1980, she became assistant prosecuting attorney in Wood County, Ohio and expeditiously progressed, first to the post of Perrysburg city prosecutor and then Wood County prosecuting attorney, where she increased the felony conviction rate by 250 percent during her tenure.

In 1989, Attorney General Montgomery joined the Ohio Senate where her notable achievements in the areas of crime and law enforcement, such as the drafting of Ohio's

first living will law, Brownfields legislation and its Victim's Rights Law were complemented by her chairmanship of the Criminal Justice Subcommittee and service as Vice-Chair of the Senate Judiciary Committee and Ohio Criminal Sentencing Commission.

Throughout her career, Attorney General Montgomery has proven herself one of the great public servants in the state of Ohio dedicated to the protection of consumers and families. I look very forward to her testimony this morning, but wish it were under better circumstances.

**OPENING STATEMENT OF**
**RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON CORPORATE ACCOUNTING PRACTICES: IS THERE A CREDIBILITY GAAP?**

**WEDNESDAY, MAY 1, 2002**

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Mr. Chairman, we meet today to learn more about problems with corporate accounting practices. Although this matter has attracted considerable media attention in recent months, I have held serious reservations about the reliability of certain corporate accounting practices for some time. These problems could also have potentially serious and negative consequences for our country's flourishing capital markets. After all, if investors cannot trust the reliability of the numbers produced by corporate accountants in audited statements, then they might as well spend their hard-earned money on lottery tickets.

Because of my concerns, Mr. Chairman, I wrote to you last June -- well before the collapse of Enron -- about the techniques used by some corporations in order to meet their quarterly earnings estimates. In that letter, I urged you to convene hearings on the many accounting irregularities that contribute to the problem of earnings management. Included among these practices are the accounting treatment of derivatives, swaps, special purpose entities, goodwill, and stock options.

In my view, we should have also convened this hearing before considering the Corporate and Auditing Accountability, Responsibility, and Transparency Act on the floor of the House last week. Such a hearing would have helped us to develop a more comprehensive piece of legislation. Nevertheless, Mr. Chairman, I am pleased that you have called this hearing today. I believe that we must continue our efforts to guarantee that we maintain the vibrancy of our country's capital markets in the long term. Our work today will begin that process.

Our capital markets are the most successful in the world for one simple reason -- investor confidence. The transparency fostered by the application of the U.S. Generally Accepted Accounted Principles, or GAAP, has played an important role in this achievement. Unfortunately, the failure to implement GAAP consistently has now led to an almost daily discovery of accounting irregularities at American corporations. This evolving situation has also sparked a crisis of confidence that continues to ripple through our capital markets.

We have, however, known about these problems for some time. For example, research published in 2001 by Financial Executives International identified some startling facts. The study found 464 cases of earnings restatements in corporate America over a three-year period, more than the previous seven years combined. It also determined that 156 earnings restatements in 2000 wiped out more than $31 billion in market capitalization. I suspect that when we tabulate these figures for 2001, these two already sizable statistics will grow considerably.

In recent months, the Securities and Exchange Commission has also broadened the scope its inquiry beyond the accounting issues raised by the collapse of Enron to include a laundry list of other potential accounting abuses at some of the country's largest companies. In fact, during

the first quarter of 2002, the agency opened 64 new financial-reporting investigations, an increase of more than 100 percent over the cases begun during the same timeframe in 2001.

What factors contributed to this troubling state of affairs? In recent decades, the rules governing corporate accounting have become increasingly complex. Since the early 1990s, for example, the Financial Accounting Standards Board has developed several fair-value measurement, recognition, and disclosure standards. These standards often permit multiple interpretations. Accounting has also evolved from determining the cost of producing and the revenue from selling a good like a screwdriver, to ascertaining the cost and revenue from selling an intangible service like a 25-year energy derivative. These and other developments have helped to make corporate financial statements increasingly impenetrable and confusing.

From my perspective, an effective accounting system must ensure the comparability of financial data from one company to another. Comparability in the data used by investors will allow them to evaluate apples against apples, and oranges against oranges. Improvements in accounting transparency will also facilitate the efficient flow of capital.

Since we assumed jurisdiction over securities issues last year, investor protection and financial literacy have become top priorities for my work on this panel. Investors deserve to have timely financial reports that they can read and understand, instead of annually receiving a Byzantine, incomprehensible document dotted with countless footnotes. The collapse of the Internet bubble and the downfall of Enron have only heightened the skepticism of America's investors about corporate accounting practices. After our hearings to today, we need to work to change those attitudes by ensuring that our public companies return to the basics of accounting and avoid financial gymnastics in their future filings.

In closing, Mr. Chairman, I believe our Committee should comprehensively explore the issues related to corporate accounting practices. This hearing should also help us to alert investors about some of the key accounting issues that could affect their portfolios.

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# OPENING STATEMENT

## Corporate Accounting Practices: Is There Credibility GAAP?

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

5/1/02

**Rep. Stephanie Tubbs Jones**

Good Morning, Chairman Baker, Vice Chairman Ney, Ranking Member Kanjorski and Members of this Subcommittee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Since the collapse of Enron and Global Crossing, we in the Financial Services Committee have heard countless hours of testimony regarding accounting rules and regulations. We now understand how critical accounting standards are in keeping the capital markets efficient. We now know that millions of American investors rely on these standards in order to make decisions that will directly impact their financial well-being and decide the futures of generations to come. And we are now painfully aware of what happens when corporations learn how to manipulate and bend these accounting rules.

Today we will hear testimony from, among other people, Betty Montgomery who is the Attorney General from my home state - the great State of Ohio. In Ohio, investors from the Ohio Public Employees Retirement System and the State Teacher Retirement System lost a combined $115 million dollars as a direct result of the accounting improprieties of Global Crossing and Enron.

The State of Ohio is not alone in this debacle. Ms. Montgomery has had to resort to filing a class action lawsuit in conjunction with Attorneys General from the states of Georgia and Washington in order to act as co lead plaintiffs in what has become a nationwide lawsuit against Global Crossing and its accountant Arthur Andersen LLP. And why has it come to this? Part of the reason is because somewhere imbedded in the volumes of rules and regulations that have become GAAP, the original purpose of these rules has been lost.

It is usefull that we are exploring the impact, or lack thereof, of the GAAP rules and regulations with regard to presenting a standard format for corporations to use to present financial information. Moreover, I hope that this subcommittee, and the Financial Services Committee in full, will continue to explore and scrutinize the rules and regulations that might have allowed Enron to drive itself into the ground and take millions of dollars from hard working Americans with it.

Mr. Chairman, I thank you for my time.

**STATEMENT BY OHIO ATTORNEY GENERAL BETTY D. MONTGOMERY**
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES
WEDNESDAY, MAY 1, 2002

## I. Introduction

Mr. Chairman and members of the committee. I want to thank you for the opportunity to testify today regarding the impact on the state of Ohio of the collapse of Enron and Global Crossing. I want to applaud the members of this committee and the House as a whole for passing Congressman Oxley's legislation to reign in the fraudulent accounting measures that have already cost investors billions of dollars.

My goal in being here today is to continue to draw public scrutiny and encourage congressional pressure on the accounting practices that led to the collapse of these industry giants. The more public scrutiny we place on the scenarios that led to the debacles in Enron and Global Crossing, the less likely other companies will be to issue blatantly false and misleading financial statements. Playing fast and loose with accounting standards and financial figures is precisely the kind of activity that I thank this committee for investigating. It simply cannot be allowed to continue.

Currently, my office is seeking lead plaintiff status in the class action lawsuit filed against Global Crossing and its accountant, Arthur Andersen LLP ("Andersen"). As was the case with other state pension systems, Ohio was hit extremely hard when Global Crossing filed bankruptcy. Overall, two of Ohio's public employee pension funds lost more than $116 million after investing in the Company based on Global Crossing's fraudulent public financial statements. Ohio pension systems lost an additional $114 million from Enron's collapse. While our pension funds remain strong, the fraudulent financial practices of these two companies

certainly cannot be overlooked. What is more, it is incumbent on us – as public servants – to work diligently to ensure these kinds of fraudulent disasters do not happen again.

## II. Global Crossing – Background

Global Crossing was founded in March 1997, to provide telecommunications services in two principal segments: (1) the telecommunications services segment through its global fiber-optic network and; (2) the installation and maintenance services segment, which installed and maintained undersea fiber-optic cable systems. The Company operated throughout North, Central and South America and Europe, and provided services in Asia through its 58% owned subsidiary, Asia Global Crossing (a separately publicly traded company).

Global Crossing went public in August 1998 at $9.50/share increasing to $60 in just eight months. At its height, the Company's market capitalization was $24.68 billion. Today, it is close to zero.

Since before Global Crossing went public, its auditor had been Andersen. Andersen was renowned for auditing telecommunication companies. In addition to serving as Global Crossing's auditor, Andersen has provided consulting services to the Company. For the year 2000, Global Crossing allegedly paid Andersen $2.26 million for auditing services and nearly $12 million for consulting services.

Between 1997 and 2000, Global Crossing took on approximately $7.2 billion in debt to build 1.7 million miles of fiber-optic cable. With Internet use exploding, Global Crossing was intent on building a trans-Atlantic Internet protocol-based network. However, as other carriers began to enter the market and the economy declined, demand for telecommunication companies' capacity subsided leaving those companies, including Global Crossing, with insufficient revenue to pay the massive debt accumulated to build their costly networks.

Global Crossing regularly entered into agreements with other telecommunications companies to sell bandwidth capacity on their respective networks – agreements which typically last for 15, 20 or 25 years.

Global Crossing booked revenue from these transactions by recognizing **all** of the revenue up-front (in the same reporting period that the sale took place), but recorded the costs of providing the services as a capital expense spread over the life of the contracts rather than as an operating expense in the initial accounting period. Thus, the sales of bandwidth capacity provided an immediate boost to the Company's income statement.

In 1998, Global Crossing recorded $419 million of this revenue or 99% of its total revenues. In 1999, from January to June, Global Crossing reported $728 million of this revenue or 49% of its total revenues. This was a controversial practice, which drew scrutiny from the Financial Accounting Standards Board (FASB).

On February 10, 1999, with Global Crossing stock trading below $30/share, Andersen's 53-year-old lead auditor on the Global Crossing account, Joseph P. Perrone, co-wrote a memorandum outlining for Global Crossing's management a plan to give aggressive accounting treatment to so-called "swap agreements" that would allow Global Crossing to circumvent a ruling from FASB disapproving of the booking of revenues from the sale of bandwidth capacity in a lump sum. A swap is an exchange of network capacity between two companies. Perrone's idea was to use swaps to enable Global Crossing to record a significant gain on exchanges of capacity of equal value.

Perrone explained how Global Crossing could manipulate these exchanges so that they would be trading assets carried at historical cost on their books for assets that could be carried at fair value. In first quarter 2000, for example, Global Crossing reported $1.4 billion in gains from

asset sales on its Statement of Cash Flows even though the swaps caused **no cash gain**.

Global Crossing, which not only adopted Perrone's proposal, but also handsomely rewarded him with the plush position of executive vice president of finance, failed to disclose its accounting maneuvers to the investing public. Moreover, Global Crossing eventually entered into swaps with **no business purpose** solely to inflate its financial results. For example, in the spring of 2001, EPIK Communications, Inc., an Orlando, Fl-based company, paid $40 million for the right to divert some of its telephone and data traffic through Global Crossing's Latin American fiber routes. Global Crossing offset that payment by spending $40 million for an unspecified future use of EPIK's facilities. Global Crossing engineers never found any use for EPIK's facilities. Nevertheless, Global Crossing recorded the purchase from EPIK as a capital expenditure while booking the sale to EPIK as immediate revenue. This is only one of many examples.

According to Roy Olofson, a former Vice President of Finance for Global Crossing, the Company routinely entered into deals in which Global Crossing exchanged network capacity for identical or unnecessary routes without exchanging any cash for the purpose of generating paper revenues, cash flow, and earnings. Other former employees have confirmed that Global Crossing entered into swap agreements and that knowledge of the transactions and improper revenue recognition reached the highest levels. According to a former Global Crossing employee whom we have interviewed as part of our own investigation, Dan Cohrs, the Company's CFO, Joseph Perrone, the executive vice-president of finance, and John Scanlon, a former vice chairman and CEO of Asia Global Crossing, were fully aware that swap transactions were occurring and being booked on the last day of each quarter.

Another former Global Crossing employee with whom we have spoken admitted that

when the demand for network capacity slowed in 1999, telecom companies, including Global Crossing, engaged in swaps to "hide the fact that there really wasn't a demand." The employee illustrated one example where Lucent Technologies "accidentally" wired a payment to the Global Crossing's Beverly Hills office on the last day of the first quarter of 2000 instead of to Global Crossing's Bermuda office. The amount Lucent sent to Beverly Hills exactly matched an amount that the Beverly Hills office had just sent to Lucent. It was this kind of merry-go-round money transfer that created the problems we are faced with today.

Analysts were led to believe that Global Crossing was no longer permitted to book all of the cash as it was received, but instead was now required to prorate the cash in its income statement over a period of time-typically 20-25 years. Global Crossing's first quarter 2001 press release was typical. It touted "cash revenue" of $1.6 billion, and adjusted Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) of $441 million. Analysts such as Merrill Lynch, lauded Global Crossing's ability to make its numbers. Global Crossing's stock price then increased from $13 to $16.

Eventually, the level of the swap agreements rose to such a material level that Global Crossing had to disclose the transactions. However, these disclosures were themselves misleading. In an August 1, 2001, press release announcing financial results for the second quarter of 2001 and in its quarterly report filed on August 14, 2001, Global Crossing disclosed:

> During the quarter, Global Crossing entered into several agreements with various carrier customers for the purchase or lease of capacity and co-location space. These 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.

These obscure and misleading disclosures and other similar disclosures in no way explained the way these swaps were contributing to the Company's reported numbers. In no way would investors looking at this disclosure know that there was no business purpose for Global Crossing to acquire this capacity, that the Company was merely exchanging equal amounts of capacity or cash and recording that cash as revenue, that the Company was entering into these transactions a day or few days before the end of the reporting period, and that the Company was claiming significant gains on the transactions.

Luckily, there was a whistleblower in this case. In May 2001, after taking a 5-month leave of absence to battle lung cancer, Olofson, the 62-year-old former Vice President of Finance who had been employed at Global Crossing for almost 4 years, voiced his concerns to Perrone, Global Crossing's executive vice president of finance, about the accounting practices. To Olofson, it seemed as if Global Crossing was entering into last minute swap transactions with no business purpose merely to manipulate its financial results.

When Perrone failed to take action, Olofson sent a 5-page letter to Global Crossing's chief ethics officer and general counsel, James Gorton, on August 6, 2001. Olofson requested that Gorton investigate the propriety of the Company's accounting methods and charged that Global Crossing was engaged in deceptive accounting practices.

In response to Olofson's letter, Global Crossing directed its outside counsel, Simpson Thatcher & Bartlett, to conduct an investigation. According to Olofson, he was never contacted about his claims during that investigation. Olofson was eventually fired in December 2001. In February 2002, Olofson's letter became public. Global Crossing discounted Olofson's claims as unfounded allegations from a disgruntled former employee.

On October 4, 2001, Global Crossing announced that cash revenues in the third quarter would be approximately $1.2 billion, $400 million less than the $1.6 billion expected by analysts and forecast several times earlier in the year by the company. In addition, Global Crossing stated that it expected recurring adjusted EBITDA to be "significantly less than $100 million" compared to forecasts of $400 million made several times earlier in the year.

The Company also reported that the Company's CEO, Thomas J. Casey (the fourth CEO in as many years), was being replaced and that Global Crossing was in preliminary talks to merge its affiliate, Asia Global Crossing, in an effort to attain operating cost savings of $15

million to $25 million annually. Following these announcements, Global Crossing's share price plummeted nearly 50% to $1.07/share on extremely heavy trading.

On January 28, 2002, Global Crossing and its affiliates (not including Asia Global Crossing) filed voluntary petitions for bankruptcy in the United States Bankruptcy Court in New York. The SEC, FBI and United States Attorney's Office commenced investigations into the Company's accounting practices. Global Crossing also created a special committee and hired an independent auditor, other than Andersen, to review the accounting matters being investigated by the SEC.

Delisted from the New York Stock Exchange after having declared bankruptcy, Global Crossing shares fell from a high of $64.25 as low as $0.125 in over-the-counter trading.

In February 2002, Olofson filed a lawsuit in the Central District of California against certain current and former Global Crossing executives. In the complaint, Olofson detailed the alleged securities fraud that took place at Global Crossing.

## III. Conclusion

It is clear from the facts that Global Crossing's executives, auditors, and financial planners undertook scheme after scheme to alter public profits and financial statements to make the Company look lucrative to investors. Investors took the bait and poured billions into what they thought was a strong company with long-term investment advantages. As was the case with Enron, investors were victimized by these fraudulent tactics. Enron was not an isolated incident. Investors, both public and private, deserve accurate, honest information so they can make sound financial decisions for themselves and their families. Even expert investors, such as those working for public pension funds, cannot make good choices when the financial information provided is less than truthful. If the market can't trust financial information validated by

supposedly independent corporate auditing firms, our free market system of trade is in grave danger.

Thank you, Chairman Baker, Congressman Kanjorski, and members of the committee. I applaud the House for its passage of Congressman Oxley's bill, and I am eager to cooperate with this committee on any future legislative proposals that protect investors from fraud and ensure that truthful financial information is being transmitted to the marketplace. I would be happy to answer any questions you may have.

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**TESTIMONY OF**

**WILLIAM W. HOLDER**
**ERNST AND YOUNG, LLP PROFESSOR OF ACCOUNTING**
**DIRECTOR, SEC AND FINANCIAL REPORTING INSTITUTE**
**UNIVERSITY OF SOUTHERN CALIFORNIA**[1]

# CORPORATE ACCOUNTING PRACTICES

**Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises**

**Committee on Financial Services**

**May 1, 2002**

Chairman Baker and Members of the Subcommittee:

I am pleased to appear before you to testify about corporate accounting practices of significance to our capital markets. As the Subcommittee has requested, my testimony will be based on publicly available information and will address: 1) the use of questionable accounting methods and the degree of management discretion involved in reporting results of operations that have led to financial statement restatements and 2) "the circumstances surrounding reports of accounting problems at the following companies: Xerox, Adelphia, Dynegy, AOL, and WorldCom and whether the problems at these companies are further reflected in other publicly traded companies."

## Inherent Attributes of the Financial Reporting System

Our system of financial reporting, which supports the functioning of our capital markets, has developed over a relatively long period of time. Like other complex systems, financial reporting has been developed with certain expectations, capabilities, limitations and extant conditions in mind. That system has served us exceptionally well for many years but, like many such systems, what has been historically exceptional may require substantial improvement to continue to fulfill its responsibilities. Several aspects of our financial reporting system are being challenged by change, particularly in the business

[1] I also currently serve as a member (part time) of the Governmental Accounting Standards Board.

environment. The financial reporting problems of several companies that you have identified provide examples of many of these changes and related challenges for the system of financial reporting.

Selected Financial Reporting Cases

My analysis is based on information that is publicly available and, as such, is thereby limited. Notwithstanding this limitation, however, the available information about financial reporting problems at these companies illustrates well a number of related aspects of our financial reporting system that should be strengthened.

AOL Time Warner Inc. I understand that this company recently wrote down intangible assets that resulted from acquisitions that did not prove to be as successful as anticipated. The need to write down those assets was generally brought about through the recent promulgation of Statement of Financial Accounting Standards (FAS) No.142, "Goodwill and Other Intangible Assets" by the Financial Accounting Standards Board (FASB). I also understand that the company has acknowledged that a special purpose entity with which it is related has approximately $2 billion of debt not reflected on its own balance sheet. These circumstances illustrate the effect that new accounting standards can have on financial statements, the subjective nature of many accounting determinations and how the manner in which a company's management decides to structure and operate a company can affect the financial reporting of its transactions and business activities.

Dynegy Inc. I understand that Dynegy entered into certain derivative contracts that were accounted for in accordance with FAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." That standard requires such contracts to be valued at their fair values for financial reporting purposes. Estimating the fair value of such contracts frequently involves the use of relatively sophisticated modeling techniques and the use of a number of specific but necessarily subjective assumptions. Because of the inherent uncertainties involved in developing these assumptions, estimates of the fair value of such instruments requires complex and subjective judgments and the resulting amounts may vary substantially. The increased estimated fair values of the contracts boosted the company's income; however, they did not directly and simultaneously contribute to the company's operating cash flows. According to published accounts, the company developed a device (Project Alpha) involving a borrowing plan providing income tax benefits that also allowed the company to report additional cash flows from operating activities. This circumstance illustrates both inherent uncertainties involved in financial reporting as well as management's ability to design transactions and programs that accomplish financial reporting goals as well as other management objectives.

WorldCom, Inc. I understand that certain accounting and financial reporting practices of WorldCom have been characterized as aggressive. Specific aspects of those practices have been characterized as "pushing the envelope" by capitalizing certain costs as assets that may have been more appropriately reported as expenses. Practices such as those characterized in the press are illustrative of the inherent subjectivity of many accounting decisions and the related necessary professional judgments that are common in financial

reporting. Those same articles also indicate the belief that WorldCom is expected to write down goodwill in much the same fashion as that described in the discussion of AOL Time Warner.

Adelphia Communications Corp. I understand that an important issue for this company is the appropriate treatment of certain borrowings by its owners. The Rigas family's interest in Adelphia is reported to approximate "a 23% economic stake, majority voting control, five board seats on the nine member board and four top executive positions, including chairman, chief executive and chief financial officer." I understand that the loans to the Rigas are guaranteed by Adelphia. A portion of the proceeds of that debt was used to acquire Adelphia stock. An important financial reporting question relates to whether the debt of the owners should be reported as the debt of Adelphia. This circumstance illustrates some of the judgments that are necessary about such fundamental issues as whether a company has incurred a liability.

Xerox Corp. I understand that the financial reporting problems of Xerox involved accounting for agreements that called for Xerox to lease equipment and to provide related goods and services to their customers. I understand that inappropriate allocations of the overall contractual consideration for these various goods and services were made to the equipment lease portions of those contracts. In such a fashion, gross profit on the sales type leases was inappropriately recognized at the beginning of the agreements. While FAS No. 13, "Accounting for Leases", as amended and interpreted, provides much valuable guidance on lease accounting, the need for professional judgment in applying its provisions is apparent. I further understand that Xerox changed certain aspects of its employee benefit program and "systematically and improperly" recognized the effects of that change over a number of periods rather than recognizing the effects of the change in earnings immediately.

Aspects of Financial Reporting

The examples described above illustrate that financial reporting requires many subjective determinations and seasoned judgments. Those that are generally unfamiliar with the detailed aspects of preparing financial statements are sometimes surprised at the inherent ambiguity and subjectivity of that process. Although financial statements convey the appearance of great precision, many significant amounts contained therein are inherently imprecise and require complex professional judgments. This inherent subjectivity provides opportunities for bias to intrude on the financial reporting process. For example, much significant financial information contained in financial statements is the product of estimates of future events. Further, management has the ability to structure transactions and events in such a manner that, while achieving important operating objectives, are reported in the company's financial statements in the manner desired by management. Increasingly complex business transactions (e.g., complex business relationships and contractual features) and events (e.g., the rise of intellectual and other intangible things of value) can result in similarly situated professionals reasonably disagreeing about how the economic effects of those events should be reported in financial statements. Accounting judgments and practices must sometimes be made in the

absence of professional standards which often naturally lag behind the development of transactions they are designed to address. Differing, but good-faith, interpretations of existing accounting standards can also result from this process. The importance of and need for objectivity and independence in the financial reporting process are thereby self evident. Another result of these inherent aspects of financial reporting is the opportunity for abuse.

Historically, the assets of many business enterprises have been represented by their physical productive capacity (e.g., plant and equipment). Relatively recently, however, the most valuable assets of many business have become knowledge, intellectual capacity and other intangibles such as information about consumer characteristics and behavior. Distinguishing between expenditures that should be accounted for as the acquisition of reportable assets and expenditures that, while perhaps providing future benefits, do not result in the acquisition of reportable assets has become much more subjective and nuanced. For example, the WorldCom matter to which I previously referred illustrates this very decision and the related questions that can arise. Accountants, however, must decide: does this cost represent the acquisition of an asset to be charged to expense in future periods or does it represent the incurrence of an immediate expense? It is not sufficient, in my view, to adopt some simplistic approach such as an unbending obedience to "conservatism" and charge all expenditures about which there is any doubt of realization to expense immediately as a reduction of earnings. To do so would violate the important concept of "neutrality": that is, the obligation of the accountant to "call it as he or she sees it". Systemic conservatism introduces bias into the information provided to the securities market and, generally, unbiased information is considered to be of greater value. Thus neutrality is an important conceptual feature of financial reporting.

Nevertheless, the accountant is not provided meaningful reporting tools of nuance. The accountant lives in a multimodal world (one containing much ambiguity and subjectivity) but must generally communicate through a bi-modal reporting model e.g., every expenditure (other than debt repayment and capital transactions) results in either an immediate expense or the acquisition of an asset. The financial reporting system currently in place needs much study and improvement to address these realities with which contemporary accountants must deal.

Financial reporting has assumed great significance in our economy. The research literature of the accounting profession has established that accounting information matters. That is, accounting information affects security prices and, as such, is relevant to investment and credit decisions. Recent evidence confirms that certain accounting information can have a counter-intuitively great influence on security prices. For example, the failure to meet quarterly earnings per share expectations by a relatively small amount (e.g., one cent) can result in a significant diminution of shareholder value (e.g., 15% reduction in price per share). If management perceives financial accounting numbers to be of such significance, then it is reasonable to expect them to exercise the inherent discretion provided by the financial reporting system to "manage" the amounts they report. Within reasonable constraints, such conduct is not unreasonable or even questionable. Managements' perception of the importance of accounting information,

however, may put additional pressure on the system of financial reporting that has, heretofore, been attenuated.

In my view, it is these factors, many of which are an inescapable feature of relevant financial reporting, that provide managers of business enterprises the discretion to measure the effects of transactions and events in ways that serve their interests (i.e., earnings management) within the confines of generally accepted accounting principles (GAAP). Such discretion, within limits, is an unremarkable and abiding feature of financial reporting. That is not to say, however, that management discretion cannot be abused or that financial reports cannot be misstated and, in extreme cases, misleading. Clearly, they can be. Indeed, as pressure increases on managers to achieve earnings and other financial goals, the motivation to bias information presented in financial statements increases. Many of the elements of our financial reporting system are, in my view, designed, in significant part, to limit such discretion. Financial reporting standards, the auditing function, the regulatory structure and the system of corporate governance put in place each should contribute to attaining this goal. As such, each of these functions represents an important element of maintaining a financial reporting system of the highest quality.

Financial Statement Audits

Financial statement audits are considered an essential feature of providing reliable financial information to our capital markets. The changes I have just described combined with other factors have influenced the structure, practice and responsibilities of professional auditing firms.

The public practice of professional accountancy has changed considerably in the last several decades. Firms that had traditionally confined most of their work to financial statement audits[2] or tax advice and return preparation became recognized as repositories of great and valuable business knowledge. Substantial consulting opportunities were presented to those firms and they broadened the range of services they offered. They eventually evolved into professional service firms providing a host of additional services. As a result of this phenomenon the financial statement audit function in those firms diminished in terms of revenues generated from other services offered. Ethical and regulatory requirements did not prohibit or significantly limit such activities. There is no conclusive empirical evidence demonstrating that diminutions of independence and objectivity result from the provision of consulting services. In fact some studies find evidence consistent with the belief that such associations are not present.[3] Nevertheless, substantial controversy now exists about the appropriate role of financial statement

[2] The financial statement audit itself can be viewed as encompassing consulting elements. For example, significant deficiencies in internal accounting controls noted in a financial statement audit must be communicated to the company's board of directors or audit committee. While the auditor need not also identify cures for those deficiencies, I do not believe doing so is inconsistent with the need for independence and objectivity.

[3] The resulting empirical evidence from such research is certainly not conclusive nor is there an extensive body of such work.

auditors. Suggestions have been made to eliminate the ability of financial statement auditors to provide any services to an audit client other than the financial statement audit. Many observers have expressed the belief that consulting fees received by firms of financial statement auditors have an adverse effect on auditor independence and objectivity. They assert that auditors whose firms also receive substantial consulting fees from audit clients are too willing to compromise with their clients. Such conduct, they contend, diminishes the effectiveness of financial statement audits.

Financial statement audits differ from other types of audits or investigations. Financial statement auditors possess neither the power to subpoena records nor to take sworn testimony of company management. Thus, the ability of the auditor to investigate aggressively and to do so in a fashion that permits timely filings with regulatory authorities (e.g., the SEC) is not as great as the power and time involved in many ex post governmental audits and investigations (e.g., SEC proceedings and IRS audits). While I am not suggesting that it would be desirable to arm financial statement auditors with such powers. It would take far too long to "audit" financial statements in such a mode – the information would almost certainly become too stale to be relevant before it was audited and reached the market. The fact remains that an auditor's ability to compel the production of evidence and to identify and investigate inconsistencies in representations of those primarily responsible for financial statements is less than in other venues.

Finally, a distinction that is rather technical but nevertheless of considerable importance relates to the auditor's only limited ability or authority to require financial statement audit clients to adopt superior accounting principles. The financial statements are the responsibility of the management of a company. The auditor also has substantial responsibility for the financial statements subjected to an audit. Specifically, the auditor is responsible for planning and conducting the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[4] The auditor is charged generally with conducting the audit in accordance with generally accepted auditing standards (GAAS) and to express a professional opinion on whether the financials statements subject to that audit are 'presented fairly … in conformity the generally accepted accounting principles". Thus the auditor's responsibility is generally confined to assessing whether the accounting principles used by the client are generally accepted, appropriate in the circumstances and meet certain other criteria in the authoritative literature. These requirements, in my view, generally require that the auditor consider the substance of transactions in considering whether the financial statements may be materially misstated. The inherent subjectivity of many decisions, however, precludes a singular interpretation of the substance of many transactions. The auditor cannot insist, on pain of a qualified or adverse opinion, that the client use accounting principles that the auditor considers preferable as long as those used by the client are generally acceptable in the circumstances and meet other criteria. This has led on occasion to the alleged use of "least common denominator accounting principles. The collective effect of these factors suggests to me that substantial changes in the role, responsibility and authority of the financial statement auditor are appropriate to consider.

[4] U.S. Auditing Standards, AU Sec. 110.02.

Standard Setting and Regulation

Accounting standard setters (e.g., the FASB) and regulators (e.g., the SEC) have worked diligently, and for the most part successfully, to address significant financial reporting issues. It is clear, however, that steps to improve financial reporting should be taken, that the need to improve this system is urgent and that improvements are possible throughout the entire financial reporting system. The Financial Accounting Foundation (FAF), the organization that oversees the FASB, has recently taken a number of actions to change the structure and process of standard setting. Additional steps may also be desirable.

Over a considerable period of time the accounting standard setting function has evolved from a part-time endeavor involving the volunteer efforts of concerned professionals to today's full-time FASB that is subject to oversight responsibility and authority of the SEC. From this historical perspective and given the increasingly complex business environment, there is nothing remarkable about the need to reconsider the structure and adequacy of resources devoted to the accounting standard setting process. Today, for example, there are a number of other accounting standard setting organizations at work. For example, the Emerging Issues Task Force of the FASB, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) and the SEC each develop authoritative accounting literature that guides professional accountants. While these organizations generally communicate and work well with each other, certain inefficiencies may be present that unnecessarily delay the timely development of accounting standards.

The FASB is bound to follow extensive due process procedures in the standard setting process. While due process is an essential feature of the standard process, there may be inefficiencies in that process that can be mitigated without diminishing the quality of the resulting standards.

The FAF has the major responsibility for raising funds to support the operations of the FASB. Further, many of the resources available to the FASB come from voluntary contributions provided by stakeholders in the financial reporting process. Because many of the accounting issues with which the FASB must deal are controversial disagreements over proposed new accounting standards between the FASB and organizations that contribute to its support are not uncommon. Such relationships may cause dysfunctional consequences in the standard setting process.

The FASB does not have a role in enforcing compliance with its standards although other organizations do have enforcement responsibilities. The relatively large number of organizations that are concerned with practitioner compliance with FASB and other accounting standards include individual state boards of accountancy, the SEC, the peer review process and the AICPA ethics function. Again, greater efficiencies may be possible in this area.

**Pathways to Improving the Financial Reporting System**

As I previously discussed, systems are generally established with certain capabilities and environmental features in mind. Over time, systems require modification and improvement. In my view it is desirable to modify the structure of and increase the resources devoted to the financial reporting system at this time.

Financial Statement Preparation

In my view and regardless of any improvements in the standard setting process, management discretion will remain a significant attribute of financial reporting. Such latitude is an inherent and inescapable part of financial reporting if the relevance of the information provided is to be sustained. Accordingly, any enduring improvement to the financial reporting system must address the issue of opportunities for excessive management bias in preparing financial reports. Management should not be inappropriately limited, however, in interpreting and communicating the results of economic activity in financial reports. The appropriate goal, I believe, should be to thwart excessive or abusive bias. Perhaps the best mechanism to accomplish this goal lies in two areas: effective corporate governance[5] and external financial statement auditing.

Corporate Governance

In my view, strengthening the system of corporate governance is one of the most important steps that can be taken to improve our system of financial reporting. I understand that recent legislation addresses this, as well as other, crucial issues.

Improved corporate governance can be accomplished by requiring the development of more effective corporate boards of directors and audit committees. For example, requiring that a number of board members in general and audit committee members in particular remain **independent** of the company and to possess finance and financial reporting skills should lead to more effective oversight of the financial reporting process. Assigning specific responsibilities to audit committees to more closely oversee the financial reporting process, interact more closely and cooperatively with external and internal auditors and to have the sole authority to retain and discharge the external auditor, the internal auditor and, perhaps, the chief financial reporting officer, could also serve to diminish the potential for excessive bias in financial reporting. The accounting profession has advocated for some time strengthening the role and function of corporate audit committees. It is my belief that strengthening the system of corporate governance is an essential feature of any initiative to substantially improve our financial reporting system.

Auditing

[5] I am aware of the recent action on HR 3763 and believe that it will lead to many needed improvements in the system of financial reporting. Nevertheless, I am compelled to recognize the need for reform as well as the progress that is taking place through your efforts.

The role of the independent financial statement auditor has historically been viewed as essential to the provision of relevant reliable financial statements. If steps are to be taken to strengthen the hand of the auditor in dealing with management a number of possibilities are evident. As previously suggested, one way to address such a need would be to strengthen the system of corporate governance. Doing so would also have the salutary effect of providing more muscular oversight of management conduct in the original preparation of financial statements. Some steps have recently been taken in that direction. For example, the financial statement auditor is now charged with discussing "with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting."[6] Much more could be done. For example, the auditor could be charged with providing such information through the audit report as well. Further, more effective practice monitoring and the potential for effective disciplinary action, such as that contained in HR3763, could result in more timely improvements in audit quality.

Standard Setting and Regulation

The fact that the accounting profession is now governed by a relatively large number of distinct organizations may result in a less than optimal standard setting and regulatory structure. While the standard and regulatory functions are performed by well motivated and capable individuals, changes in that structure to harmonize and coordinate those functions may be desirable. The Public Regulatory Organization (PRO) called for in HR3763 is a logical step toward enhancing the enforcement of existing standards and should provide significant improvements in the performance of that function. In general, a good model would retain the substantial benefits of private sector standard setting while enhancing oversight and regulation. Greater strength seems particularly needed in the areas of practice monitoring, deterrence and corrective action. In addition, several other, more specific, measures could potentially increase the effectiveness of the accounting standard setting process. I suggest three general actions related to accounting standard setting that could result in such improvements.

First, the FASB currently possesses excellent attributes of an effective standard setting organization. For example, to assure independence, it requires that its members separate themselves from previous professional relationships and refrain from commercial involvement in financial reporting endeavors. The FASB also enjoys an excellent and effective staff. Its board members command the respect of the general business community. Notwithstanding these attributes, however, its processes could be streamlined and made more efficient so that standards can be more responsive to changes in business activities and practices. More timely standards can provide needed guidance and reduce acceptable alternative accounting practices for similar transactions and events in a more timely fashion. Second, different approaches to the development and nature of resulting accounting standards may serve to improve financial reporting by diminishing the extent of management discretion available in their application. Just last week the FAF announced a number of specific steps that are being taken which are responsive to these two suggestions. Third, greater independence in funding for the FASB could also

[6] U.S. Auditing Standards, AU Section 380.11.

yield desirable results by further insulating the standard setting process from inappropriate pressure.

Finally, I offer one additional observation. A proposal has been made that financial reporting could be improved if accounting standards became more conceptual and principle-based than is now the case. Some critics contend that current accounting standards are too rule oriented and observe that financial statement preparers are able to structure business activities in ways that are designed to technically comply with those rules while failing to honor the substance of the transactions and events in their financial statements. If, in an unacceptable number of instances, preparers are indeed able to thwart the intent of detailed standards, such individuals surely will be able to do so to an even greater degree if those standards become more general and less specific unless other accompanying changes are made in the structure of our financial reporting system. That is, simply changing the nature of standards to make them more general without also changing other crucial features of the financial reporting system will not, in my view, serve to improve financial reporting. Those who prepare and those who audit financial statements also need clear, complete and unequivocal professional standards to guide their work. Professional accountants deserve such guidance so that they can practice with the confidence that their work is acceptable and conforms to norms of expected conduct.

**Concluding Remarks**

The process of improving the performance of the accounting profession, while recognizing that the great preponderance of practitioners today adhere to the spirit and letter of professional standards and concepts, should, in my view, generally be one of positive enhancement rather than punitive measures. This is certainly not to say that those who mislead others in the operation of our capital markets should not be punished. Clearly they should be and, in my view, such punishments should be severe. The harm such conduct causes to the trust on which our capital markets depend has great adverse consequences for our economy.

Those who are responsible for interpreting and applying accounting and financial reporting standards and regulations must not perceive themselves as the adversaries of those charged with setting the standards and enforcing them. This means that professional accountants should be viewed as interested and participating stakeholders in improving the process of providing relevant and reliable information to our capital markets. Finally, the accounting profession should be structured so that it continues to be an attractive career opportunity to individuals with great intellectual capacity, lofty ambitions, and high ethical standards. To do less relegates this essential profession to diminished capacity – to the detriment of us all. Thank you for your attention. I will be pleased to answer any questions that you may have.

Statement of Charles L. Hill, CFA
Director of Research, Thomson Financial/First Call
U.S. House of Representatives
Subcommittee on Capital Markets, et al
Examination of Recent Reports of Accounting Problems
1 May 2002

Good Morning Chairman Baker, Ranking Member Kanjorski, and members of the House Subcommittee on Capital Markets, et al.

Thank you for again giving me the opportunity to testify in front of this committee. I am particularly glad to do so because I believe this committee (on both sides of the aisle) and its staff have taken the time to do their homework and understand the problems. This committee's early involvement got the ball rolling, thereby either stimulating others to get involved, or in some cases forcing their had to get involved.

I also believe this committee is truly trying to reach a solution that is for the good of all concerned, and, therefore, I am glad to try to help in any way I can. The outcome is important not only to restoring investor confidence in the system, but is important to maintaining the general public's confidence in the capitalist system.

My goal today is to examine why the system got to this sorry state and what needs to be done to right the ship.

But why were the abuses greater this time? Three reasons stand out:

1. Huge management compensation incentives.
2. Bigger and longer bubble during the last economic expansion.
3. Increasing dependence of analyst compensation on investment banking.

First, and foremost in our judgment, is that management compensation at public companies has become increasingly dependent on the relatively short term performance of the companies earnings and/or stock performance (earnings results of course are one of the prime determinants of stock prices). The potential compensation if certain milestones were met, and often the compensation realized, skyrocketed in the late 1990's to previously unheard of heights.

Their was so much at stake that the incentive to push the envelope on accounting or on the "adjusted" earnings cited in the earnings releases was huge. Apparently, some managers succumbed to temptation.

In general, the abuses can be divided into those generated by cyclical factors and those generated by secular factors.

Even without the increased monetary incentives for management, the business cycle would have fostered a number of abuses similar to what happened in previous cycles. But in the 1990's the level of abuses was exaggerated by both the increased incentives for management and by the fact that the bubble created during the last cycle was bigger and longer than in earlier cycles.

Therefore, it should come as no surprise that the abuses in accounting and in earnings releases were far more egregious in the just ended cycle than in recent cycles. That the poster child this time is a company as big as Enron and one who committed so many serious abuses should be no surprise.

The cyclical problems are the excesses that creep into the system at the frothy part of the business cyclical when investors tend to be careless and overlook the warning signs that companies are pushing the envelope on accounting rules and earnings releases. The excesses become even more excessive when the economy begins to slow. Companies push even harder in order to keep up the appearances of continuing good earnings growth.

The inevitable market correction tends to correct most of the abuses of this type. The investor backlash causes companies to modify their behavior for the good, and investor confidence returns until the next market correction reminds investors that they again let their vigilance slip and that company managements had again misbehaved. The corrective behavior process starts all over again.

Sometimes some tightening up of the accounting rules or other regulations is necessary each cycle to close some of the loopholes that emerged in the last cycle as a clever way to inflate earnings.

Several obvious (but in some cases not obvious until after the bubble broke) loopholes that became newly fashionable in the last cycle included special purpose entities (SPE's) to hide debt off the balance sheet, a more liberal use of stock options to reduce employee compensation on the income statement, indefeasible rights of use (IRU's) swaps to inflate revenues, and heavy use of derivatives that resulted in reduced transparency.

Among the old favorites that blossomed again in the last cycle were the changing of pension fund assumptions to inflate or to smooth earnings, and stretching the accounting rules on revenue recognition to inflate current revenues by including those that would not be unequivocally consummated until a later period.

Another abuse created by the increased management compensation incentives was one that was more of a secular issue and not just an extension of prior cyclical abuses. That abuse is the pressure put on brokerage analysts to help inflate the perceived earnings.

Analyst routinely adjust a companies GAAP earnings (the earnings required to be reported to the SEC using Generally Accepted Accounting Principles as enumerated by the Financial Accounting Standards Board) to exclude items the analysts consider non-recurring or non-operating. Companies often would provide earnings in their quarterly earnings releases that were adjusted to a basis of the company's choosing.

There was a cyclical nature to this problem in that the company pushed the envelope on what they considered non-operating or non-operating and therefore, excludable from GAAP earnings. For example, costs for layoffs and plant shutdowns triggered by the slow economy became a restructuring charge.

The new twist in the 1990's was that the companies pressured analysts to go along with the company basis for adjusting earnings, even when the exclusions ran counter to common practice. Some companies also pressured analysts to maintain favorable recommendations on the company's stock.

Aiding management in achieving this was that an increasing part, in many cases the majority part, of analyst compensation was coming from the investment banking side of the analyst's firm. Therefore, in addition to the threat of cutting off analyst communication with the company, companies could use the lure of investment banking business to have additional pressure put on the analysts by the investment banking arm of the analyst's firm.

Even more damning then what happened in the late 1990's, is that the companies still do not seem to get it. Investors had hoped that the actions of Enron and other abusers of the system would have led companies to bend over backwards to do the right thing in accounting for their earnings and in presenting them to the public. Yet some companies continue to abuse the system.

Companies are still providing "pro forma" or adjusted earnings that continue to be on highly questionable footing. Even some companies that announced in January that they would no longer be reporting "pro forma earnings" welched on their promise and continued to report them in their 1Q02 releases.

The new accounting change, FASB 142, that eliminated the amortization of goodwill, requires that companies include pro forma results for any prior periods cited in their 10Q and 10K filings that restate the prior period earnings as if FASB 142 had been implemented before the start of those periods. Yet no pro forma 1Q01 results were included in the 1Q02 earnings releases of many companies, and some said when called that they would not provide them until the 10Q was filed.

One company that had provided a pro forma result for 1Q01 for the accounting change when they reported 1Q01 results (even though FASB 142 had not yet been issued) chose not to report a 1Q01 pro forma number when

they reported 1Q02 results. Doing so in the 1Q01 release made 1Q01 earnings growth look better, but doing so in the 1Q02 release would have made 1Q02 earnings growth look worse. Therefore, no surprise in why they conveniently forgot this year.

Another company that omitted the pro forma 1Q01 number, showed an earnings increase by doing so, but if the 1Q02 results had been compared to the pro forma 1Q01 earnings, their earnings were down by one cent, yet the company and the analysts reports only discussed earnings as being up.

The net result of this abuse is that it is misleading investors by inflating the apparent 1Q02 earnings growth for many companies. Unless this practice is changed, it likely will be repeated in the next three quarterly reporting periods.

Despite some companies last year raising the assumed returns on their pension fund investments in a year when the market was down, we are not aware of any reducing their assumptions so far for this year. And in the face of growing opposition to the current accounting rules on options, companies continue to announce re-pricing of options.

Because the cyclical abuses were greater this time, because the analyst conflict issue is a new one, and because some companies still do not get it, it follows that the remedies for this cycle may have to be more severe and more far reaching than those in prior cycles.

# Ullico And Global Crossing: The Tip of the Union Pension Fund Scandal Iceberg

Testimony Before the
Subcommittee on Capital Markets, Insurance
and Government-Sponsored Enterprises
of the
Committee on Financial Services
U.S. House of Representatives

May 1, 2002

Presented By:
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Mr. Chairman and Members of the Subcommittee, thank you for this opportunity to testify.

My name is Ken Boehm and I serve as Chairman of the National Legal and Policy Center (NLPC). My legal center sponsors the Organized Labor Accountability Project which publishes *Union Corruption Update*, a fortnightly newsletter summarizing union corruption news and legal cases. Our database of union corruption case information is available on the web at **www.nlpc.org** and is used by the public, media, elected officials and union members as an authoritative archive of union corruption cases.

The Global Crossing bankruptcy, the fourth largest in U.S. history, has cost investors billions, resulted in over 9,000 people losing their jobs and has set in motion a federal investigation as to questionable accounting practices.

The Ullico Insider Stock Scandals

As a result of a series of recent articles in *Business Week* and *The Wall Street Journal,* a whole new controversy linked to Global Crossing has arisen. The focus is on Ullico, a privately held insurance company which is owned largely by unions and their pension funds. It was an early major investor in Global Crossing and its directors used the telecom's volatile stock price history to personally enrich themselves at the expense of the union members and retirees whose pension funds own Ullico. Its board of directors is mostly made up of current or former union presidents and includes AFL-CIO head John Sweeney.

The multi-billion dollar Ullico was one of the original investors in Global Crossing, providing $7.6 million to the company in seed money. Global Crossing chairman Gary Winnick was pleased to get the early money and allowed Ullico directors the opportunity to personally buy the Global Crossing stock at IPO prices. This sweetheart stock investment deal allowed some Ullico directors to make millions off the sale of the stock according to labor officials. ("Global Crossing: Labor's Questionable Windfall," by Aaron Bernstein, *Business Week*, March 14, 2002) The fact that Gary Winnick offered such a lucrative deal to Ullico directors has raised questions as to the integrity of Ullico's investment decision making with respect to Global Crossing as well as with other Ullico investments of pension funds into deals associated with Winnick during the same time period.

Ullico's directors also benefitted personally from an arrangement set up in 1997, the same year Ullico made its original investment in Global Crossing, which allowed Ullico to repurchase its stock from shareholders. Departing from a practice of giving Ullico's stock a fixed value of $25 a share, Ullico began changing its share price annually according to a value determined by an accounting review. Insiders knew in advance of the price change whether the stock would go up or down and set up a system that allowed them to buy or sell to lock in a profit. It was the equivalent of investing in the stock market when you knew for sure which way a given stock would go.

In practice, this scheme allowed directors to make virtually guaranteed insider profits.

Here's the way *Business Week* labor reporter Aaron Bernstein describes how Ullico directors personally profited from the arrangement they approved for themselves:

> **Fall, 1999** Ullico is losing money on its operations but earns $127 million by selling some Global stock. Insiders knew those gains would lift the annual valuation of Ullico's shares from $54 to about $146

when its books closed on Dec. 31.

**December 1999** Ullico offers each director the chance to buy 4,000 Ullico shares at the 1998 valuation of $54. The union pension funds that own almost all of Ullico aren't given the same offer, or even told about it.

**Dec. 2000/Jan. 2001** Ullico buys back 205,000 of its 7.9 million shares at $146. Stockholders with fewer than 10,000 shares are allowed to sell all their holdings, so officers and directors can take full advantage, but the pension funds can't. Insiders know the decline of Global Crossing's stock puts the true value of Ullico's shares closer to $75.

**Dec. 2001/Jan. 2002** Ullico buys back an additional 200,000 shares, allowing officers and directors who hadn't sold before to cash out at $75. Again, insiders know that the further collapse of Global has again cut Ullico's true value, this time to $44.

**March 2002** Ullico's pension-fund shareholders now own a less valuable company. Its Global profits have gone disproportionately to officers and directors, some of whom are trustees of the union pension funds that lost out on the deal.
("Global Crossing: Labor's Questionable Windfall," Aaron Bernstein, *Business Week,* March 14, 2002)

In a follow-up article to the one above, Mr. Bernstein summed up the Ullico controversy by stating, "The labor movement is being roiled by what could be one of its worst scandals in years."

Just blocks from this hearing room, a federal grand jury has been hearing evidence about the Ullico case. Ullico officials have been subpoenaed to describe how board members bought and sold stock in the privately held Ullico.

The Ullico Board

The U.S. Attorney's office originally came across the Ullico case while conducting a criminal investigation of Mr. Jake West, former head of the ironworkers union. Mr. West, a Ullico director since 1990, has been indicted on federal charges that he embezzled funds from his union. He is currently awaiting trial on the embezzlement charges.

Mr. West isn't the only Ullico director with a questionable background.

Another director (since 1993) is former Laborers Union boss, Arthur Coia. A draft racketeering complaint by the U.S. Department of Justice in 1994 described Coia as influenced by organized crime. An internal memo at the time by the head of the Organized Crime and Racketeering section of the Justice Department referred to him more succinctly as a "mob puppet." In January, 2000, Arthur Coia pled guilty to fraud for evading Rhode Island taxes on the purchase of a $1 million Ferrari.

Apparently, this guilty plea by one of its directors was not viewed as a problem to overseeing the integrity of billions in union pension funds. The Ullico board allowed Coia to remain on their board. As of today, he has refused to state publicly whether he profited from either the Global Crossing IPO stock deal or the insider Ullico stock deals.

One of the more interesting Ullico directors is Marty Maddaloni, a director since 1998 and President of the United Association of Plumbers and Pipefitters union. Maddaloni also heads one of his union's pension funds which has been involved in one of the biggest real estate boondoggles in pension fund history. After purchasing the rundown Diplomat Hotel in Hollywood, Florida for $40 million, renovation costs ballooned to $400 million, then $600 million and finally, when the hotel opened two years late, the final cost was in excess of $800 million. An independent appraiser valued the property as being worth $587 million, more than $200 million less than the pension fund paid for the project.

The Hotel Diplomat renovation had numerous other problems. The construction was so mismanaged that walls tilted, floors sloped and pipes leaked. Some of the contractors hired for the job had been banned from New York City construction because of bid rigging.

To make matters worse, Maddaloni has recently written to union locals letting them know that the Department of Labor is nearing the end of its lengthy investigation of the Hotel Diplomat boondoggle and they may take action against the trustees of the pension fund as a result of that investigation.

Things haven't been much better for Maddaloni on the Ullico front. In a front page story on April 5, 2002, *Wall Street Journal* reporters Tom Hamburger and John Harwood revealed that Maddaloni had reaped a profit of $184,000 selling Ullico shares back to the company. After describing the process of insider trading, the reporters concluded, "A platoon of union chiefs responsible for serving their members used Ullico as a means of enriching themselves."

One of the Ullico directors most on the spot over the scandal is Morton Bahr, the longtime head of the Communications Workers of America (CWA) and a Ullico director since 1996. Many of the workers who lost their jobs and their life savings because of the Global Crossing bankruptcy were CWA members.

And the emerging record shows that Bahr was intimately involved in the Ullico-Global Crossing deal from the beginning. Bahr pushed for the Global Crossing deal even though the company was involved in telecommunications but not unionized. Time and again, Bahr used his authority as CWA boss to promote the interests of Gary Winnick's Global Crossing:

- Bahr supported Global Crossing's merger with Frontier Communications and opposed the bid for Frontier by Qwest.
- Bahr wrote 14 state governors supporting a takeover of U.S. West by Global Crossing
- Bahr's support of the Ullico initial major investment in Global Crossing was essential since he represented one of the larger unions involved in Ullico.

Apparently the favoritism was not a one-way street. The *Wall Street Journal* expose of the Ullico scandal revealed that Bahr had personally profited from insider trading of Ullico stock to the tune of $27,000. However, a spokesman for Mr. Bahr assured the reporter that Bahr was "concerned about the propriety of stock trading by Ullico board members." ("Inside Deal: How Union Bosses Enriched Themselves on an Insurer's Board," by Tom Hamburger and John Harwood, *The Wall Street Journal,* April 5, 2002, page 1)

The revelation was especially embarrassing to Bahr since less than a month earlier he had put out a press release in which he blasted "corporate arrogance" and singled out the "secret dealings and employee abuses of Enron and Global Crossing." (PR Newswire, March 6, 2002, Communications Workers of America)

Many CWA members, especially in upstate New York, had special reasons to question secret dealings and employee abuses by Global Crossing. And by Morton Bahr. Not only had Bahr pushed hard for the takeover of Frontier by Global, but the Global disaster meant a serious hit to CWA members at Frontier.

National Public Radio (Feb. 12, 2002) reported on the effect of Global Crossing's shut down on CWA members:

> JIM ZARROLI("All Things Considered" reporter): As with Enron, the company's[Global Crossing's] implosion has taken its toll on employee pensions. Linda McGrath is head of Local 1170 of the Communications Workers of America. The local's members used to work for Frontier Telephone, and had Frontier stock in their 401(k)s. But McGrath says that when Frontier was bought by Global Crossing a few years ago, the shares were converted to Global Crossing stock. With Global Crossing in bankruptcy, McGrath says, many people have lost a lot of their retirement savings.
>
> Ms. LINDA McGRATH (Communications Workers of America): They've given their life to this company. And for Global Crossing to come in here and then within three years take us right down so that we've lost everything that they've worked 30, 35 years for, they're devastated.

If any doubt remains that telecommunications workers from Frontier and Global Crossing were truly victimized by the Global Crossing meltdown, consider these comments from blue collar employees of Frontier Communications which was taken over by Global Crossing:

- Zigment Ozarowsky, former Global Crossing Employee: I worked 38 years for the company, and I lost 3,195 shares, which actually amounts to about $200,000.
- Tim Dailor, Global Crossing employee: I lost 8,300 and some odd shares, about $400,000.
- Anthony Alfano, Global Crossing employee: I've contributed about probably $150,000. With company match it was probably about $200,000. ("401[CHAOS], by Paul Solman, WGBH, Boston, as broadcast on NewsHour with Jim Lehrer, Feb. 28, 2002)

To add insult to injury, those who lost their life savings and who also had CWA pension funds invested in Ullico now know that the head of their own union was revealed as profiting on insider trading - at their expense. But they can take comfort in the fact that his spokesman says he was really concerned about the propriety of the stock deals.

Conflict of Interest

Union leaders have a fiduciary duty to serve the best interests of their members. This duty is found throughout federal labor law. In reaction to the old-fashioned corruption of

sweetheart deals in which management paid labor bosses bribes to betray their union, federal law strictly forbids a whole range of corrupt practices:

- Employers may not contribute to union elections
- Employers may not give union officials money or anything of value
- Union officials have a very strict and very broadly construed fiduciary duty to put their responsibility to their members above their own personal interests, especially their financial interests.

Aside from the federal grand jury currently hearing evidence pertaining to possible criminal liability in the Ullico case, the Department of Labor is investigating whether the Ullico stock schemes violated civil labor laws against conflict of interest. If such a conflict of interest occurred, and evidence is mounting that it clearly did, the result could be fines and removal of offenders from union office.

While the excellent investigative articles in *Business Week* and *The Wall Street Journal* have done a fine job of detailing the self-enrichment games played with Ullico stock at the expense of union pension funds, the conflicts of interest associated with Gary Winnick's dealings with the Ullico board were only touched.

Gary Winnick appears to be the last person a group of union bosses would ever want to associate with. At a time when railing against corporate greed is the staple of every union speech, Winnick comes off as a stereotype of a union boss's arch enemy. He began as an employee of convicted junk-bond king Michael Milken. Frequently described as an egomaniac, he lived a lifestyle that defined excess. His home cost $92 million. He sold in excess of $734 million in Global Crossing stock from the time it went public until it went bankrupt. And one of his top former executives has alleged that some of the especially questionable, if not out right illegal, accounting practices by Global were made to cover his cashing out.

So why would Ullico's board of union bosses not only invest more than $7 million in seed money with Winnick, but also get involved in a number of other venture capital deals? Certainly, the prospect of being cut in on the lucrative IPO stock offer was an inducement that may have made the Ullico board pour union pension funds into Winnick's non-union company.

The Ullico board also jumped into deals with Pacific Capital Group (PCG), an investment firm owned by Winnick. Together with PCG, Ullico invested in the high-flying internet company, Value America, another non-union company which quickly went into bankruptcy. And Ullico went in with PCG on Playa Vista, a troubled Los Angeles real estate deal plagued with environmental and regulatory problems. One of Ullico's top officials, former Democratic National Committee executive director Michael Steed went to Winnick's PGC as a managing director and went onto the Value America board.

As revelations continue to grow about the Ullico case, the most common reaction appears to be how closely the actions of the Ullico board resemble what union chiefs so often denounce as wrong with corporations. Consider this recent comment by AFL-Cio head John Sweeney:

> "Enron exposed what many of us have been saying: the boards of directors that are charged with acting in the interests of investors and the public are riddled with greed, self-dealing

and plain selfishness."

Change a few words and you have a perfect description of the Ullico board on which John Sweeney sits. While he has publicly claimed not to have participated in the insider stock schemes, the fact remains that as a director he played a role in letting the schemes continue. Fiduciary duty extends to taking steps to prevent others from violating their fiduciary duties.

It's difficult to imagine the Ullico board going forward with their self-enriching schemes if the head of the AFL-CIO strongly opposed them. Nor is there any evidence that Mr. Sweeney or any of the other directors took any steps to expose the secret deals. Just the fact that the group of union bosses busily enriching themselves at the expense of their own members chose to keep their deals secret speaks volumes about what they considered the deals to be.

The Bigger Picture

The Ullico case is important because it involves the heads of some of the largest unions in the country improperly, if not illegally, enriching themselves at the expense of union members and retirees.

It's also important because it illustrates the growing trend of union corruption involving pensions.

Just as the Ullico stock scandal was being exposed, the Department of Labor announced that it was suing Ullico and a subsidiary for imprudently investing $10 million in assets of two Laborers International Union pension funds in a risky Las Vegas land deal. According to the Department of Labor, Ullico failed to properly investigate the large real estate investment and ended up abandoning the project without selling any lots.

A March 25, 2002 BNA Daily Labor Report article based on an interview with Department of Labor Inspector General Gordon S. Heddell provides a good idea of the scope of the problem affecting union pension funds. As of March, there were 357 pending labor racketeering investigations under way by the Inspector General. Of those 39% involved organized crime and of the 357 investigations, 44 percent involve pension and welfare plans.

The IG cited an number of cases in which pensions lost funds because of violations of fiduciary duties by plan trustees, the very issue involved in the Ullico case. The IG went on to state that investigations of this type involve plan assets of more than $1 billion are at risk.

Accompanying my testimony are 25 recent examples of union corruption involving union pension and benefit funds. A review shows that the cases are all recent, large and widespread. The Ullico case shows that the pension corruption goes right to the very top of the labor movement.

The amount of money being stolen from pension and benefit funds is staggering.

In an Oregon case, the Department of Labor estimates that a large number of union funds lost more than $100 million.

In a New York case, an alleged member of the Genovese crime family was recently indicted in connection with the embezzlement of more than $1 million from benefit funds of

two locals of the United Brotherhood of Carpenters.

In some cases, only quick action by law enforcement has stopped major pension fund looting as when the F.B.I. uncovered plans in 2000 to move $300 million in union pension fund money into management firms run by the Lucchese crime family.

## What Can Be Done

The first step is to admit that there is a major problem with the integrity of union pension funds. The Ullico case and the epidemic of related corruption provides ample evidence of the scale of the problem.

Second, the public, especially union members whose pension funds own Ullico, have a right to know what Ullico directors did to enrich themselves at the expense of the union members. A Congressional hearing featuring the entire Ullico board being sworn in and asked direct questions would be a good start. If they all chose to take the Fifth Amendment, that act will speak for itself. Certainly, hundreds of thousands of union members short-changed by the Ullico directors are entitled to an accounting.

Third, the laws regarding pension funds are sweeping but contain very serious loopholes. The Department of Labor Inspector General recently pointed to the fact that independent public accountants are not required to report ERISA violations to the Department of Labor. That loophole has no policy justification whatsoever and should be closed.

Fourth, union members are entitled to know the sources of income of top union officials. International union presidents receive large salaries and are expected to give their full time and attention to their duties. Had Ullico directors known they would have to disclose the insider stock profits, they may not have been so quick to enrich themselves. The annual financial disclosure form filed by unions with the Department of Labor, the LM2 form, should be amended to require union leaders to disclose all income by source and amount. A recent House hearing by two subcommittees of the Education and the Workforce Committee co-chaired by Congressmen Norwood of Georgia and Johnson of Texas featured extensive testimony calling for better disclosure of union financial information. The underlying policy is the time-honored belief that "Sunshine is the best disinfectant.

If protecting the integrity of pension funds relied upon by millions of honest, hardworking Americans is not an issue worth addressing, what is?

# Top 25 Recent Union Corruption Stories Involving ERISA-Protected and Similar Benefit Funds

*From the pages of the National Legal and Policy Center's Union Corruption Update: see http://www.nlpc.org/olap/ucu/index.htm*

**1. Oregon Boss Gets 15 Months for Racketeering, Some $100 Million Lost**

U.S. District Judge Anna J. Brown (D. Or.) sentenced racketeer and tax-evader John D. Abbott, ex-secretary-treasurer and business manager of the Laborers' International Union of North America's District Council of Oregon, South Idaho, and Wyoming, November 21, 2001, to two concurrent terms of 15 months in prison and one year probation. He must pay $195,400 in restitution plus back taxes. He was an official for five LIUNA benefit funds.

He pled guilty on February 26, 2001, to accepting gratuities from union fund manager Jeffrey L. Grayson (indicted October 2, 2001 and whose sentencing is eminent) to use his influence as a pension trustee and filing a false tax return. Abbott pled guilty to racketeering charges, under 18 U.S.C. § 1954, and to understating his income on his 1997 tax return by $76,560. He earned the shortened sentence in exchange for cooperating against other trustees and Grayson in the massive $355 million Capital Consultants scam. Laborers lost about $25 million.

Assistant U.S. Attorney Lance Caldwell, told Brown that Abbott's testimony has been crucial in building the case against Grayson who was indicted on 22-counts. of conspiracy, witness tampering, money laundering, mail fraud, and making illegal payoffs to Abbott. Because of Abbott's cooperation, and the "very valuable" evidence it produced, the government recommended reducing his sentence from a maximum of 33 months.

Grayson assisted Abbott in 1998 when he was in trouble with LIUNA for allegedly pocketing office funds and failing to make restitution. Abbott, according to an audit released in March 1998, took at least $172,000 from office funds including $150,184 in personal charges on his union credit card. As Abbott was being pushed to explain what the audit uncovered, Grayson arranged the sale of Abbott's late wife's catering business, netting the union boss $60,000.

Abbott repaid the unauthorized credit card charges and promised LIUNA that he would pay back the rest of the money, nearly $32,000. But he failed to make payments, and in September 1998, LIUNA gave him the choice of resigning or being expelled. Abbott chose to quit and promised once more to reimburse the money he owed. Meanwhile, he organized a consulting company, Kaylano Consulting, and signed a contract with Grayson that promised to pay Kaylano at least $805,000 over five years.

Not everyone thought Abbott's 15-month sentence was sufficient. Gayland German, a retired Oregon LIUNA member who attended the hearing, later called Abbott "a Judas" and predicted his fellow union members "will be extremely disappointed" with the length of his sentence.

Forrest Rieke, Abbott's attorney, portrayed his client as just one of ten trustees with no more and no less clout than the rest. He called Lee Clinton, Abbott's successor at the District Council, to the stand, to testify that he saw no evidence of Abbott favoring Grayson in the placement of union money. But Clair Anderson, another ex-LIUNA boss who served on several trusts with Abbott, disagreed, telling the *Oregonian* after the sentencing that Abbott effectively controlled the trusts as well as the union. "He ruled with a strong hand," Anderson said. "He had influence with every damn local in the state."

Rieke told Brown that his client "simply has no money," and the judge agreed that he could work out a payment plan. Clinton estimated that Abbott receives between $8,000 and $10,000 a month in union pension payments. Abbott will report to prison on May 1, which will give him time to testify at Grayson's impending trial. Abbott's sentencing came 24 hours after Brown sentenced Grayson's son, Barclay, Capital Consultants' president, to 24 months imprisonment and three years probation for mail fraud. He pled guilty on March 19, 2001, and is cooperating. [UCU 4.25]

On a second front, a $16 million class action settlement was reached in cases filed by union members against their fund trustees for breach of fiduciary duty in the scandal. However, the

funding of the settlement is now in question due to the financial difficulties of the insurance company that provided liability coverage for some of the funds' trustees. All the settlement payments were to be funded by the funds' fiduciary liability policies.

Before the insurer problem surfaced the five unions reached the following terms. The class action settlements with the Oregon Laborers Union and Idaho Laborers Union were filed March 7, 2002, with the U.S. District Court in Portland. A similar settlement for members of Office & Professional Employees International Union Local 11 based in Portland was scheduled to be filed in March 2002. These settlements called for a payment of $4 million to the trust funds administered by the Oregon Laborers Union, which lost an estimated $40 million in investments. The Idaho Laborers Union, which had a loss of $10 million, was scheduled to receive $1.9 million, and Local 11, which had a loss of $10 million, was scheduled to receive just under $1 million.

Another class action settlement was reached March 7 in the same federal court with members of plans administered by Portland-based Local 290 of the United Association of Plumbers & Pipe Fitters. It called for a payment of $3.7 million. The fund has $29 million at risk due to the investment losses at Capital Consultants. Finally, members of the Eighth District of the International Brotherhood of Electrical Workers in Denver were scheduled to settle in March a suit against trustees of their trust funds.The Eighth District includes Idaho, Utah, and Colorado. That settlement was expected to be for about $6 million. The trust has $50 million at risk due to investment losses at Capital Consultants. [UCU 5.6]

Finally on a third front, the Department of Labor April 4, 2002, filed five consent orders with the U.S. District Court in Portland settling allegations against more than 40 trustees of union pension and benefit funds concerning alleged ERISA violations of. At the same time the consent orders were filed, DOL filed the complaints upon which the settlements were based. DOL's settlement resulted in the dismissal of 27 trustees from their current positions and a new set of procedures that the funds' must abide by in the years ahead in their investment management.

Capital Consultants has been under federal receivership since September 2000. DOL estimates that a large number of union funds lost more than $100 million due to risky investments made by Capital Consultants. DOL's five lawsuits detailed how trustees in fund after fund ignored warnings by outside investment "monitors" of the risks of certain private investments. Trustees for a number of the funds ignored their funds' guidelines on the amount of their funds that should be invested in such ventures. When the amount of such investments exceed the guidelines, trustees often voted to relax the guidelines, the suits said. For example, in the case involving the Oregon Laborers-Employers Health and Welfare Trust, the plan called for investments only in readily marketable securities and real estate. Yet during the mid-1990s Capital Consultants invested up to 35% of the fund under its management in collateralized notes, the suit said.

Between 1995 and 1999 the trustees of the Oregon Laborers-Employers Pension Plan allowed Capital Consultants to invest 55%, or $ 103 million, of its assets under the firm's management in private placements, the suit said. Trustees of the union's 401(k) plan allowed up to 100% of the funds managed by Capital Consultants to be placed in risky private investments, contrary to the fund's diversification policy, the suit said.

Further, three funds were administered by IBEW's Eighth District. The union's pension fund in the early 1990s had a $300,000 limit on the amount Capital Consultants could loan to any one borrower in a private placement, according to the suits. In 1996 the trustees changed this limit to 20% of fund's assets under management by Capital Consultants. And in 1997 the trustees changed the limit to 50%. By 2000, the fund had $46 million under management by Capital Consultants, much of it private placements, the suit said.

Similarly, UA Local 290's pension plan was "repeatedly warned" in 1995 by its outside investment monitor about Capital Consultants' private placements, the suit said. The trustees were warned of the low returns and high risks of such investments, the suit said. The monitor characterized Capital Consultants' nontraditional asset portfolio as "drastically underperforming," the suit said. Trustees were charged with failure to protect interest, with failure to act with prudence and diligence, failure to heed warnings and for relying on inadequate investment reports.

In addition to Abbott, two other union officials who served as trustees were singled out for accepting tainted Capital Consultant gifts. The other two union officials charged in DOL's trustee suits for accepting gratuities as trustees were Gary Kirkland, chief executive of the Portland-based OPEIU Local 11, and Robert Legino, a trustee on two funds administered by the IBEW's Eighth District. A portion of the charges against Kirkland were not included in the settlement and remain in dispute with DOL. [UCU 5.8]

**2. DOL Alleges ULLICO Imprudently Invested $10 Million**

The Department of Labor sued Washington, D.C.-based Trust Fund Advisors, Inc., and its parent, ULLICO, March 22, 2002, for imprudently investing more than $10 million in assets of two Laborers' International Union of North America pension funds in a risky real estate project. LIUNA hired TFA as a union fund manager for the Local Union and District Council Pension Fund and National Industrial Pension Fund. TFA hired ULLICO to handle all real estate investments made on behalf of clients of TFA. ULLICO-TFA contracted with the pension funds in 1993-94 to handle their investment in real estate. Admitted criminal and ex-LIUNA boss Arthur A. Coia was elected to ULLICO's board in 1993 and was on the board as of Sept. 30, 2000, according to a State of New York's Insurance Department document.

The suit alleges that ULLICO-TFA violated ERISA by imprudently investing more than $10 million of plan assets in a risky real estate project. In 1995, ULLICO-TFA used plan assets to purchase and develop a 120-acre tract of raw land in North Las Vegas, Nevada, into saleable building lots. ULLICO-TFA then incorporated LF Las Vegas Realty Corp., paid close to $6 million for the property, and spent more than $4 million to develop it. The suit also alleges that ULLICO-TFA failed to properly investigate the merits of the Sommerset Ridge project (failed to obtain an appraisal) and, ultimately, abandoned the project in 1997 without selling any lots. The funds suffered losses when the property was sold in June 1999 to Capital Pacific Holdings for less than the money invested by the funds.

DOL is seeking a court order that requires ULLICO-TFA to reimburse the funds for all losses, plus interest, resulting from the breaches; and permanently bars them from violating ERISA in the future. The suit was filed in federal court in Washington, D.C.[UCU 5.7]

**3. Trustees Settle ERISA Suit for $4.9 Million**

Trustees of the National Electrical Benefit Fund must pay more than $4.9 million to reimburse the fund under a consent order settling Department of Labor charges that they breached their fiduciary duties under ERISA by investing in a Florida real estate limited partnership. The two trustees, Jack Moore and John Grau, also agreed to pay a civil penalty of $555,000 under the consent order signed October 16, 2001, by the U.S. District Judge Deborah K. Chasanow (D. Md.). The order resulted from a suit filed in May 1999 by DOL, alleging that the trustees imprudently loaned pension plan assets to a corporation for certain real estate purchases linked to tainted Democratic National Committee Chairman Terence McAuliffe.

Moore and Grau denied the allegations, but entered into the agreement with DOL after U.S. District Judge Alexander Williams, Jr. (D. Md.) ruled in July that DOL could proceed with its suit. Williams denied the trustees' motion for summary judgment, rejecting their contention that they did not breach their fiduciary duties because the real estate transactions had beneficial results.

According to Williams, the trustees arranged for the fund to become a limited partner in a partnership established to purchase real estate in Florida The fund subsequently loaned $10 million to the general partner of the partnership, McAuliffe, enabling him, through another company, to acquire and develop additional property. The trustees then took McAuliffe up on his offer to sell the fund shares in the partnership at a 15% discount, increasing the fund's interest to more than 88%. The partnership subsequently repurchased the fund's shares for more than $30 million.

NEBF is operated jointly by the International Brotherhood of Electrical Workers from which Moore retired as secretary in 1997, and the National Electrical Contractors Association. [UCU 4.22]

**4. New York Boss Sentenced, Benefit Funds Lost $1 Million**

On March 1, 2002, a boss and a member of the United Brotherhood of Carpenters were indicted, pled guilty, and sentenced in Manhattan Supreme Court for taking bribes to let a contractor use nonunion workers at two Manhattan job sites. Stephen Goworek was sentenced to six months in jail and 54 months' probation, and Thomas Riccardo got five years' probation. A third, John Mingione, pled not guilty and will return to court. The scheme allegedly caused the union's pension and welfare fund to be deprived of more than $1 million that was supposed to be paid by the contractor.

The New York State Attorney General charged Goworek in an 11-count indictment, which included Grand Larceny in the First and Second Degrees, four counts of Bribe Receiving by a Labor Official, and five counts of Violating a Fiduciary Duty. Before his arrest, Goworek managed UBC's Stamps Enforcement Unit of the Benefit Funds of the District Council of New York and Vicinity. As the Stamps Enforcement manager, he was responsible for ensuring that contractors remitted the payments to the benefit funds required by contract.

Mingione was a UBC shop steward, and Riccardo was on the payroll at one site. Both allegedly acted with Goworek in the bribery and grand larceny scheme. All three faced up to 25 years in prison if convicted of the top count of Grand Larceny in the First Degree. The indictments were the result of a nine-month state and federal probe. It targeted remodeling projects at the Warwick Hotel and Carlton Hotel. A contractor working on those projects cooperated in the probe, which included audio and video taping the defendants' demands for bribes, as well as the actual bribe payments. Some bribes were delivered by undercover agents from New York's Statewide Organized Crime Task Force.

"My office will continue to work with [the Department of Labor's] Inspector General to ensure that the labor laws are enforced, that workers receive the wages and benefits which they are entitled to, and that the integrity of the collective bargaining process is protected," New York State Atty. General Eliot Spitzer said. [UCU 5.6]

**5. Genovese Allegedly Stole $1 Million from Union Funds**

Federal prosecutors brought a 98-count indictment against 73 members and associates the Genovese crime family in New York. The charges include embezzlement, extortion, labor racketeering, loansharking, illegal gambling operations, selling counterfeit money, gun trafficking, credit card fraud, and attempted bank fraud, some of which led to conspiracy and racketeering counts. The crimes reportedly earned about $14 million this year. At least 60 defendants were arrested December 5; some were already in custody. If convicted, some defendants would face as little as 5 years in prison while others would face hundreds of years; one could face up to 530 years.

Among those indicted are 3 alleged "capos" or captains, who are responsible for supervising the criminal activities of the members of their crews. They were identified as Pasquale "Patsy" Parrello, Joseph Dente, Jr., and Rosario "Ross" Gangi, who is already serving a 97-month sentence in federal prison for his role in a penny stock fraud.

Parrello is accused of embezzling more than $1 million from the benefit funds of Local 11 and Local 964 of the United Brotherhood of Carpenters. Allegedly, Parrello and others stole the funds through S&F Carpentry, a unionized company based in Tuckahoe, N.Y., by reporting a fraction of the union carpenters they employed, using non-union labor and destroying payroll records. UBC members allegedly were threatened if they complained about the use of non-union workers. [UCU 4.26]

**6. Chicago Bosses Sentenced for Abuse of Benefit Funds**

On March 15, 2002, U.S. District Judge Blanche M. Manning (N.D. Ill.) sentenced John Serpico, ex-president of the Central States Joint Board and ex-vice president of the Laborers' International Union of North America to six concurrent 30 months prison terms followed by three years of supervised release. CSJB is a labor organization which handles pension and other

employee benefit funds for eight locals including locals of LIUNA and the International Union of Allied Novelty & Production Workers. A jury convicted the powerful Chicago boss July 16, 2001, on six counts of mail fraud. Manning also fined him $100,000, ordered him to make restitution of $30,000, and ordered him to pay the cost of imprisonment. Serpico was CSJB president from 1975-94 and, at the time of the conviction, was a $50,000-a-year consultant. He was purged from LIUNA in 1995.

Serpico, 71, and his longtime mistress, Maria Busillo, 56, engaged in a 12-year scheme trading their control over union pension, benefit, and other funds to obtain some $5 million in loans for personal business ventures. Assistant U.S. Attorney David Glockner said Serpico and Busillo frequently flew together in a union jet to "frolic" at Busillo's beachfront condo in Marco Island, Florida, "financed in part with a loan obtained by dumping workers' money into a corrupt bank." Busillo allegedly obtained loans for a the Florida condo as well as for her $900,000 house in Glenview, Illinois. She reportedly obtained the loan on the house even though the monthly mortgage payment exceeded her gross income.

From 1978-90, the two obtained 17 loans from eight banks that received substantial union deposits, in some cases just days after the banks made the loans. The key dealings were with Capitol Bank & Trust. In return for some $5 million in personal loans at favorable rates, the two deposited about $4 million in union funds in Capitol. The bank also managed $16 million in union pension and welfare plans. Capitol pled guilty in 1996 to the scam and was fined $800,000. Its two owners were forced to sell it and were banned from banking. At Serpico's trial, ex-Capitol president Robert Hahn testified for the government. Among Capitol's actions was a $1.8 million loan to Serpico and his partner, ex-U.S. Representative Morgan F. Murphy (D-Ill.), on a film studio project despite cash-flow woes and no clients. The building was later bought by Oprah Winfrey and turned into Harpo Studios.

Manning sentenced Busillo, also an ex-CSJB president and ex-ANPW president, to 15 months imprisonment followed by three years supervised release on each of two mail fraud counts and one count of making a false statement on a loan application of which she had been convicted, with the sentences to run concurrently. Manning also fined her $100,000 and ordered to pay the cost of imprisonment.

Further, Serpico and Gilbert Cataldo, an ex-Chicago housing commissioner and ex-lllinois International Port District executive director, were convicted of sharing in a kickback scheme of more than $330,000 after CSJB secured a $6.5 million loan for a failing hotel project in Champaign, Illinois. Serpico was IIPD's longtime chairman until 1999 when he was indicted. Manning sentenced Cataldo to 21 months imprisonment followed by three years supervised release on each of three mail fraud counts of which he had been convicted, with the sentences to run concurrently. Manning also fined Cataldo $5,000 and ordered to perform 250 hours of community service.

"All three of these defendants have held themselves out for years and even throughout this trial as champions of labor and workers and pillars of the community," said Glockner. "The evidence in this case shows that they're simply crooks."

"Insufficient," is the way LIUNA dissident and Laborers for Justice leader Jim McGough described Serpico's sentence. Expressing outrage at the sentence's brevity, McGough told the Union Corruption Update, "Serpico raped and pillaged Laborers Local 8 and facilitated Organized Crime's control of the Laborers Union and Central States Joint Board."

Manning order the aging Serpico to surrender to prison June 28, but his attorney, Matthias Lydon, said he will seek his continued release pending appeal because of upcoming spinal surgery and an expected six-month recuperation period. After sentencing, Serpico, his hand raised to shield his face, ran into traffic outside the Dirksen Federal Building in an attempt to shake free from photographers. [UCU 5.7, 4.15]

**7. New Jersey Boss Accused of Embezzling $2 Million**

Carmelo J. Sita, ex-fund manager for the Hudson County (N.J.) District Council of Laborers (HCDCL) , was arrested the morning of December 12 at his home in Mountainside, N.J., and accused of embezzling more than $2 million from HCDCL and its benefit funds. He used the money for a lavish lifestyle, including a Martha's Vineyard vacation home and luxury cars, according to the 59-count indictment handed up December 10. U.S. Magistrate Judge Susan D. Wigenton set bail at $250,000, which was reportedly secured by a coop apartment that Sita owns on Manhattan's Upper West Side.

From January 1995 to March 1999, Sita allegedly conspired with others who concealed the embezzlement, and he wrote checks from benefit fund and HCDCL accounts to himself or to pay his personal expenses. Allegedly, Sita stole money to pay for "monthly credit card debts, mortgage payments, lease payments on luxury vehicles, personal taxes, Martha's Vineyard vacation home and boat, and unauthorized political and charitable contributions." Further, he allegedly used union money to pay country club dues. Specifically, the indictment charges him with conspiracy, theft from employee benefit and health care plans, health care fraud, and falsifying disbursement documents about HCDCL.

In addition to prison time, prosecutors are seeking criminal forfeiture of Sita's Mountainside home, his condo in Tisbury, Mass. (Martha's Vineyard), a Wellcraft 20-foot motor boat, and $1,062,787 million in cash. They charge that the property and money came from the embezzled funds.

Sita resigned in 1999 after 22 years as executive manager of HCDCL's benefit funds. The Jersey City based council consists of Laborers' International Union of North America Locals 21, 31, 202, and 325. He is now a self-employed consultant on commercial real estate deals. Sita's attorney, David A. Ruhnke, said his client denies any wrongdoing: "this indictment represents a gross misunderstanding of how matters of compensation were handled in this union." Ruhnke admitted that last year, the Department of Labor sued Sita and other bosses, accountants, and attorneys linked the funds over the alleged embezzlement. The parties reached a confidential settlement, he said. [UCU 4.26]

**8. Rhode Island Embezzler Loses $1.3 Million Suit; Trustees to Repay $24,000**

U.S. District Judge Ronald R. Lagueux (D.R.I.) ordered the trustees of the International Brotherhood of Electrical Workers Local 99 Health & Welfare Fund January 11, 2002, to repay $24,000 to cover improper benefit payments. A suit, filed in May 2001 by the Department of Labor claimed the board of trustees had violated a law protecting employee pension and welfare benefit plans. Allegedly, from January 1994 and December 31, 1995, trustees of for the Providence, R.I., based fund failed to adequately ensure the accuracy of employee eligibility data. As a result, payments were made to seven ineligible people. Lagueux's judgment also bars the defendants from committing similar infractions in the future. [UCU 5.2]

Further, ex-union pension manager and prison inmate Todd LaScola must repay $1,279,656 to Local 99's retirement plan under terms of a federal default judgment. Lagueux signed the order July 24, 2001, after LaScola and his firm, CPI Financial Services., Inc., failed to respond to an ERISA suit filed in January 2001 by DOL accusing them of misusing plan assets. DOL's suit alleged that LaScola invested approximately $5,970,000, over 20% the plan's total assets, in unregistered, highly risky notes issued by real estate limited partnerships owned by RBG Management Services., Inc., of Chicago. Allegedly, there was no trading market for the RBG notes, making the investment a violation of the plan's guidelines. LaScola received approximately $312,400 in commissions from RBG, as well as $127,652 in management fees from the plan.

In 1998, plan trustees demanded that LaScola immediately liquidate improper investments. He subsequently returned $5,993,800 to the plan, but he obtained that money through other illegal acts, for which he is currently serving a federal prison term. The $1.279 million ordered to be repaid is the total of the opportunity losses, $839,603, plus the commissions and management fees. LaScola must repay his criminal obligations before making these civil payments. He was

ordered to repay $8.12 million May after pleading guilty to nine embezzlement and fraud charges. He is serving an eight-year sentence in a medium-security federal prison in Estill, S.C. [UCU 4.16]

**9. DOL Wins $597,700 for Michigan Funds**

On March 19, 2002, trustees and the ex-administrator of the Millwrights Local 1102 Supplemental Pension Plan and Health Plan, which are linked to United Brotherhood of Carpenters Local 1102 in Warren, Michigan, agreed to restore $597,775 to the plans. Further, U.S. District Judge Avern L. Cohn (E.D. Mich) ordered the trustees to resign their positions with the plans.

Cohn's judgment resolved a suit filed Aug. 23, 2000, by the Department of Labor against administrator Automated Benefit Services, Inc. and trustees Walter R. Mabry, Jerry D. Moore, Ronald M. Krochmalny, Keith R. Scrutton, Milford E. Woodbeck, Sr., and Roy Shields. Allegedly, the defendants violated pension laws by 1) paying unreasonable compensation and fees to ABS, 2) failing to prudently invest the plan's cash assets, 3) paying excessive fees relating to the collection of employer contributions to the plans, and 4) making mortgage loans to participants which did not comply with the terms of the pension plan document.

Cohn also ordered the pension plan to comply with the requirements of ERISA in any future activity and gave Nat'l City Bank of Cleveland the authority to manage the mortgage loan portfolio of the pension plan. Reportedly, the bank then exercised that authority and sold the pension plan's portfolio for $1,173,813.40. [UCU 5.7]

**10. Two Confess to Embezzling some $453,000 from Benefit Funds**

On April 11, 2002, Raymond Robertson, ex-general vice president of the International Association of Bridge, Structural, Ornamental & Reinforcing Iron Workers and director of its National Training Fund, pled guilty in U.S. District Court in Washington, D.C., to one count of conspiracy to defraud an employee welfare benefit plan, one count of aiding and abetting embezzlement from an organization receiving federal funds, and six counts of embezzlement from an employee welfare benefit plan. According to the plea agreement, he agreed to pay a fine of $30,000, to make restitution of $103,170, and to assist the government in other investigations.

Further, Kerry J. Tresselt, ex-bookkeeper for BSORIW admitted November 8, 2001, that she embezzled more than $350,000 from a union job-training fund, the National Ironworkers & Employers Apprenticeship & Journeyman Upgrading Fund, and attempted to cover it up. She pled guilty in U.S. District Court in Washington, D.C., to three counts of embezzlement from an employee benefit plan and one count of conspiring to make false statements. She admitted to illegally issuing checks to herself and others while working for the training fund set up by BSORIW with contributions from contractors. She agreed to make restitution and assist prosecutors in a continuing criminal probe of BSORIW.

From about 1985 to April 2001, Tresselt worked as the bookkeeper for the Fund. In that capacity, she was responsible for issuing checks drawn against the Fund's accounts, recording payments in the Fund's general ledger, and performing other bookkeeping responsibilities. Through several different types of schemes, Tresselt stole more than $350,000 from the Fund from approximately April 1998 through April 2001. Tresselt stole more than $30,000 through, in effect, a "ghost" employee scheme and more than $270,000 by simply writing checks to herself on the Fund's checking account. In addition, she stole more than $40,000 of funds obtained by the Fund in connection with a federal grant received from the Department of Labor to train workers in Poland. Tresselt stole that money by submitting false and fraudulent claims for work which she did not perform. Finally, Tresselt created false and fraudulent records to conceal and cover-up some of her thefts. Under federal sentencing guidelines, Tresselt reportedly faces up to to 27 months in federal prison when she is sentenced by Chief U.S. District Judge Thomas F. Hogan (D.D.C.).

Robertson and Tresselt are the sixth and seventh persons from BSORIW to be charged in the probe launched by the FBI and Department of Labor. Four other bosses have pled guilty to

embezzlement or related charges. The fifth, ex-BSORIW boss Jacob "Jake" West, is awaiting trial. He is accused of embezzling $50,000. Others charged in the scandal are: Darrel E. Shelton, ex-general organizer, who pled guilty to embezzling as much as $120,000; Fred G. Summers, the former executive director of organizing, who admitted embezzling more than $50,000; James E. Cole, ex-general secretary , who pled guilty to embezzling more than 10,000; and Michael J. Brennan, the ex-head of the Iron Workers Political Action League, who pled guilty to charges involving the theft of $7,000. Brennan received probation. Shelton, Summers, and Cole are awaiting sentencing. [UCU 5.9, 4.23]

**11. Northern Illinois Boss Charged with $353,000 Theft**

Charles C. Isely, III, ex-president and treasurer of the International Employees Welfare Union was indicted December 19, 2001, on one count of embezzlement and three counts of mail fraud. He allegedly embezzled $353,000 from the Waukegan, Ill.-based union, which he founded and ran from 1974 to 1998. He allegedly wrote 30 fraudulent checks totaling $225,000 from IEWU's death trust fund. He also allegedly wrote another 40 checks for $108,000 on IEWU's bank accounts. The checks were allegedly routed to Isely's bank accounts and used for personal expenses. Further, Isely allegedly obtained a $20,000 bank loan under the union's name and reportedly deposited it in his personal bank account. The alleged crimes occurred in 1994-98. His wife, Patricia, IEWU's ex-vice president and secretary, was not charged. Both resigned in March 1998. In November 1998, Isley and his wife filed for bankruptcy and claimed outstanding debts to IEWU. [UCU 5.1]

**12. Illinois Boss Gets Two Years for Taking $350,000**

Patrick Stiles, ex-boss of Aurora (Illinois) Firefighters Local 99, pled guilty March 21, 2002, to felony theft in connection with the embezzlement of union and firefighters association funds and was sentenced to two years in prison. The plea agreement, entered in Kane County Circuit Court before Judge Donald C. Hudson, requires Stiles to pay $244,000 in further restitution to Aurora Firefighters Local 99 and the Aurora Firefighters Relief Association. Stiles was released on bail and ordered to turn himself in to authorities on April 23.

Aurora police testified at a bail hearing in Oct. that Stiles had stolen about $350,000 from the two organizations, but the restitution was based on a $275,000 settlement in a related civil suit. Stiles, a firefighter, resigned January 15, 2001, after eleven years with the Aurora Fire Department. He was secretary and treasurer of the Relief Association from 1995 to 1999 and held the same post at Local 99 from 1992 until his resignation.

"We won't feel it's complete until he pays the penalty--doing the time--and pays us back the money he owes us," said Local 99 president Gregory Frieders. Stiles agreed in April 2001 to pay $275,000 to the two groups in a civil suit they filed. He agreed to turn over about $64,000 in retirement funds. The groups have received about $31,000 from his pension , but await payment from a deferred compensation fund. Stiles has made no further payments. Though a lien has been place on his home, unions officials said they doubt he has equity in that home.

Stiles allegedly made out union checks to pay for personal expenses, including $16,800 to credit cards, $8,839 for telephone bills, $3,250 for computer equipment and $8,000 for payments to a non-union bank account. The Relief Association alleged that Stiles wrote $15,092 in checks to himself, $12,000 credit cards, $1,941 to his mechanic and $4,420 to firefighters to work on his house.

When the allegations surfaced, only one signature was required to sign Relief Association checks. Union checks required two signatures, but checks that only had Stiles' signature still were cashed, Frieders said. Since then, both organizations have reportedly revamped their accounting procedures. [UCU 5.6, 4.22]

**13. $289,000 Allegedly Stolen from New York Fund**

Barbara Monfre, pension fund administrator for the International Brotherhood of Electrical Workers Local 3 in New York City was arraigned March 22, 2002, in U.S. District Court in Manhattan on charges of embezzling approximately $289,000 from the local's Elevator Division Retirement Plans. [UCU 5.7]

**14. Buffalo Boss-Widow Pleads Guilty, Repays $144,400**

Anna M. Ervolino, ex-vice president of Hotel Employees & Restaurant Employees International Union Local 4 in Buffalo, pled guilty March 22, 2002, to one count of willful and unlawful failing to disclose for a benefit plan annual report a payment to a party in interest. She and her husband, the late Frank Ervolino, ex-local president, were indicted on May 16, 2000, on multiple charges of embezzlement and conspiracy relating to the local, an associated union, and their benefit plans. The indictments alleged that some $235,000 was stolen.

The indictments came a year after HERE's court-appointed monitor found that the couple embezzled some $491,472 from Local 4 and two other unions by allegedly working half-days, at most, and took a four-month annual vacation in Florida as well as by other bogus salary, bonus, and loan scams. Frank was also the longtime head of the now defunct AFL-CIO Hospital & Nursing Home Council in Buffalo and the Intonational Laundry Workers, based in Pittsburgh. Anna has reportedly paid $144,470.79 in restitution to the plans. Frank died November 2, 2001, without ever pleading guilty or facing trial. [UCU 5.7]

**15. Ohio Boss Stole $130,500 to Cover Gambling Debts**

Robert D. King, Jr., admitted December 11, 2001, that a gambling habit led him to embezzle $130,507 from the United Union of Roofers, Waterproofers & Allied Workers Local 86 in Columbus, Ohio. Specifically, he embezzled $88,757 from the local and $41,750 from local's employee benefit funds. During his arraignment before U.S. District Judge George C. Smith (S.D. Ohio), King pled guilty to two embezzlement-related charges. King stole the money from August 1999 to January 2001 by writing himself checks from Local 86's general and apprentice-training funds. King told the *Columbus Dispatch*, "I got hooked on gambling and got in over my head. I got deeper and deeper." He bet at casinos on the Ohio River and in Las Vegas and placed sports bets with bookmakers.

King served as the local's business manager and financial secretary for six years until the international removed him in January 2001. Local 86 officers became suspicious of King because his sloppy record-keeping. The international union audited the local's books and confronted King with numerous discrepancies. King admitted stealing the funds, and the case was turned over to the Department of Labor. [UCU 4.26]

**16. Georgia Boss Sentenced to Six Months for $90,000 Thefts**

On April 11, 2002, in Steven Jones, ex-business manager and ex-secretary-treasurer of International Association of Bridge, Structural, Ornamental & Reinforcing Iron Workers Local 387 in Atlanta, was sentenced to six months imprisonment and three years probation and was ordered to make restitution of $90,000--$29,724.73 in union funds and $39,949.42 in apprenticeship funds. He pled guilty on October 11, 2001 in U.S. District Court in Atlanta. [UCU 5.9]

**17. New Jersey Boss Accused of Stealing $75,000**

A Hackensack policeman was charged Mar. 8 with stealing more than $75,000 from police union funds, including money for the widows and orphans of slain officers. Allegedly, Kevin Schneider, who oversaw the several union funds as treasurer for seven years, used the money during the past four years to finance his gambling forays at the Meadowlands Racetrack and casinos in Atlantic City and Las Vegas. Much of the money allegedly came out of the Policemen's Benevolent Association Local 9's death-benefits fund, which helps families after officers die. Reportedly, Schneider has almost totally depleted the fund. He also allegedly ravaged Local 9's

general-operating fund, contract negotiating fund, golf-outing fund, and a fund to build an in-line skating park for city youngsters.

"I'm devastated," said Local 9 president Philip Carroll, who discovered discrepancies in the local's books only a week before the charges were brought. Schneider started stealing from the local in 1998 and took an increasing amount of money every year since to fund his gambling habit, said Police Chief Ken Zisa. "[This was] a total shock to us. He was hiding it very well," Zisa said. Investigators said the boss operated alone. Carroll confessed that he wasn't sure why the dwindling accounts weren't discovered sooner.

The alleged crimes began to unravel after Carroll, who took over as president six months ago, started looking at the local's books as his new administration prepared for an internal audit. Carroll talked with Schneider about the accounts and "didn't like the answers he got," Zisa said. Carroll asked Schneider to show him the local's books, but for a couple of days, Schneider avoided him. Carroll told Zisa, and Zisa subsequently told the Bergen County Prosecutor's Office. When Schneider finally brought the local's books to the police station March 5, he was joined by his attorney.

Investigators reportedly discovered a mounting list of withdrawals that Schneider either made out to cash or directly to himself. Police photographed, fingerprinted, and released Schneider on his own recognizance. His charge of theft of more than $75,000 is a second-degree crime punishable by up to 10 years in prison and fines of up to $100,000. Zisa suspended him with pay on Mar. 5 and then suspended him without pay after he was charged on Mar. 8. Zisa said an administrative hearing will be scheduled at which Zisa will seek to remove Schneider from the force. Carroll said the local is working to find out exactly what's left of its accounts and then will start to rebuild with fundraisers. [UCU 5.6]

**18. Boston Boss Faces Embezzlement and Bribery Charges**

George W. Cashman, president of International Brotherhood of Teamsters Local 25 in Charlestown, Massachusetts, along with four other individuals and three firms were indicted January 16, 2002 on 179 counts of embezzlement and bribery. Allegedly, 19 non-employees were ordered or placed on the firms' payrolls in order to allow the non-employees to receive health benefits from Local 25's Health Services & Insurance Plan to which they were not entitled. Assistant U.S. Attorney Fred Wyshak said the defendants robbed the fund of benefits belonging to qualified members: "The loss is to the fund that has to pay benefits it normally would not have to pay."

Disilva Transportation, Inc., Hutchinson Industries, Inc., and Manfi Leasing Corp., run by brothers Thomas A. and James P. Disilva and their brother-in-law William P. Belanger, filed false documents for the bogus employees from 1992-2001 thereby costing Local 25's HSIP $72,000 in wrongful health benefits. Also, two non-employees were allegedly placed on the firms' payrolls in order to be eligible for pension benefits from the New England Teamsters & Trucking Indus. Pension Fund, which covers several IBT locals.

Cashman and Local 25 vice-president William Carnes allegedly participated in the scheme and directed benefits from the firms to the bogus employees in violation of the Taft-Hartley Act. Cashman and Carnes have run Local 26 since 1992. Additionally, both are trustees of Local 25's HSIP, and Cashman is a trustee of NETTIPF as well as the head of IBT Joint Council 10. All five pled not guilty and were released on $25,000 bond. U.S. Magistrate Judge Joyce L. Alexander rejected arguments that the case against Cashman and Carnes was not serious enough to warrant bail but reduced the prosecutors' demand for $50,000 bail. [UCU 5.2]

**19. Five Allegedly Stole $71,000 from Atlantic City Local**

New Jersey Police announced January 2, 2002 that they have charged five people with conspiring to steal from Atlantic City's largest union, in an embezzlement scheme that allegedly drained at least $71,000 from the severance fund of Local 54 of the Hotel Employees & Restaurant Employees International Union. Mariana Candelaria, who works for Garden State Benefit

Services, Inc., the company that administers the local's severance and pension funds from desks inside Local 54's office, was arrested on December 21. Candelaria allegedly conspired with an ex-colleague and three outsiders by falsifying claims for severance payouts and then issuing and cashing the checks. Police charged Candelaria with embezzling more than $50,000, along with conspiracy, forgery, and theft by deception after an investigation by Detectives Edward Riegel and Brian Paige.

Local 54 vice president Al Cohen attempted to distance himself and other bosses from the thefts. He claimed that union members were the victims of a crime committed by a third party working inside the union office.

Also charged were Rhonda Jones, who reportedly left her job working for GSBS inside Local 54's office last year; and Jaymes Browne, a friend of Candelaria who allegedly cashed more than $6,800 in fraudulent union checks and forged documents. Jaime Cambrelen, an acquaintance of Candelaria, also faces charges of forgery and fraudulent check-cashing. Another suspect, identified as Sinclair Caesar remains at large. He is wanted on charges of theft by deception in excess of $50,000, fraud and forgery. All five suspects have been charged with conspiracy. The probe is continuing in cooperation with the Atlantic County Prosecutor's Office and the U.S. Department of Labor.

The timing of the arrests of Jones, Browne, and Cambrelen was unclear. News of Candelaria's arrest was kept private for several days because of concerns that releasing the information would jeopardize the investigation. The investigation began as a minor fraud case, when authorities began looking into a severance check issued by GSBS to a union member who supposedly had worked for Tropicana Casino and Resort. But when the probe reportedly showed that the union member never had worked at Tropicana, detectives began following a trail of financial documents, allegedly finding many other fraudulent checks that were issued from Local 54's severance fund starting in March 2001. "Two detectives followed through with it and it blossomed into a major conspiracy," Police Sgt. Michael Tullio said.

The arrests come as more bad news for Local 54 bosses, just weeks after an audit was released to union members that showed that Local 54's net assets dropped by $742,000 to $412,256 in 2000, and two weeks before a court-ordered special officer election. In October, a federal judge in threw out the results of a June 1999 election, ruling that the union failed to mail notices of the election to 1,975 members and failed to send ballots to 1,596 members. [UCU 5.3]

**20. Philadelphia Boss Accused of $50,000 Theft; $2,500 from Widow**

A federal grand jury in Philadelphia returned a 21-count indictment February 13 charging Kendall Williams with theft of union funds, theft from a union health and welfare fund, failure to keep required records, and failure to file required reports with the Department of Labor. The alleged thefts totaled $50,983.84. Williams is the president of the independent PNI Security Union, which represents the security officers at the facilities of the Philadelphia Inquirer and Daily News.

Between 1997-99, Williams allegedly embezzled approximately $29,683.84 from the PNI Security Union Health & Welfare Fund by falsely claiming that another union member, L. Zane, would join him in traveling to benefit plan administration conferences put on by the International Foundation of Employee Benefit Plans. After obtaining funds for the bogus expenses (conference fees, preconference fees, air transportation, lodging, lost wages, and per diem expenses), he deposited the Fund's checks into the union's checking account and then withdrew that money for his own personal use.

Also, he sought and received refunds from IFEBP for preconference programs that he did not attend. He did the same for Zane's unused conference and preconference fees. However, he did not return the refund checks to Fund. He deposited them into the union's checking account and withdrew that money for his personal use. Six conferences were involved: Las Vegas, Stateline, Pa. (2), Vancouver (2), and Washington, D.C.

Even more outrageous, Williams allegedly obtained a $2,500 check from the Fund in

February 2000 that was meant to be paid to the widow of a recently deceased union member. According to the indictment, he never gave that check to the widow. Instead, he deposited the check in the union's checking account on June 8, 2000, and on June 9, he withdrew the money for his personal use.

Further, Williams allegedly embezzled union monies by taking an unauthorized salary between 1997-2000, totaling about $18,800. Finally, Williams allegedly failed to keep proper records of union finances between 1997-99 and failed to timely file required financial reports with DOL for the years 1996-99. If convicted on all counts, he faces a maximum possible sentence of 77 years imprisonment, 3 years supervised release, a $4,200,000 fine, a $2,100 special assessment, and restitution. [UCU 5.4]

**21. Virginia Bosses Indicted for Stealing From Disaster Fund**

Five union bosses of United Steelworkers of America Local 9336 in Radford, Virginia, were indicted February 19, 2002, with embezzling more than $10,000 that was paid the Local 9336 Disaster Relief Fund established after a fatal explosion at the Intermet New River Foundry in March 2000. The fund was earmarked for workers affected by the explosion, in which three workers were killed. About $22,500 was raised. Some workers were facing foreclosure, repossession, and eviction as a result of the subsequent plant shutdown.

The five are charged with making payments to themselves totaling $11,856 from the Fund, while denying payments to workers in greater need. Allegedly, they did not publicize the fund and made payments to themselves after they had gone back to work or on paid sick leave. William E. Fricker, ex-local president, is charged with stealing $3,154; Edward A. Ramsey, ex-president and vice president, $1,101; Joseph W. Burress, ex-financial secretary, $1,276; Rhonda L. Creed, ex-grievance committee chairwoman, $1,239; and Elizabeth J. George, an unidentified officer, $4,186. George, who never returned to the foundry, is also charged with approving $900 in unauthorized payments to Robert E. "Robbie" Martin, with whom she had a "relationship." Martin was not charged.

All but George were also charged in a second scheme which secured about $10,809 from false or excessive claims for "lost time"--they allegedly double-billed the local for lost time for which they were also paid by the foundry. Further, some submitted claims at excessive pay rates. Fricker is charged with stealing $3,217; Ramsey, $3,964; Burress, $1,745, and Creed, $1,883. The 19-count indictment included charges of conspiracy to embezzle, conspiracy to make false entries in union records, embezzlement, and false entries. If convicted, the four face up to 17 years in prison and a $950,000 fine. George faces 11 years in prison and a $600,000 fine. The union reported the schemes to the Deportment of Labor. The five surrendered to federal authorities on February 21 in Roanoke.

"We are saddened that there may have been people who tried to profit from the tragedy of others," said Mike Kelly, communications manager at Intermet's headquarters in Troy, Mich. "These things happen. . . . It's strictly a matter between the Department of Labor and certain former officials of the union." [UCU 5.5]

**22. Hawaiian Boss, Daughter, Accused of Fraud and Other Crimes**

A federal grand jury in Honolulu returned an indictment December 19 against United Public Workers boss Gary Rodrigues and his daughter Robin H. Sabatini adding to an existing union corruption indictment that was brought in March 2001. The new indictment alleges that Rodrigues accepted more than $100,000 in kickbacks from a life insurance agent in connection with an employee benefit plan. In March, he was indicted for allegedly embezzling from the union's medical and dental plans through overcharging.

Currently, both are charged with 50 counts of mail fraud, one count of conspiracy to defraud a health care benefit program, two counts of conspiracy to commit money laundering, and 42 counts of money laundering. Also, Rodrigues is charged with five counts of embezzling union assets and one count of accepting kickbacks in connection with an employee benefit plan. Their

trial was set to begin in January, but the new charges are expected to cause a several month delay.

Rodrigues allegedly negotiated agreements with Hawaiian Dental Services and Pacific Group Medical Association, under which some of the money paid by union members for monthly premiums was later used to pay consultants reviewing the health plans. He allegedly instructed the health care firms to issue checks for consultant services to firms owned by Sabatini. Also, he allegedly never told UPW that he had included consulting fees as part of the contract and set up his daughter and her firms to primarily receive those fees. [UCU 5.1]

**23. Union Fund Manager Admits to Kickbacks**

A New York union pension fund consultant admitted February 6, 2002, that he paid kickbacks to a fund trustee. George W. Philipps, ex-president and owner of Pension Fund Evaluations, Inc., a consulting firm in Centerreach, N.Y., pled guilty before U.S. District Judge Nancy Gertner (D. Mass.) in Boston to a charge of paying kickbacks to William V. Close, who was then a trustee of the pension funds of International Brotherhood of Teamsters Local 710 and International Association of Machinists Local 701 (a.k.a., Auto Mechanics Union Local 701), both of which are in Chicago.

At the plea hearing, Assistant U.S. Attorney Jeanne M. Kempthorne told Gertner that Philipps caused three cash payments totaling $55,000 to be paid to Close between September and November 1997, in return for Close's using his influence to cause Fiduciary Management Associates, Inc., an investment manager to the union pension funds, to direct trades for the benefit of Philipps' firm. Clearing brokers with commission-splitting arrangements with Pension Fund Evaluations, paid the firm a portion of the commission earned on trades. Philipps, in turn, paid Close the kickbacks. As a result of the deal, Philipps' firm received hundreds of thousands of dollars in commissions without providing any services to the union pension funds, a practice known as "free business." Philipps, while admitting to the essential elements of the crime charged, denied that the payments were a bribe he agreed to pay as a condition of his receiving the union pension fund business.

Gertner scheduled sentencing for May 23. Philipps faces a maximum sentence of three years in prison and a $250,000 fine. Close, of Chicago, pled guilty on June 2, 2000 to receiving kickbacks and to money laundering. He is scheduled to be sentenced in U.S. District Court in Chicago on March 12. [UCU 5.4]

**24. New York Bosses Sentenced for Mob Leaks in Stock Scam Case**

U.S. District Judge William H. Pauley III (S.D.N.Y.) sentenced ex-treasurer of the NYPD's Detectives Endowment Association Stephen E. Gardell March 18, 2002, to a year and a day in prison on a federal wire fraud charge. He allegedly leaked law enforcement secrets to the mob and in exchange his mob friends built an $8,000 swimming pool at his home, comped him at a casino, and gave him a fur coat for his wife, according to prosecutors.

Gardell quietly pled guilty in November 2001 to the fraud charge after being linked to a sweeping case of mob stock ripoffs and crooked brokers. Federal prosecutors in Manhattan had first charged Gardell with conspiring to move pension investments into a crooked mob-backed financial firm in exchange for a big payoff. The scheme was caught before any pension money was touched. Gardell was arrested in June 2000 along with 119 others as part of the FBI's "Operation Uptick," which targeted mob influence on Wall Street. Weeks before his arrest, he put in for retirement and left with an $80,000-a-year pension.

Gardell asked that he be sentenced to home confinement so he could care for his ailing 87-year-old mother. In turning him down, Pauley said, "You violated the most sacred trust, a trust that is reposed in you by the community [and] by all law enforcement personnel." [UCU 5.7]

On March 26, 2002, Pauley also denied motions for acquittal by a stock promoter and hedge fund manager who were found guilty of participating in a union pension fund fraud and kickback conspiracy by a Manhattan jury. The indictment alleged that John M. Black Jr., a stock promoter, and Glenn B. Laken, a hedge fund manager, along with their co-conspirators, some of

whom were members of organized crime, devised fraudulent investment products such as a venture fund and preferred stock.

The proposed scheme targeted the pension funds of three unions: Production Workers Local 400 in New York City, the Annuity Fund of the Detectives' Endowment Association, and International Union of Operating Eng'rs Local 137 of Briarcliff Manor, New York.Black and Laken were charged with violating RICO by participating in a conspiracy involving wire fraud and bribery schemes. They also were charged with the illegal acts themselves, such as using interstate wires to defraud the pension funds, and promising to pay illegal kickbacks to union officials. Black and Laken were convicted by a jury of all the charges against them. Black and Laken moved for a judgment of acquittal, asserting that the government's proof of a corrupt agreement with one union does not amount to a pattern of racketeering activity essential to conviction under RICO or support convictions for some of the other offenses. Pauley found that the government's proof, which principally consisted of taped conversations obtained by court-ordered electronic surveillance and consensual recording, was sufficient to sustain all counts of conviction against Black and Laken. [UCU 5.8]

The two were indicted in June 2000 along Gardell . So far, 92 defendants have been convicted of various fraud schemes and another 17 cases are pending. The federal jury in Manhattan also acquitted three other men who were on trial with Black and Laken: Dallas-based real estate developers Gene Phillips and A. Cal Rossi as well as San Francisco-based investment strategist William M. Stephens. Of the 120 defendants charged, 11 have had the charges against them dismissed or were acquitted at trial. Black and Laken face up to 20 years in prison at their sentencing scheduled for May 31.

No bribes were ever paid, and the union money was never diverted to the other investments. Arrests were made before any union pension funds were squandered. Most of the evidence at trial against Stephens arose from 30 to 35 hours of taped conversations between the various defendants and Jeffrey Pokross, a government informant who ran a corrupt investment bank that had been infiltrated by the Gambino and Bonanno crime families, DMN Capital On the tapes played in court, Pokross made reference to bribing pension fund managers in conversations with Stephens. But Stephens, the only defendant to take the witness stand in his own defense, testified that he did not believe Pokross was serious and was merely going along with him to meet potential new clients. [UCU 5.4]

**25. $77.5 Million Suit Against Union Wins Class Action Status**

U.S. District Judge Sidney H. Stein (S.D.N.Y.) granted class certification January 8, 2002, to a suit brought by participants in the International Ladies Garment Workers' Union death benefit fund who allege that the fund violated its fiduciary duties when it transferred $77.5 million of fund assets to the union, which is now part of the Union of Needletrades Industrial & Textile Employees. The fund was established in 1937 and included language prohibiting any withdrawals except for payment of benefits and administrative costs. In 1976, an amendment was added to ILGWU's constitution that permitted termination of the fund by the union's board. In 1997, the board terminated the fund and transferred the bulk of the fund's assets to a new death benefit fund. However, it also transferred $77.5 million of assets to the union itself, and $12.5 million of which was routed to a nonprofit corporation, 21st Century ILGWU Heritage Fund.

Stein granted the participants' and beneficiaries' motion for class certification, finding that the requirements for a class action were met. There were common questions such as whether the transfer to ILGWU violated ERISA; whether the documents governing the fund permitted the transfer; and whether the original fund was "terminated" within the meaning of ERISA. Reportedly, 100,000 to 132,000 participants and beneficiaries who could be included in the class. [UCU 5.3]

# APPENDIX

May 14, 2002

*(Prepared, Not Delivered)*
**Opening Statement**

# Chairman Michael G. Oxley

## Committee on Financial Services

**Subcommittee on Capital Markets, Insurance,**
**And Government-Sponsored Enterprises**
**"Corporate Accounting Practices:**
**Is There a Credibility GAAP?"**
**May 14, 2002**

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Good morning. I want to thank Chairman Baker, for holding this second day of a set of important hearings. As I said on the first day of hearings two weeks ago, our responsibilities to build confidence in the capital markets require us to review the accounting principles and corporate practices that American companies use every day to report on their operations.

The average American is learning more about the Financial Accounting Standards Board, or FASB, and its role in the changes in their personal investment and retirement accounts. FASB's accounting principles are the bedrock of the financial reports that we rely upon as investors. The hard-working folks in Findlay, Ohio, don't have to check the FASB Web site for its latest pronouncements, but they depend on FASB to advise company management and auditors how to report billions of deals and daily transactions in the marketplace.

Federal securities law gave the authority for overseeing the process for setting those principles solely to the Securities and Exchange Commission. Practically from its beginning, the SEC wisely worked through private-sector bodies to set those standards. It would be sheer lunacy to imagine that the federal government could dictate accounting principles. Even after the recent spate of unpleasant news, the result of the SEC's collaboration with the private sector is the best financial disclosure and reporting system in the world, bar none.

But the folks in Findlay, indeed all of our "shareholders," also know that you can't stand still in America. Whole industries and some of our biggest companies didn't exist 20 years ago, and some that did then are gone now. Investments and structures that didn't exist then are now accepted as standard. The process for setting accounting principles has to adjust. FASB has to respond rapidly with the appropriate guidance, and the SEC has to work aggressively to ensure FASB's rapid approval of any new principle and adoption by the industry.

I have here an accounting textbook that was used in accounting courses at my alma mater, Miami University of Ohio, during the 1960s and '70s. Very early in the book, it cites some of the most basic guidance for accountants for the ideal that useful accounting information includes qualities such as relevance, understandability, timeliness, and comparability. I wonder whether the accounting information in financial statements possesses those qualities. For instance, AOL Time Warner reported a massive write-down in its assets, while Intel reported a huge increase in operating income, solely because of changes in

accounting principles for reporting the value of goodwill. Those headlines produced confusion, misunderstanding, and doubts, and the companies have nothing to do with it; it was all based on the accounting.

And I'm beginning to wonder if the "cash flow game," which this Committee explored in two separate Subcommittee hearings on March 21 and May 1, is a real gamble for investors. In one quarter last year, Global Crossing reported cash flow that was 50 percent higher than its audited revenues. The other telecom companies have their own definitions of cash flow, and they all differ, and none of the claims by any company are audited or otherwise verified. Dynegy, which backed away from buying Enron as it collapsed, announced last month that it had its own accounting problems with its cash flow statement. It had to reduce its cash flow for 2001 by $300 million, or 37 percent, because it wasn't reported accurately.

Mr. Chairman, I know you agree that we need to do better if we are to prevent the volatility we've seen in the markets over corporate accounting. I hope we can use our bully pulpit here to help jump-start the process.

Beyond the accounting information, all of the value in a company should be reported with all of the same qualities that make accounting information useful. Several of our witnesses will discuss what they see as a revolution in corporate reporting. We look forward to hearing these ideas for innovative and dynamic mechanisms that will benefit investors.

That concludes my comments, and I will now yield back to the Subcommittee Chairman, Mr. Baker, for what I anticipate will be an outstanding hearing.

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**OPENING STATEMENT OF**
**RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**SECOND HEARING ON CORPORATE ACCOUNTING PRACTICES: IS THERE A CREDIBILITY GAAP?**

**TUESDAY, MAY 14, 2002**

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Mr. Chairman, we meet again today to learn more about problems with corporate accounting practices. The many recent news reports of corporate accounting problems have raised numerous questions about whether our Nation's accounting principles and practices provide sufficient guidance to management, corporate directors, and auditors.

As you know, Mr. Chairman, I have held serious reservations about the reliability of certain corporate accounting practices for some time. If not fixed in the short term, these problems could have potentially serious and negative consequences for our country's flourishing capital markets in the long term. After all, if investors cannot trust the reliability of the numbers produced by corporate accountants in audited statements, then they might as well spend their hard-earned money on lottery tickets.

Today's hearing furthers the investigations that we began earlier this month. Our capital markets are the most successful in the world for one simple reason -- investor confidence. The transparency fostered by the application of Generally Accepted Accounting Principles has played an important role in this success. In fact, former Treasury Secretary Lawrence Summers has suggested that the development of GAAP was one of the most important innovations in the history of our capital markets, because that standardization enabled investors to compare and contrast the performance of companies. Unfortunately, the failure to implement GAAP consistently has now led to an almost daily discovery of accounting irregularities at American corporations. This evolving situation has also sparked a crisis of confidence that continues to ripple through our capital markets.

We have, however, known about these problems for some time. For example, research published in 2001 by Financial Executives International identified some startling facts. The study found 464 cases of earnings restatements in corporate America over a three-year period, more than the previous seven years combined. It also determined that 156 earnings restatements in 2000 wiped out more than $31 billion in market capitalization. I suspect that when we tabulate these figures for 2001, these two already sizable statistics will grow considerably.

What factors contributed to this troubling state of affairs? In recent decades, the rules governing corporate accounting have become increasingly complex. Since the early 1990s, for example, the Financial Accounting Standards Board has developed several fair-value measurement, recognition, and disclosure standards. These standards often permit multiple interpretations. Accounting has also evolved from determining the cost of producing and the revenue from selling a good like a screwdriver, to ascertaining the cost and revenue from selling an intangible service like a 25-year energy derivative. These and other developments have helped to make corporate financial statements increasingly impenetrable and confusing.

From my perspective, an effective accounting system must ensure the comparability of financial data from one company to another. Comparability in the data used by investors will

allow them to evaluate apples against apples, and oranges against oranges. Improvements in accounting transparency will also facilitate the efficient flow of capital.

Today's hearing will help us to examine the roles of the Securities and Exchange Commission and the Financial Accounting Standards Board in developing Generally Accepted Accounting Principles. Throughout its history, the Securities and Exchange Commission has relied on the private sector to establish accounting standards. We will explore today whether that policy should continue.

We will also explore today whether we should move from a "rules-based" accounting system to a "principles-based" accounting regime. International accounting standards presently rely more on principles and general guidelines than the American system. As the participants in our global economy become increasingly interdependent, it may be time for us to modify our own accounting regime. I approach this debate with an open mind.

In closing, Mr. Chairman, I believe our Committee should comprehensively explore the issues related to corporate accounting practices, and I am looking forward to hearing from our distinguished witnesses.

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**OPENING STATEMENT**

Corporate Accounting Practices: Is There Credibility GAAP?
Part II
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
5/14/02

**Rep. Stephanie Tubbs Jones**

Good Morning, Chairman Baker, Vice Chairman Ney, Ranking Member Kanjorski and Members of this Subcommittee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

A few weeks ago, this subcommittee held its first hearing on these issues focusing specifically on the impacts of accounting rules on investors. Today, we are here to explore the role of those individuals that created those rules.

In 1973, the Financial Accounting Standards Board, otherwise known as FASB, was named as the principle entity responsible for the creation of standard accounting rules and regulations. GAAP is apparently the result of many years of deliberation and debate regarding these standards.

For one reason or another, we have seen these rules and regulations stretched to, and past, the breaking point often leading to financial disasters like Enron and Global Crossing. There seems to be a variety of opinions as to why these rules and regulations are so easily circumvented. Some say that the GAAP standards do not reflect the global

pulse of modern business and thus are not able to accurately reflect the financial condition of an international corporation. Others say that FASB is simply not able to react quickly enough in order to deliver new rules and regulations that reflect the escalating complexity of financial transactions between multinational corporations. Still others say that it is simply ineptitude on the part of the members of FASB to deliver.

We are here today to find out for ourselves what the case may be. This committee is fortunate to not only have experts from both academic and corporate accounting circles testifying today but the Chairman of FASB has been gracious enough to appear before us as well as the Chief Accountant of the SEC. With all of the debate regarding the efficacy of FASB as it pertains to its stated mission, I look forward to hearing the perspective of those closest to the issue.

Mr. Chairman, I thank you for my time.

**TESTIMONY OF**
**ROBERT K. HERDMAN**
**CHIEF ACCOUNTANT**
**U.S. SECURITIES AND EXCHANGE COMMISSION**
**THE ROLES OF THE SEC AND THE FASB IN ESTABLISHING GAAP**

**Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services**
**U.S. House of Representatives**
**May 14, 2002**

Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee:

I am pleased to appear before you on behalf of the Securities and Exchange Commission to testify concerning the roles of the Securities and Exchange Commission and the Financial Accounting Standards Board in establishing generally accepted accounting principles, and questions that have arisen with respect to the relevancy of generally accepted accounting principles in today's business environment.

I know that all of the Members of this Subcommittee have worked diligently over the past few months, and I would like to commend the leadership shown by you, Mr. Chairman, and Ranking Member Kanjorski, as well as Chairman Oxley and Ranking Member LaFalce of the full Committee, in exploring these important issues and working to maintain investor confidence. The recent House action on H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, was a significant achievement, and this Committee should be commended for the informative hearings and debate leading up to the bill's passage by the House of Representatives. I would also like to add that the SEC has appreciated the opportunity to work with you and your staffs, and we look forward to continuing that cooperation.

Recent events and press articles have raised questions about the transparency of the accounting and disclosure practices of some companies. More specifically, the announcement of the need to restate and subsequent implosion of Enron, the indictment of Arthur Andersen, the bankruptcy of Global Crossing and other recent SEC enforcement actions, among other events, have shaken investors' confidence in the quality of the financial information they are receiving and on which they are basing their investment decisions.[1]

While our financial reporting system in the U.S. continues to be the best in the world, certain aspects of the system can and should be improved. In particular, the Commission believes that the process for setting financial accounting standards must be enhanced so that changes to accounting standards can be implemented more quickly, be more responsive to market changes, and provide more transparent information to investors.

The SEC has a unique position in the financial reporting process. The Commission not only has authority under the securities laws of the United States to set accounting standards to be followed by public companies but also the power to enforce those standards. Practically since its inception, the Commission has looked to the private sector for leadership in establishing and improving the accounting methods used to prepare financial statements.[2] The body currently performing that function is the Financial Accounting Standards Board, or the FASB. As a result, the FASB has the power to set, but not enforce, accounting standards to be used by public companies. With this context in mind, I would like to share with the Subcommittee the SEC's insights into the standard-setting process and the needed reforms to continue to support our capital markets.

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[1] Any information relating to ongoing investigations is nonpublic and accordingly my statement will be confined to the public record.
[2] See Accounting Series Release (ASR) No. 4 (April 1938) and ASR No. 150 (December 1973).

**The SEC's Role in Financial Reporting**

The SEC is on the front line of financial reporting and often is among the first to identify emerging issues and areas of accounting that need attention. Issues needing attention often can be attributed to new and unique transactions that arise in the marketplace, but they also may arise from the authoritative literature.

The SEC staff frequently learns of these issues when companies engage us in a dialogue as to the appropriate financial reporting answer in advance of an event or transaction, commonly referred to as "pre-clearing" an accounting question. While these pre-clearance questions usually relate to single transactions, trends tend to develop surrounding certain issues. When they do, the staff refers these issues to the FASB and its interpretative bodies for guidance. For example, the SEC has urged the FASB to provide consolidation guidance concerning special purpose entities.

The staff also gains insights from the selective review process performed by the Division of Corporation Finance and actions taken by the Division of Enforcement. For example, the SEC staff asked the FASB to add revenue recognition to its agenda because approximately one-half of restatements and one-half of all enforcement actions relate to revenue recognition.

Other major FASB projects that have been completed or that were added to the Board's agenda were done so at the request of the then current Chief Accountant of the SEC because of problems the SEC observed in practice. These projects include business combinations, because of issues related to the pooling-of-interests method of accounting, and accounting for financial instruments at fair value, which the SEC staff referred to the FASB because of transparency issues related to derivatives, investments and loans. We have a responsibility to refer such issues to the FASB, and the FASB has a responsibility to address the issues we refer to them in a timely manner.

Some of the issues the SEC staff encounters do not require a fundamental change to existing accounting or completion of a major project by the FASB. In these situations, we may refer an issue to the Emerging Issues Task Force, or EITF,[3] for interpretation. In this manner, timely and appropriate guidance can be provided to preparers and auditors before inappropriate practices become ingrained.

In light of the SEC's unique role, it is critical that the SEC work closely with the FASB, particularly as it relate to the FASB's agenda. In addition, the SEC has the ultimate responsibility to ensure that the FASB deals with issues referred to it by the SEC. The cooperative effort between the public and private sectors has given the United States the best financial reporting system in the world, and the Commission is intent on making it even better.

**Importance of Transparent Financial Reporting to the Capital Markets**

Now I would like to discuss more fully the importance of transparent financial reporting to our capital 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 visible and understandable to investors and other market participants – is central to meeting this goal. Transparency:

- Enables investors, creditors, and the market to evaluate an entity;
- Increases confidence in the fairness of our markets; and
- Is fundamental to corporate governance because it enables boards of directors to evaluate management's effectiveness, and to take early

[3] The EITF is a committee of accounting practitioners that assists the FASB in providing timely guidance on emerging issues and the implementation of existing standards. If the EITF reaches a consensus solution to an emerging or implementation issue, Commission or FASB action may not be considered necessary. The SEC Chief Accountant participates as an observer at EITF meetings.

> corrective actions, when necessary, to address deterioration in the financial condition of companies.

Therefore, it is critical that all public companies provide transparent disclosures that result in an understandable, comprehensive and reliable portrayal of their financial condition and performance.

To this end, the SEC mandates certain content and disclosures in SEC filings, such as audited financial statements and Management's Discussion and Analysis. A company's financial statements form the core of its required SEC filings and greatly influence the content of the mandated disclosures included elsewhere in the documents. Thus, audited financial statements, and the standards that underlie them, play a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

**U.S. Accounting Standard-Setting Process**

The Securities Act of 1933 and the Securities Exchange Act of 1934 each clearly state the authority of the Commission to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under the Acts.[4] In meeting this statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission, for over 60 years, has looked to the private sector for leadership in establishing and improving accounting standards. The quality of our accounting standards and our capital markets can be attributed in large part to the private sector standard-setting process, as overseen by the SEC.

The primary private sector standard setter is the FASB, which was established in 1972. An oversight body appoints the members of the FASB. This oversight body, the

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

Financial Accounting Foundation, or FAF, is comprised of investors, business people, and accountants. The FASB's standards are designated as the primary level of generally accepted accounting principles, or GAAP, which is the framework for accounting. The FASB's standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

Concerns About the FASB

Historically, the determinations by the FASB and its predecessors generally have been regarded, by the Commission, as being responsive to the needs of investors. Lately, however, concerns have arisen that the FASB is not being as responsive as it should be. Even before the recent events, the SEC staff called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity. Specifically, we asked the FASB to address the following concerns:

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

Evolution of Standard-Setting

As we contemplate reform, we need to consider how we got here. So it is important to understand how the current system of standard setting evolved. In its nearly 30-year history, the FASB has undertaken a series of projects to drastically change how financial information is reported to investors and other financial users. These projects, which include consolidation of financial statements and accounting for financial instruments at fair value, represent major conceptual changes in financial reporting. As you might expect, such sweeping change has been very controversial and sapped the resources of the FASB.

As a result, the FASB has not issued comprehensive guidance on issues such as revenue recognition and consolidation of special purpose entities. The FASB's interpretive body, the EITF and the SEC staff have attempted to address some of the issues, but without an underlying principle the result has been disappointing.

The Fair Value Project

An example of the fundamental changes that have taken place in how financial information is reported is the FASB's project on measuring financial instruments at fair value. This project, which has been broken down into discrete pieces, has resulted in several standards concerning measurement and disclosure of financial instruments. Furthermore, it has fundamentally moved the paradigm for the financial reporting of financial instruments away from historical cost.

While certain issues are unresolved, changes this broad and fundamental take time and, necessarily, must be accomplished on a step-by-step basis. One such issue is reliability. Some of the guidance that has been issued has raised questions about the quality of earnings because certain fair value measurements have been estimated using models, and objective inputs to the model are not available. A question that the FASB must address is how to measure fair value when objective evidence does not exist for determining the assumptions from which to estimate fair value using a valuation model. Another open and related question that the FASB must address is the one of recognition of changes in fair value in the income statement. We continue to support the FASB's consideration of these important issues.

Principles Versus Rules

Additionally, over the last few years, certain of FASB's standards have been rule-based, as opposed to principle-based. Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments

from the application of the reporting. Examples of rule-based accounting guidance include the accounting for derivatives, employee stock options, and leasing. And, of course, questions keep coming. Rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.

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

A move to principle-based standards will require greater discipline by the corporate community, the accounting profession, private-sector standard-setting bodies, and the SEC staff. A move away from a check-the-box approach to financial reporting means that all constituencies must make concerted efforts to report transactions consistent with the objectives of the standards. While this may mean that not all transactions are recorded in exactly the same manner, it is my belief that similar transactions in this system of principle-based standards will not be reported in materially different ways, preserving comparability. Finally, a critical and important benefit of principles-based standards is that it would mitigate the opportunities to financially engineer around the rules. We have been working with the FASB to change its style to be more principle-based.

Past FASB Achievements

An objective analysis of the FASB's process must take into consideration what it has done well. U.S. GAAP, which is the backbone of our disclosure system, is the most

complete and comprehensive set of accounting principles in the world. Some countries do not have any guidance on how to account for financial instruments.

And GAAP continues to be improved. Recently, the FASB completed the first phase of its project on business combinations, which eliminated pooling-of-interests accounting, enhanced disclosure requirements relating to goodwill and intangible assets and moved towards international convergence. Another example of an improvement is SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* The FASB took up this project, which was very controversial at the time, and promulgated a standard that not only improved financial reporting by requiring companies to account for their non-pension postretirement benefits on an accrual rather than a cash basis, but also served to increase corporate awareness of the underlying economics surrounding such postretirement benefits.

Recent Developments

Recently, in an effort to speed up the standard setting process, the FASB has initiated a reorganization of its staff. The primary change is one that divides the Technical Director position into three separate positions, all reporting to the Chairman. Additionally, the FAF has recently appointed a new FASB chairman, effective July 1, 2002 and has instructed him to review, between now and the end of the year, the structure and procedures of the FASB, and to make recommendations to improve efficiency and timeliness.

The FAF also has changed the FASB voting process to require a simple majority vote for the issuance of an accounting standard. Previously, a supermajority of the seven-member board was required. Critics of the supermajority requirement have commented that the need for five votes has resulted in a lack of accounting guidance in certain controversial or complex areas, as the FASB was unable to gather a sufficient number of votes. In addition, critics also comment that in an effort to obtain five votes, the FASB has compromised on certain aspects of a standard. We are encouraged by these recent

actions and hope that they will lead to more timely and improved guidance. We applaud the FASB and the FAF for their efforts.

**International Convergence**

In this day and age, one cannot talk about standard setting in the United States without discussing international convergence. On the international front, capital markets of the world are increasingly interdependent while technology is making borders disappear. This trend has been accelerated by the European Commission's proposed regulation that would generally require all listed EU companies to apply international accounting standards for their 2005 consolidated financial statements. In light of this, there is a critical need to focus on the convergence of U.S. GAAP and international accounting standards.

While convergence can have a variety of different meanings, it has generally assumed that, ultimately, all standard setters should agree on a single, high-quality accounting answer. In the long-term, this definition of convergence is a laudable one to which all should aspire. However, there is an immeasurable need for the FASB and the International Accounting Standards Board, or IASB, to converge the high-level principles in their standards in the short-term, rather than the long-term, and so, much more needs to be done. We recognize there is a joint IASB/FASB project on accounting for business combinations. In order to achieve convergence in the short-term, however, the FASB and the IASB have to work together more closely than they have to date. To this end, the SEC has encouraged both the IASB and the FASB to re-examine their agendas in order to speed up their short-term convergence efforts.

**The Public Accountability Board**

Now I would like to briefly address another critical and related part of the financial reporting process, which is the oversight of the accounting profession. Auditing is a critical component in the financial reporting process. It provides credibility to the

financial statements and comfort to investors. Accordingly, the Commission is exploring ways to strengthen the system of overseeing the work of the accountants that perform audits of public companies. This oversight is not presently, nor is it contemplated to be, under the umbrella of the FASB.

The oversight or "peer-review" system that has been used in the U.S. since 1977 has been questioned as to its effectiveness in ensuring high-quality audits. As a result, the Commission expects to soon make a proposal for a different system. The proposed system would include the concept of a Public Accountability Board or PAB. The PAB would direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and also would discipline auditors for incompetent and unethical conduct.

There are several important aspects of the PAB that I want to mention. First, our proposal would call for the PAB to work as a complement to the enforcement efforts of the Commission and focus on ethical and competence requirements rather than existing statutory and regulatory requirements. We have seen success of such a two-tier system of regulation, specifically within the securities industry. The proposed system is aptly designed to handle behavior that is unethical or incompetent.

Second, the PAB would be an organization that is dominated by members that are unaffiliated with the accounting profession. Because there is a public benefit to having some expertise of the accounting profession, the PAB should have a minority of representation from that industry.

Lastly, the source of funding of the PAB is one that must be secure and independent. Our proposal would include a system where involuntary fees would be imposed upon those who benefit from financial statements audits, whose quality would be overseen by the PAB. Those subject to the involuntary fees would include, but not be limited to, the accounting firms that perform such audits.

**Conclusion**

In summary, let me state that we have the deepest and most liquid capital markets in the world largely because of the high quality of our financial reporting system. However, even though our system is the best at present, there is room for improvement. Recent events have been a catalyst for reform and the work related to implementing the needed reforms I have discussed today has begun. While it is imperative that the criticisms of the accounting standards-setting process be addressed, we should not abandon the system that has allowed us to achieve what we have to date. Instead we must take the opportunity to make fundamental improvements to standard setting and oversight. Thank you for your interest in having scheduled this hearing today and inviting me to participate. I am pleased to answer any questions that the Subcommittee members may have.

**Testimony of Edmund L. Jenkins**
**Chairman**
**Financial Accounting Standards Board**
**Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services**
**May 14, 2002**

**Full Text of Testimony**

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to appear before you today on behalf of the Financial Accounting Standards Board ("FASB" or "Board"). My testimony includes a brief overview of the FASB and our structure and process, a summary of the significant activities that the Board has completed over the past year, and a summary of some of the Board's current projects. My testimony includes a summary of the FASB's responses to the report of the American Institute of Certified Public Accountant's ("AICPA") Special Committee on Financial Reporting. My testimony also includes a brief discussion of Enron Corp.'s ("Enron") failure to comply with existing accounting requirements. Finally, my testimony concludes with some brief comments about the "credibility GAAP."

***What Is the FASB, What Does It Do, and What Has It Done Lately?***

The FASB is an independent private-sector organization. We are not part of the federal government and receive no federal funding. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the markets because investors, creditors, and other consumers of financial reports rely heavily on credible, transparent, and comparable financial information.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For more than

60 years, the SEC has looked to the private sector for leadership in establishing and improving those standards.

The FASB's standards govern only the information contained in enterprises' financial reports—financial statements and accompanying notes. Those reports are only one element of the broader universe of information provided by enterprises to the public. Other important information for consumers includes management's discussion and analysis, information provided in an enterprise's annual report, presentations to analysts, fact books, and information provided on an enterprise's website.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with the FASB's standards rests with the officers and directors of an enterprise, the auditors of the statements, and for public enterprises, ultimately with the SEC. Generally, when an enterprise restates its financial reports, it publicly acknowledges that it has failed to comply with existing accounting standards.

The FASB also has no authority or responsibility with respect to auditing, including the independence of auditors and the scope of services of auditors. Rather, our responsibility relates solely to establishing financial accounting and reporting standards.

The focus of the FASB is on consumers—users of financial reports, such as investors, creditors, and others. We attempt to ensure that financial reports give consumers an informative picture of an enterprise's financial condition and activities and do not color the image to influence behavior in any particular direction.

The US capital markets continue to be the deepest, most liquid, and most efficient markets in the world. The unparalleled success and competitive advantage of the US capital markets are due, in no small part, to the high-quality and continually improving US financial accounting and reporting standards. As Federal Reserve System Chairman Alan Greenspan stated:

> Transparent accounting plays an important role in maintaining the vibrancy of our financial markets. . . . An integral part of this process involves the Financial Accounting Standards Board (FASB) working directly with its constituents to develop appropriate accounting standards that reflect the needs of the marketplace.[1]

The FASB has been very active this past year issuing standards and other accounting literature and information to improve the relevance and transparency of financial reports. The Board issued the following standards since June 2001:

- A standard that improves the transparency of business combinations[2]
- A standard that improves the transparency of purchased goodwill and intangible assets[3]

[1] Letter from Federal Reserve System Chairman Alan Greenspan to SEC Chairman Arthur Levitt (June 4, 1998).
[2] See FASB Statement No. 141, *Business Combinations* (June 2001).
[3] See FASB Statement No. 142, *Goodwill and Other Intangible Assets* (June 2001).

- A standard that improves the transparency of asset retirement obligations[4]
- A standard that improves the transparency of impairment or disposal of long-lived assets[5]
- A standard that updates, clarifies, and simplifies several existing accounting requirements.[6]

Other accounting literature and information issued the past year include:

- A video to assist the public in understanding the importance of financial reporting to the US capital markets and to individual investment decisions[7]
- A report that identifies redundancies between generally accepted accounting principles ("GAAP") and SEC disclosure requirements and ways to eliminate them (see below the discussion, "How Has the FASB Responded to the Report of the AICPA's Special Committee on Financial Reporting?")[8]
- A report that encourages enterprises to continue improving their business reporting and to experiment with the types of information disclosed and the manner by which it

[4] See FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (June 2001).
[5] See FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (August 2001).
[6] See FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (April 2002).
[7] See *FASB Presents Financially Correct with Ben Stein* (2001).
[8] See Business Reporting Research Project, Steering Committee Report, *GAAP-SEC Disclosure Requirements* (2001).

is disclosed (see below the discussion, "How Has the FASB Responded to the Report of the AICPA's Special Committee on Financial Reporting?")[9]

- A report that examines the impact of the "new economy" on business and financial reporting.[10]

***What Is the Financial Accounting Foundation ("FAF"), and What Is the FAF's Relationship to the FASB?***

The FASB is an operating unit of the Financial Accounting Foundation ("FAF"). The FAF is a not-for-profit foundation that was incorporated in 1973 to operate exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code.

The FAF is separate from all other organizations. Its 16-member Board of Trustees is composed of prominent individuals with a broad range of backgrounds. Each of them shares a common understanding of the importance of independent private-sector accounting standard setting to the efficiency of the US capital markets.[11]

The FAF Trustees have several important responsibilities with respect to the FASB.

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[9] See Business Reporting Research Project, Steering Committee Report, *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures* (2001).
[10] See FASB Special Report, *Business and Financial Reporting, Challenges from the New Economy* (April 2001).
[11] See Attachment 1 for a list of the current FAF Trustees.

Those responsibilities include:

1. Oversight of the FASB's process to ensure that the FASB is fulfilling its stated mission (see below the discussion, "What Process Does the FASB Follow in Developing Accounting Standards?")

2. Selection of the FASB Board members

3. Arranging for the financing of the FASB.

FAF Trustees select the FASB Board members based on their technical expertise in financial accounting and reporting. Board members, however, have diverse backgrounds. Of the seven current members of the Board, three are from the accounting profession, two from the business community, one from the analyst community, and one from the academic community.

Each of the Board members is a full-time employee of the FAF and is required to be independent of all other business and professional organizations. Thus, upon joining the FASB, Board members are required to sever all financial ties with former employers. Board members can serve no more than two full five-year terms.

Approximately two-thirds ($15 million in 2001) of the FASB's financing results from the public sale and licensing of the FASB's publications. The remaining one-third ($6 million in 2001) results from the fundraising efforts of the FAF Trustees who solicit donations from a broad range of consumers, preparers, and auditors of financial reports.

To ensure the independence and objectivity of the FASB, the Board members are prohibited from participating in the FAF Trustee's fundraising efforts, and the FAF Trustees are prohibited from participating in the Board members' technical decisions on establishing and improving accounting standards.

***What Process Does the FASB Follow in Developing Accounting Standards?***

Because the actions of the FASB affect so many organizations and are so important to the efficient functioning of the US capital markets, its decision-making process must be open and thorough. An open and thorough process is essential to ensuring the credibility and quality of the resulting standards. An open and thorough process also reduces the possibility that standards will create unintended consequences inconsistent with transparent financial reporting.

Our Rules of Procedure require an extensive and public due process that is broader and more open in several ways than the Federal Administrative Procedure Act, on which it was modeled. The FASB process involves public meetings, public hearings, field tests, and exposure of our proposed standards to external scrutiny and public comment. The Board makes final decisions only after carefully considering and understanding the views of all parties, including consumers, preparers, and auditors of financial information.

The FASB and the FAF, in consultation with the Board's constituents, periodically review the FASB's due process to ensure that the process is working efficiently and effectively. Beginning in January of this year, in response to constituent requests,

including requests from our Financial Accounting Standards Advisory Council,[12] the FAF and FASB have undertaken several actions to improve the Board's due process procedures, as well as improve the ease of access to our standards and related accounting literature, reduce the complexity of our standards, and modernize financial accounting and reporting. Those actions include the following:

- Reducing the Board voting requirement from a 5-to-2 supermajority to a 4-to-3 majority to make the process more efficient without compromising the quality of the FASB's standard-setting process.

- Reorganizing the FASB's research and technical activities staff by reallocating the staff functions across three distinct areas versus one that had been in place previously. The reorganization is designed to address increasing demands on staff and other resources of the FASB.

- Implementing an improved approach to determining what new major topics should be added to the FASB's technical agenda. That approach involves issuing a proposal for public comment before the Board decides whether to add a particular project to its agenda. The proposal discusses the problem to be addressed (that is, the reason for the project), the proposed scope, relationship to the conceptual framework and relevant research, the main issues and alternatives the Board expects to consider, and how practice might be affected. The proposal also explicitly reviews the Board's agenda decision criteria.[13] The Board believes this improved approach provides

[12] See Attachment 2 for information about the Financial Accounting Standards Advisory Council.
[13] See Attachment 1 for information about the Board's agenda criteria.

additional discipline to the Board's project management capabilities, particularly in the area of defining and refining the scope of a new agenda project. Scope expansion during the life of a project has sometimes been a significant impediment to the timeliness of the Board's standard setting.

- Implementing a more rigorous project planning and management process, which requires the establishment of clear project milestones and plans for meeting them, resource budgets, and status reporting in terms of previously established milestones.

- Working with the Emerging Issues Task Force ("EITF"),[14] the AICPA, and the SEC to more clearly define and coordinate their accounting-standard-setting roles with those of the FASB with an eye toward streamlining certain activities.

- Making it easier for constituents to find all of the appropriate accounting requirements for a particular topic by including references to all applicable US accounting literature in the FASB's future standards and in the FASB's *Current Text,* a compilation of all FASB accounting standards categorized by subject. In addition, the FASB is seeking to partner with others in developing an online database that will include all of the US accounting literature.

- Reducing the complexity of accounting literature by (1) seeking to determine if the FASB can issue standards that are less detailed and have few, if any, exceptions or alternatives and (2) more actively engaging FASB constituents in discussions about the cost-benefit relationship of proposed standards.

[14] See Attachment 1 for information about the EITF.

- Working with the SEC in its initiative to modernize financial reporting and disclosure.

***What Are the Board's Current Projects to Improve the Relevance and the Transparency of Financial Reports?***

The FASB has 18 current agenda projects (and 1 proposed agenda project) designed to improve the relevance and transparency of financial reports.[15] A brief description of four of the more significant of those projects (and the proposed project) follows:

*Interpretative Guidance on Consolidation of Special-Purpose Entities*

As evidenced by Enron, transactions involving special-purpose entities ("SPEs") are becoming increasingly prevalent and complex. The complexity of their structure makes it difficult to determine if another enterprise has a controlling financial interest in the SPEs that would result, under existing accounting requirements, in that other enterprise consolidating (reporting the assets and liabilities of) the SPEs. Preparers of financial reports, their auditors, and analysts and other users of financial reports have indicated that additional guidance is needed for determining when SPEs should be consolidated by another enterprise.

Since November 2001, the Board has been working with constituents to develop, at public meetings, interpretative guidance that would require that many nonsubstantive SPEs that are currently not consolidated, be consolidated by the enterprise they support. The interpretative guidance would result in a more representationally faithful depiction of enterprises' assets and liabilities.

[15] See Attachment 3 for a list and detailed description of the FASB's agenda projects.

The Board plans to issue proposed interpretative guidance before the end of June.

*Interpretative Guidance on Guarantees*

The FASB has observed that there are differing practices about the need for disclosures by enterprises that guarantee the debt and other obligations of SPEs and other enterprises. The FASB has also observed that there are differing practices about the need for the guarantor enterprise to recognize an initial liability for its obligation under the guarantee.

Since February 2002, the Board has been working with constituents to develop, at public meetings, interpretative guidance that would require that enterprises recognize a liability at fair value for the obligations they undertake when issuing a guarantee and that they provide additional disclosures about the guarantee. The interpretative guidance would result in a more representationally faithful depiction of enterprises' assets and liabilities and improved transparency of enterprises' obligations and liquidity risks related to guarantees issued.

The Board plans to issue proposed interpretative guidance within the next 30 days.

*Disclosures about Intangible Assets*

For many enterprises, the amounts of intangible assets reflected in their financial reports are very small. In a recent article in *Financial Executive* (March/April 2002, p. 35), a prominent researcher indicated that ". . . in the late 1990s, the annual U.S. investment in intangible assets—R&D, business processes and software, brand enhancement, employee training, etc.—was roughly $1.0 trillion, almost equal to the $1.2 trillion total investment of the manufacturing sector in physical assets. Further, intangible capital currently

constitutes between one-half and two-thirds of corporate market value. . . ." The FASB has observed that there is very little information—quantitative or qualitative—about those intangible assets in financial reports.

In January 2002, the Board added a project to its agenda to expand the disclosures required about intangible assets. The FASB Board and staff are currently gathering additional information from constituents to determine, at public meetings, what qualitative and quantitative disclosures about intangible assets would be most relevant for consumers.

The Board plans to issue a proposed standard in the fourth quarter of this year.

*Financial Performance Reporting by Business Enterprises*

The FASB has observed that increased reporting of numerous and inconsistent alternative (pro forma) financial measures has heightened investor confusion and has raised significant questions about the credibility of financial reporting.

In October 2001, the Board added a project to its agenda to (1) improve the quality of information displayed in financial reports so that consumers can better evaluate an enterprise's financial performance and (2) ascertain that sufficient information is contained in the financial reports to permit calculation of key financial measures used by investors and creditors.

Since adding the project to the Board's agenda, the Board and its staff have conducted a series of interviews with 56 individuals who use financial reports—investors, creditors, and their advisors (equity and credit analysts)—to assist the FASB in identifying key

financial measures that they use in evaluating the performance of an enterprise. A summary of the findings resulting from those interviews is available on the FASB website. The FASB has discussed the results of the user interviews with its project task force of constituents.

The Board has begun its public discussions of the project issues and plans to issue a proposed standard next year.

*Liabilities and Revenues*

The FASB has observed that enterprises and auditors have continually received and raised questions about revenue (and related liability) recognition issues. In addition, recent studies on financial reporting indicate that revenue recognition is the largest category of fraudulent financial reporting and restatements of financial reports.

In January 2002, the Board issued a proposal on a potential major project on the recognition of liabilities and revenues in financial reports. The Board has received approximately 30 comment letters from constituents in response to the proposal. The Board plans to discuss those comments at a public meeting on May 15 and determine whether a project on liabilities and revenues should be added to the Board's agenda.

***How Has the FASB Responded to the Report of the AICPA's Special Committee on Financial Reporting?***

In 1991, the AICPA formed a Special Committee on Financial Reporting ("Special Committee"), which I chaired, to address questions about the relevance and usefulness of

"business reporting."[16] The Special Committee's 1994 report ("AICPA Report") contained 20 recommendations to the AICPA, the auditing profession, lawmakers, regulators, and standard setters.[17] Six of those recommendations were directed at financial statements and related disclosures.[18]

Responding to the AICPA Report, in February 1996, the FASB issued an Invitation to Comment, *Recommendations of the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research,* to solicit views on the Special Committee's recommendations made to standard setters and the recommendations contained in a similar paper published by the Association for Investment Management and Research.[19] Issue 1 of the Invitation to Comment asked: "Should the FASB broaden its activities beyond financial statements and related

[16] Business reporting was defined broadly to include "the information a company provides to help users with capital-allocation decisions about a company. It includes a number of different elements, with financial statements as one of those elements." See AICPA, *Improving Business Reporting—A Customer Focus* (1994), page 2.
[17] Ibid., pages 121–127.
[18] Ibid., pages 123-124. See Attachment 4 for a list of the recommendations.
[19] Association for Investment Management and Research, *Financial Reporting in the 1990s and Beyond* (1993).

disclosures to also address the types of nonfinancial information that would be included in a comprehensive business reporting model?"

Overall, respondents had mixed views about the Board's involvement with nonfinancial information. Some respondents opposed FASB standard setting for the disclosure of nonfinancial information. Other respondents suggested that the Board be selective and initially limit its efforts to focusing on operating data and performance measures and reasons for changes in such data and key trends. Others suggested that the Board take a primary leadership role in developing a comprehensive business-reporting model similar to the one developed by the Special Committee.

At a public Board meeting on January 29, 1998, the Board decided, as a first step, to undertake a research project on business reporting. The Board formed a Steering Committee to conduct the project and instructed the Steering Committee to:

- Study present practices for the voluntary disclosure of certain types of business information that users of business reporting might find helpful in making investment decisions.
- Develop recommendations for ways to coordinate GAAP and SEC disclosure requirements and to reduce redundancies.
- Study present systems for the electronic delivery of business information and consider the implications of technology for business reporting in the future.

The work of the Steering Committee resulted in a three-volume research report.[20] The first volume, issued in 2000, identifies present practices for the electronic distribution of business information. Among the report's highlights is identification of:

- Leading-edge technologies as well as core features of corporate web sites;
- Divergent corporate strategic objectives and uses of the Internet;
- Notable present practices in terms of content and presentation; and
- Legal issues and questions related to website practices.

The second volume, issued in 2001, identifies redundancies between GAAP and SEC disclosure requirements and ways to eliminate them. The report also includes observations that the SEC is encouraged to consider in future rule-making activities.

The third volume, also issued in 2001, identifies extensive voluntary disclosures that many leading enterprises are making and provides findings and recommendations on how enterprises can better describe and explain their investment potential to investors. The report *encourages* enterprises to continue improving their business reporting and to experiment with the types of information disclosed and the manner by which it is disclosed.

In addition to the three-volume research report, the FASB has issued a number of standards, proposals, and other documents (and is actively working on some current projects) that are responsive, in whole or in part, to the specific recommendations on

[20] The entire three-volume research report is available, at no cost, on the FASB website.

financial statements and related disclosures contained in the AICPA Report. Attachment 4 to this testimony contains a listing of those recommendations and the relevant FASB responses.

***Did Enron's Financial Statements Comply with Existing GAAP?***

Enron publicly acknowledged in its November 8, 2001, Form 8-K and November 19, 2001, Form 10-Q filings with the SEC that it had failed to comply with existing accounting requirements in at least two areas. First, Enron indicated that with respect to four SPEs that it created during 2000, it issued Enron common stock to the SPEs in exchange for notes receivable from the SPEs. At the time, Enron reported an increase in assets and shareholder's equity to reflect those transactions. Longstanding accounting requirements, however, provide that notes receivable arising from transactions involving an entity's own capital stock are generally required to be reported as deductions from stockholders' equity and not as assets.[21]

As a result of this error, Enron indicated that it had overstated both total assets and shareholders' equity in its financial statements for the second and third quarters of 2000, and its annual financial statements for 2000, by $172 million. It also indicated that it had overstated both total assets and shareholders' equity in its financial statements for the first and second quarters of 2001 by $1.0 billion.

Second, Enron indicated that the assets, liabilities, gains, and losses of three previously unconsolidated SPEs should have been included in Enron's financial statements under existing accounting requirements. As a result of that error, Enron indicated that it had

overstated reported net income by approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000. It also indicated that it had understated net income by $17 million and $5 million in the first and second quarters of 2001, respectively, and overstated net income by $17 million in the third quarter of 2001. Finally, Enron indicated that as a result of this error, it also had understated debt (or liabilities) by approximately $711 million in 1997, $561 million in 1998, $685 million in 1999, and $628 million in 2000.

In commenting on Enron's restatements in testimony before Congress, former SEC Chief Accountant Lynn Turner stated:

> New accounting rules were not needed to prevent the restatements of Enron's financial statements or improve the quality of some of its disclosures. Compliance with and enforcement of the accounting rules that have been on the books for years would have given investors a timely and more transparent picture of the trouble the company was in.[22]

[21] See EITF Issue No. 85-1, "Classifying Notes Received for Capital Stock," and SEC Staff Accounting Bulletin No. 40, Topic 4-E, *Receivables from Sale of Stock.*

[22] Written statement by Lynn Turner in testimony before the Committee on Governmental Affairs, United States Senate (January 24, 2002), page 3.

In February 2002, a committee of three outside members of Enron's own board of directors filed a public report ("Powers Report") that stated that its investigation "identified significant problems beyond those Enron has already disclosed."[23]

Those further problems included entering into transactions that Enron

> could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off its balance sheet; but the transactions did not follow those rules.[24]

The Powers Report suggests that "other transactions" resulted in "Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported."[25]

The Powers Report also states that Enron's disclosures about its transactions with the partnerships were "obtuse, did not communicate the essence of the transactions

[23] William C. Powers, Jr., Chair, Raymond S. Troubh, and Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (February 1, 2002), page 3.
[24] Ibid., page 4.
[25] Ibid.

completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships."[26]

More recently, Enron publicly acknowledged in its April 22, 2002, Form 8-K with the SEC that it may have failed to comply with existing accounting requirements relating to the "valuations of several assets the historical carrying value of which current management believes may have been overstated due to possible accounting errors or irregularities."[27] The 8-K indicates that the amount of the overstatement may be in the billions of dollars.

In addition, at the ongoing trial of Andersen in Houston, Texas, two partners from Andersen's professional standards group testified on May 9, 2002, that "seriously flawed accounting methods and misleading documentation [was] prepared by the Enron team to justify the accounting."[28] They also testified that the Enron audit team "disregarded and misrepresented" the professional standards group's advice about the appropriate accounting required.[29]

***Conclusion***

The title of this hearing "Corporate Accounting Practices: Is There a Credibility GAAP?" might be read to imply that GAAP is the main contributor to what many perceive to be the growing lack of credibility of corporate financial reports. I strongly disagree. US GAAP, when properly applied, produces the most transparent financial

[26] Ibid., page 17. See Attachment 5 for additional excerpts from the Powers Report on Enron's failure to follow existing accounting requirements.
[27] Enron Corp., Form 8-K (April 22, 2002), page 2.
[28] Susan Schmidt, "Tensions Flare at Trial of Andersen: Enron Auditors Said to Have Ignored Advice," *The Washington Post* (May 10, 2002), page E4.

reports in the world—financial reports that are an essential element of an efficient capital market.

Should US GAAP be improved? Without question. As part of the Board's ongoing process, the FASB is actively working with our constituents, including the SEC, to continue to make necessary improvements to GAAP. In addition, the FASB (and the FAF) is reviewing and modifying our due process procedures and taking other steps to improve the efficiency and effectiveness of the standard-setting process. Those actions are described in detail above.

In my opinion, the most efficient and effective accounting standard setter imaginable, and the highest quality accounting standards conceivable, could not have prevented the Enron bankruptcy, could not have prevented the many corporate restatements of recent years, and could not alone improve the credibility of financial reports. (Remember, restatements, including Enron's restatements, bring financial statements into compliance with existing accounting standards.)

By working together, standard setters, reporting enterprises, auditors, and regulators share the responsibility of supporting a credible and transparent financial reporting system. Each party must carry out its responsibilities in the public interest.

Reporting enterprises seeking to access the capital markets for financing are responsible for preparing the financial reports and presenting those reports to investors. Those enterprises must apply GAAP in a way that is faithful to the intent of the standards. Unfortunately, the far too common practice of seeking loopholes to find ways around the

[29] Ibid., page E1.

intent of the standards obfuscates reporting and does not result in a transparent and true reflection of the economics of the underlying transactions. That practice must end.

Auditors examine the financial reports of enterprises to determine that GAAP has been fairly applied. Auditors also must assure that the stated intent of the standards are followed and not accept facile arguments that the reporting is acceptable because the standard does not explicitly say that the reporting is unacceptable. Auditors have primary responsibility to the public, since investors and other users do not have the same access to the underlying facts about enterprises' operations and transactions. Auditors must end the practice of accepting "show me where it says I can't do this" accounting.

Finally, regulators, principally the SEC, are responsible for protecting the investor. Through their oversight and enforcement activities, regulators ensure that enterprises report their financial information based on GAAP and that auditors are independent and examine financial statements using accepted auditing standards. The SEC must have the resources it needs to fulfill that important role.

Thank you, Mr. Chairman. I very much appreciate this opportunity, and I would be pleased to respond to any questions.

# Facts about FASB 2002

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Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

## THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and

- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

*To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

*To weigh carefully the views of its constituents* in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board's judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.

*To promulgate standards only when the expected benefits exceed the perceived costs.* While reliable quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.

*To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.* Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.

*To review the effects of past decisions* and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information. The Board believes that this broad public interest is best served by

developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

## AN INDEPENDENT STRUCTURE

***Financial Accounting Standards Board (FASB)***
The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–59) and then by the Accounting Principles Board, also a part of the AICPA (1959–73). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

***Financial Accounting Standards Advisory Council (FASAC)***
The Financial Accounting Standards Advisory Council (FASAC) has responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces and such other matters as may be requested by the FASB or its Chairman. At present, the Council has more than 30 members who are broadly representative of preparers, auditors and users of financial information.

***Financial Accounting Foundation (FAF)***
The Financial Accounting Foundation (FAF), which was incorporated to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its advisory council, funding their activities and for exercising general oversight with the exception of the FASB's resolution of technical issues.

In 1984, the Foundation established a Governmental Accounting Standards Board (GASB) to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, funding and exercising general oversight. The Foundation also receives contributions and approves the FASB budget. More than half the funds contributed are from the public accounting profession, with the remainder coming from industry and the financial community.

The Foundation is separate from all other organizations. However, its Board of Trustees is made up of nominees from sponsoring organizations whose members have special knowledge of, and interest in, financial reporting. There also are Trustees-at-large who are not nominated by those organizations, but are chosen by the sitting Trustees. The sponsoring organizations are:

- American Accounting Association
- American Institute of Certified Public Accountants
- Association for Investment Management and Research
- Financial Executives International
- Government Finance Officers Association

- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

The members of the FAF Board of Trustees include:

- Manuel H. Johnson (Chairman of the Board and President, FAF), Co-Chairman, Johnson Smick International,
- Stephen C. Patrick (Vice President , FAF), Chief Financial Officer, Colgate-Palmolive Company,
- Judith H. O'Dell (Secretary and Treasurer, FAF), Managing Shareholder, Beucler, Kelly & Irwin, Ltd.,
- John J. Brennan, Chairman and Chief Executive Officer, The Vanguard Group, Inc.,
- Samuel A. DiPiazza, Jr., Chief Executive Officer, PricewaterhouseCoopers,
- Douglas R. Ellsworth, Director of Finance, Village of Mount Prospect, Illinois,
- Peter C. Goldmark, Jr., Chairman and Chief Executive Officer, International Herald Tribune,
- William H. Hansell, Executive Director, International City/County Management Association,
- Richard D. Johnson, Auditor of State, Iowa,
- Duncan M. McFarland, President, Chief Executive Officer and Managing Partner, Wellington Management Company,
- Frank C. Minter, Retired Vice President and Chief Financial Officer, AT&T International,
- Lee N. Price, President and Chief Executive Officer, Price Performance Measurement Systems, Inc.,
- David S. Ruder, William W. Gurley Memorial Professor of Law, Northwestern University School of Law,
- Steve M. Samek, Partner, Andersen,
- David A. Viniar, Chief Financial Officer, Goldman, Sachs & Co., and
- Jerry J. Weygandt, Andersen Alumni Professor of Accounting, University of Wisconsin-Madison.

**AN OPEN DECISION-MAKING PROCESS**

Actions of the Financial Accounting Standards Board (FASB) have an impact on many organizations within the Board's large and diverse constituency. It is essential that the Board's decision-making process be evenhanded. Accordingly, the FASB follows an extensive "due process" that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and, in several respects, is more demanding.

## HOW TOPICS ARE ADDED TO THE FASB'S TECHNICAL AGENDA

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of a diverse constituency, including the SEC. The auditing profession is sensitive to emerging trends in practice and, consequently, it is a frequent source of requests. Requests for action include both new topics and suggested review or reconsideration of existing pronouncements.

The FASB is alert to trends in financial reporting through observation of published reports, liaison with interested organizations and discussions with the Emerging Issues Task Force (EITF)—see page x. In addition, the staff receives many technical inquiries by letter and telephone, which may provide evidence that a particular topic, or aspect of an existing pronouncement, has become a problem. The FASB also is alert to changes in the financial reporting environment that may be brought about by new legislation or regulatory decisions.

The Board turns to many other organizations and groups for advice and information on various matters, including its agenda. Among the groups with which liaison is maintained are the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA (AcSEC), the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as the Association for Investment Management and Research (AIMR), Financial Executives International (FEI) and Institute of Management Accountants (IMA). As part of the agenda process, the Board may make available for public comment agenda proposals that concisely describe the scope of potential projects. The Financial Accounting Standards Advisory Council (FASAC) regularly reviews the Board's agenda priorities and consults on all major projects added to the technical agenda.

After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics.

Those factors include consideration of:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);

- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability and comparability are likely to be developed;

- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;

- *Practical consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a

particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;

- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;

- *Cooperative opportunities*—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and

- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the IASB or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

***Board Meetings***

The core of the Board's due process is open decision-making meetings and exposure of proposed standards for public comment. Every technical project involves a number of Board meetings. The Board meets as many times as necessary to resolve the issues. A major project generally includes dozens of meetings over several years. All meetings are open to public observers, although observers do not participate in the discussions. The agenda for each meeting is announced in advance.

The staff presents written material, including analysis and recommendations, to the Board members in advance as the basis for discussion in a Board meeting. The meeting format calls for oral presentation of a summary of the written materials by the staff, followed by Board discussion of each issue presented and questioning of the staff on the points raised.

***The Exposure Draft***

When the Board has reached conclusions on the issues, the staff is directed to prepare a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote by written ballot to issue the Exposure Draft. Five votes of the seven-member Board are required to approve a document. Dissents, if any, are explained in the document.

The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information and an explanation of the basis for the Board's conclusions.

At the end of the exposure period, generally 60 days or more, all comment letters and position papers are analyzed by the staff. This is a search for information and persuasive

arguments regarding the issues; it is not intended to be simply a "nose count" of how many support or oppose a given point of view. In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions.

***Further Deliberation of the Board***

After the comments have been analyzed and studied, the Board redeliberates the issues. As in earlier stages of the process, all Board meetings are open to public observation. The Board considers comments received on the Exposure Draft, and often incorporates suggested changes in the final document. If substantial modifications appear to be necessary, the Board may decide to issue a revised Exposure Draft for additional public comment. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board. A vote is taken on the final document, again by written ballot. Five votes are required for adoption of a pronouncement.

***Statements of Financial Accounting Standards***

The final product of most technical projects is a Statement of Financial Accounting Standards (SFAS). Like the Exposure Draft, the Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents.

***Additional Due Process***

For major projects, the Board generally goes significantly beyond the core due process described above. Soon after a major project is placed on the Board's technical agenda, a task force or working group usually is appointed, including preparers, auditors and users of financial information who are knowledgeable about the subject matter. Experts from other disciplines also may be appointed. Care is taken to ensure that various points of view on the issues involved are represented.

The task force meets with and advises the Board and staff on the definition and scope of the project, the nature and extent of any additional research that may be needed and the preparation of a discussion document and related material as a basis for public comment. Task force meetings are open to public observers. Task forces and working groups play an important role in the standard-setting process by providing expertise, a diversity of viewpoints and a mechanism for communication with those who may be affected by proposed standards.

Before it begins deliberations on a new major project, the Board often asks the FASB staff to prepare a Discussion Memorandum or other discussion document. The task force provides significant assistance and advice in this effort. The discussion document generally sets forth the definition of the problem, the scope of the project and the financial accounting and reporting issues; discusses research findings and relevant literature; and presents alternative solutions to the issues under consideration and arguments and implications relative to each. The discussion document is published to invite constituents to comment on the project before the Board begins deliberations.

After a discussion document or an Exposure Draft is issued for comment, the Board may decide to hold a public hearing or a public roundtable meeting. These meetings provide an

opportunity for the Board and staff to ask questions about information and viewpoints offered by constituents who participated in the comment process. Any individual or organization may request to be heard at a public hearing, and the FASB attempts to accommodate all such requests. Public observers are welcome.

***Statements of Concepts***

In addition to Statements of Financial Accounting Standards (SFAS), the FASB also issues Statements of Concepts. Those do not establish new standards or require any change in the application of existing accounting principles; instead, they are intended to provide the Board and constituents with a foundation for setting standards and concepts useful as tools for solving problems. The framework defined in the Statements of Concepts helps the Board identify the right questions to ask in structuring technical projects and contributes to a consistent approach over time. Because of their long-range importance, Statements of Concepts are developed under the same extensive due process the FASB follows in developing Statements of Financial Accounting Standards on major topics.

***Other Documents***

In addition to broad issues of financial accounting and reporting, the Board considers narrower issues related to implementation of existing standards and other problems arising in practice. Depending on their nature, implementation and practice problems may be dealt with by the Board in Statements or Interpretations, by the staff in Technical Bulletins or in Implementation Guidance in question and answer form. All of those are subject to discussion at public Board meetings and to exposure for comment, although Technical Bulletins and Implementation Guidance are exposed more narrowly.

***Emerging Issues Task Force (EITF)***

The Emerging Issues Task Force (EITF) was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. EITF members are drawn primarily from public accounting firms but also include representatives of large companies. The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the privilege of the floor. Timothy S. Lucas, FASB Director of Research and Technical Activities, is Chairman of the Emerging Issues Task Force.

Composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by the FASB as an indication that no Board action is needed. A consensus is defined as an agreement, provided that no more than two of the thirteen voting members object. Consensus positions of the EITF are considered part of GAAP. If consensus is not possible, it may be an indication that action by the FASB is necessary.

The EITF meets six times a year. Meetings are open to the public and, generally, are attended by substantial numbers of observers. Because interest in the EITF is high, the FASB has separate subscription plans for keeping up-to-date on the issues.

***Availability of Publications***
To encourage public comment, Discussion Memorandums and Exposure Drafts are distributed widely through the FASB's established mailing plans. Single copies are available without charge to all who request them during the comment period and Exposure Drafts generally can be accessed from the website at www.fasb.org.

Statements of Standards, Statements of Concepts and Interpretations also are distributed broadly when published through FASB subscription plans and may be purchased separately by placing an order at the FASB website, www.fasb.org.

The FASB strives to keep the public informed of developments on its projects through a monthly newsletter, *Status Report,* and a weekly notice, *Action Alert,* which provides notice of upcoming Board meetings and their agendas with brief summaries of actions taken at previous meetings. *Action Alert* is available by e-mail subscription at the FASB website, www.fasb.org.

***FASB Website***
The FASB website includes general information about the Board and its activities, information on upcoming public meetings, announcements of Board actions, summaries and status of all active technical agenda projects, summaries of previously issued FASB Statements and Interpretations, the quarterly plan for FASB projects and information about membership in the Foundation, as well as information on how to order publications online, by phone or mail.

The website can be accessed at http://www.fasb.org.

***The Public Record***
Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record. The public records on all projects are available for inspection in the public reference room at FASB headquarters in Norwalk, Connecticut. Copies of public records also may be purchased at prices that vary according to the volume of material that has to be copied by accessing the FASB website at www.fasb.org, or contact Records Retention at (203) 847-0700, ext. 270, for more information.

## MEMBERS OF THE FASB

The seven members of the FASB serve full time and are required to sever all connections with the firms or institutions they served prior to joining the Board. While collectively they represent diverse backgrounds, they also must possess "knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting."

Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Expiration dates (at June 30) of current terms are indicated in captions beneath the members' photographs.

***Edmund L. Jenkins*** *was named Chairman of the FASB effective July 1, 1997. He was the Managing Partner of the Professional Standards Group of Arthur Andersen LLP's worldwide practice. Mr. Jenkins was Chairman of the AICPA's Special Committee on Financial Reporting (the "Jenkins Committee"), which published its report on improving business reporting in 1994. He served on the Emerging Issues Task Force (EITF) from 1984 to 1991 and on the FASB's Advisory Council (FASAC) from 1991 to 1995. He holds a B.A. degree from Albion College, an M.B.A. from the University of Michigan and is a CPA.*

***G. Michael Crooch*** *was a partner with Arthur Andersen and Director of the firm's International Professional Standards Group before joining the FASB on July 1, 2000. Mr. Crooch was the American Institute of Certified Public Accountants' (AICPA) delegate to the International Accounting Standards Committee (IASC) and served on the IASC's Executive Committee. He also served on the Institute's Accounting Standards Executive Committee, including three years as the Committee Chairman. He earned bachelor's and master's degrees from Oklahoma State University and a Ph.D. from Michigan State University.*

***John M. (Neel) Foster*** *was appointed as a member of the FASB effective July 1, 1993. Previously, he had been the Vice President and Treasurer of Compaq Computer Corporation. Mr. Foster also worked in public accounting and was employed by Price Waterhouse for eight years, serving clients in the energy, construction and electronics industries. He was a member of the FASB's Advisory Council (FASAC) from January 1992 until his appointment to the FASB. Mr. Foster holds a bachelor's degree with honors from Colorado College where he majored in economics and was Phi Beta Kappa.*

***Edward W. Trott*** *was appointed as a member of the FASB, effective October 1, 1999. Since 1992, he headed the Accounting Group of KPMG's Department of Professional Practice. Before joining the Board, he was a member of the FASB's Emerging Issues Task Force, the Financial Reporting Committee of the Institute of Management Accountants, the FASB's Advisory Council and the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA. He holds a bachelor's degree from the University of North Carolina and an M.B.A. degree from the University of Texas.*

***Katherine Schipper*** *was appointed to the FASB, effective September 2001. Prior to joining the FASB, she was the L. Palmer Fox Professor of Business Administration at Duke University's Fuqua School of Business. She has served the American Accounting Association (AAA) as President and as Director of Research. She was a member of the FASB's Advisory Council (FASAC) from 1996 to 1999. Ms. Schipper holds a B.A. degree from the University of Dayton and M.B.A., M.A. and Ph.D. degrees from the University of Chicago.*

***Gary S. Schieneman*** *was appointed to the FASB, effective July 1, 2001. Prior to joining the FASB, Mr. Schieneman served as Director, Comparative Global Equity Analysis, of Merrill Lynch. He is a member of the American Institute of Certified Public Accountants (AICPA), the New York Society of Security Analysts and the Association for Investment Management and Research (AIMR). He received a bachelor's degree in accounting from the University of Illinois and earned an MBA degree from New York University.*

***John K. Wulff*** *was appointed to the FASB, effective July 1, 2001. Prior to joining the FASB, he was Chief Financial Officer of Union Carbide Corporation where he directed the company's global financial operations, including its internal and external audits, treasury, control, financial analysis and corporate financial reporting. He is a past Chairman of the Financial Executive Institute's Committee on Corporate Reporting and is a member of the American Institute of Certified Public Accountants. He is a graduate of the Wharton School of the University of Pennsylvania.*

***FASB Staff***

The Board is assisted by a staff of approximately 40 professionals drawn from public accounting, industry, academe and government, plus support personnel. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public and prepares recommendations and drafts of documents for consideration by the Board.

FASB Fellows are an integral part of the research and technical activities staff. The Fellowship program provides the Board the benefit of current experience in industry, academe and public accounting and offers the Fellows first-hand experience in the accounting standard-setting process. Fellows take a leave of absence from their firms or universities and serve as project managers or consultants on a variety of projects.

***Timothy S. Lucas*** *is Director of Research and Technical Activities, a position equal to that of a Board member. Mr. Lucas was a Project Manager on the FASB staff from 1979 to 1986, and later joined Gordon Capital, an investment-banking firm. Before joining the FASB staff in 1979, Mr. Lucas was an Audit Manager with Deloitte, Haskins & Sells and was a lecturer at the Jesse H. Jones Graduate School of Administration at Rice University. He holds B.A., B.S. and master's degrees from Rice University and is a certified public accountant.*

***Suzanne Q. Bielstein*** *was named Assistant Director of Research and Technical Activities in July of 2001. In this position, she is responsible for supporting the FASB staff activities involving the Emerging Issues Task Force (EITF) and the technical inquiry program. Ms. Bielstein joined the FASB in March 1999, as a member of the research and activities staff and, prior to her current position, was a Project Manager on the Board's projects on business combinations and combinations for not-for-profit organizations. Ms. Bielstein earned a B.B.A. degree in accounting from the University of Notre Dame.*

## ADDITIONAL INFORMATION

***General Information***

For further information about the FASB, including Board meeting schedules, access the FASB website, www.fasb.org, call or write Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700.

***To Order Publications***
Statements, Interpretations, Exposure Drafts and other documents published by the FASB may be obtained by placing an order on the FASB website, www.fasb.org, or by contacting the FASB Order Department at (203) 847-0700.

***Public Hearings and Comment Letters***
For information about submitting written comments on documents or about public hearings, access the FASB website at www.fasb.org, or contact the FASB Project Administration Department at (203) 847-0700, ext. 389.

***Public Reference Room and Files***
The FASB maintains a public reference room open during office hours, Monday through Friday. The public reference room contains all FASB publications, comment letters on documents and transcripts of public hearings. Copies of this material may be obtained for a specified charge by accessing the FASB website at www.fasb.org, or by contacting Records Retention at (203) 847-0700, ext. 270, for an appointment.

***Fax-on-Demand***
A fax-on-demand system is available, enabling callers to receive information either by calling from their fax machine or directing information to their fax machine. Information available through this service includes the most frequently requested documents. To use this fax service, call (203) 847-0700, press 14 and follow the prompts.

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To order additional copies of *FACTS about FASB* without charge, contact Public Relations at (203) 847-0700, ext. 252, or telefax a request to (203) 849-9714.

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**Financial Accounting Standards Board**
***Serving the investing public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process.***

**No. 231-A April 19, 2002**
***(The FABB Report No. 347)***

# *THE **FASB** REPORT*

## *Technical Plan*

### *First Quarter Action*

***Project-Related Activities***

***Rescission of Statement 4.*** *On February 14, 2002, we issued a limited revised Exposure Draft,* Rescission of FASB Statements No. 4, 44, and 64 and Technical Corrections—Amendment of FASB Statement No. 13. *We requested comments by March 18. The Exposure Draft was distributed primarily through the FASB website (see page x).*

***Liabilities and Revenues.*** *We requested comments by March 29, 2002, on a proposal for a potential project on issues related to the recognition of revenues and liabilities. That proposal was distributed primarily through the FASB website (see page x).*

***Financial Performance Reporting by Business Enterprises.*** *In February 2002, members of the Board and staff completed a series of interviews of 56 individuals who use financial statements. Those individuals were investors, creditors, and their advisors (equity and credit analysts). A summary of the findings resulting from those interviews is available on the FASB website. On February 26, the Board discussed the results of its user interviews with its project task force as well as their implications for the issues to be addressed by the project (see page x).*

***Agenda Decisions.*** *The Board added the following two projects to its technical agenda:*

- ***Disclosures about Intangible Assets.*** *On January 9, 2002, the Board added a project on disclosure of information about intangible assets not recognized in financial statements (see page x).*
- ***Guarantor's Accounting and Disclosure Requirements for Guarantees.*** *On February 13, 2002, the Board added a project to address guarantor's accounting and disclosure requirements for guarantees (see page x).*

***Other Activities***

***Emerging Issues Task Force (EITF).*** *The Task Force met twice and discussed 14 issues. The next EITF meeting is scheduled for June 19 and 20, 2002. That one-and-one-half day June meeting replaces both the May and July meetings (see page x).*

***Liaison Meeting.*** *In March 2002, the Board met with representatives of the Executive Committee of Financial Executives International.*

***FASB Website.*** *We post detailed summaries of most of the Board agenda projects and other Board activities on the FASB website at www.fasb.org. We update those summaries often, and we encourage constituents to visit our website for timely and detailed information concerning Board decisions on specific projects.*

***IASB News***

*The International Accounting Standards Board (IASB) has completed deliberations on a number of its initial agenda projects and is expected to issue for public comment several Exposure Drafts in the second quarter. Those Exposure Drafts relate to the following topics:*

- *First-time application of International Financial Reporting Standards (IFRS)*
- *Improvements to existing IFRS (amendments to 13 existing standards)*
- *Amendments to IAS 39,* Financial Instruments: Recognition and Measurement, *and IAS 32,* Financial Instruments: Disclosure and Presentation
- *Business combinations, Phase I.*

*The IASB will post its Exposure Drafts to its website (www.iasb.org.uk). Those interested in commenting on the IASB's proposals can download them as they become available or contact the IASB for more information.*

**Board Agenda Projects**

| As of April 1, 2002 | 2002 2Q | 2002 3Q | 2002 4Q | 2003 1Q |
|---|---|---|---|---|
| **Business Combinations:** (page x) | | | | |
| Purchase Method Procedures (page x)* | | | E | |
| Combinations of Not-for-Profit Organizations (page x)* | | | E | |
| Combinations of Mutual Enterprises (page x)* | | E | | |
| Fresh-Start (New Basis) Issues (page x) *See Discussion** | | | | |
| Reconsideration of Statement 72 (page x)* | E | | | |
| **Certain Costs and Activities Related to Property, Plant, and Equipment** (page x) *See Discussion* | | | | |
| **Consolidations and Related Matters:** (page x) | | | | |
| Interpretive Guidance for Certain Situations (page x)* | E | | | |
| Comprehensive Policy Guidance (page x) *See Discussion** | | | | |
| Procedures (page x) *See Discussion** | | | | |
| Unconsolidated Entities (page x) *See Discussion* | | | | |
| **Disclosures about Intangible Assets** (page x)* | | | E | |
| **Financial Instruments:** (page x) | | | | |
| Measuring at Fair Value (page x) *See Discussion** | | | | |
| Replacement of Statement 107 (page x) *See Discussion* | | | | |
| Liabilities and Equity including Amendment to Concepts Statement 6 (page x)* | | | F | |
| Amendment to Statement 133 (page x)* | E | | | |
| **Financial Performance Reporting by Business Enterprises** (page x) *See Discussion** | | | | |
| **Guarantor's Accounting and Disclosure Requirements for Guarantees** (page x)* | E | | | |
| **Obligations Associated with Disposal Activities** (page x)* | | F | | |
| **Rescission of Statement 4** (page x) | F | | | |

**Potential Agenda Projects and Other Potential Initiatives**

Liabilities and Revenues (page x) *See Discussion*

**Codes: E** - *Exposure Document* **F** - *Final Statement or Other Final Document*
**Current updates of these projects are maintained on the FASB website, www.fasb.org.*

*FASB Plan for Technical Projects,*
*Research, and Other Technical Activities*
*As of April 1, 2002*

## *Discussion of Board Projects Agenda*

***The project summaries in this quarterly technical plan are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions are included in an Exposure Draft for formal comment only after a formal written ballot. Decisions in an Exposure Draft may be (and often are) changed in redeliberations based on information provided to the Board in comment letters, at public hearings, and through other communication channels. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.***

### *Business Combinations*

***Background.*** In June 2001, the Board issued FASB Statements No. 141, *Business Combinations,* and No. 142, *Goodwill and Other Intangible Assets.* The Board currently has on its agenda four projects related to the business combinations project. Those projects include (1) purchase method procedures, (2) combinations of not-for-profit (NFP) organizations and combinations of mutual enterprises, (3) fresh-start (new basis) issues, and (4) a limited-scope project to reconsider the accounting requirements of FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions.*

#### *Purchase Method Procedures*

***Background and recent developments.*** In September 2001, the FASB and the International Accounting Standards Board (IASB) agreed to work together to address issues related to the application of the purchase method of accounting for business combinations. In October 2001, the staffs of the FASB and the IASB met to discuss plans for coordinating their approach to the joint project.

Additionally, the FASB and the IASB tentatively agreed to the following working principle for recording a business combination:

- The accounting for a business combination is based on the assumption that the transaction is an exchange of equal values; the total amount to be recognized should be measured based on the fair value of the consideration paid or the fair value of the net assets acquired, whichever is more clearly evident.

1. If the consideration paid is cash or other assets (or liabilities incurred) of the acquiring entity, the fair value of the consideration paid determines the total amount to be recognized in the financial statements of the acquiring entity.

2. If the consideration is in the form of equity instruments, the fair value of the equity instruments ordinarily is more clearly evident than the fair value of the net assets acquired and, thus, will determine the total amount to be recognized by the acquiring entity.

- In a business combination, the acquiring entity obtains control over the acquired entity and therefore is responsible for the assets and liabilities of the acquired entity. An amount equal to the fair value, on the date control is obtained, should be assigned to the identifiable assets acquired and liabilities assumed.

1. If the total fair value exchanged in the purchase transaction exceeds the amounts recognized for identifiable net assets, that amount is the implied fair value of goodwill.

2. If the total fair value exchanged in the purchase transaction is less than the amounts recognized for identifiable net assets, that amount should be recognized as a gain in the income statement.

At the end of the first quarter of 2002, the Board completed its deliberations on the working principle and preacquisition contingencies.

The Board also completed a substantial portion of its deliberations on measuring the value of a business combination. The Board reached the following decisions in the first quarter of 2002:

- The description of the acquisition date in Statement 141 would be modified to clarify that the acquisition date is the date that the acquirer gains control of the acquired entity.
- The fair value equity securities issued as consideration in a business combination would be measured on the acquisition date.
- Contingent consideration issued in a business combination is an obligation of the acquirer as of the acquisition date and, therefore, would be recognized as part of the

purchase price on that date. Consistent with the working principle, the initial measurement of contingent consideration should be at fair value.

- Some contingent consideration arrangements obligate the acquirer to deliver its equity securities if specified future events occur. Presuming that the Board issues a standard on accounting for financial instruments with the characteristics of liabilities, equity, or both prior to the issuance of guidance in this project, the guidance in that standard would apply to contingent consideration arrangements.

- The exception in paragraph 11(c) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* would be eliminated so that contingent consideration arrangements that otherwise meet the definition of a derivative would be subject to the requirements of Statement 133.

- Subsequent remeasurement (after the acquisition date) of contingent consideration liabilities does not result in a change to the purchase price of the business combination. Those amounts therefore should be recognized in the income statement.

***Immediate plans.*** In the second quarter of 2002, we expect to complete the issues of measuring the fair value of a business combination and begin drafting an Exposure Draft for the decisions reached to date. The FASB staff will begin work on issues related to the recognition of assets acquired and liabilities assumed. We expect to issue an Exposure Draft in the fourth quarter of 2002.

***Combinations of Not-for-Profit Organizations***

***Background.*** In this project, the Board will develop guidance on the accounting for combinations between two or more NFP organizations and the accounting for the acquisition of a for-profit entity by an NFP organization. By early 2001, the Board had made decisions on several key issues, including the method of accounting for combinations of NFP organizations and the criteria to be used to identify the acquiring organization. Deliberations on this project were temporarily suspended in early 2001 while the Board completed its work on Statements 141 and 142. With the issuance of those Statements, the Board recommenced deliberations of the issues remaining in this

project, reaching decisions on the (1) accounting for collection items acquired in a combination and (2) initial recognition of intangible assets acquired in a combination.

***Decisions in current phase.*** The Board has made the following decisions to date in this project. A more detailed discussion of these decisions is available on the FASB website.

*Project Approach*

- The project approach presumes that Statement 141 (which supersedes Opinion 16) would apply to combinations of NFP organizations unless a circumstance unique to those combinations is identified that would justify a different accounting treatment.

*Project Scope*

- The definition of an NFP organization in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* will be used for this project.

- The project's scope includes the accounting for (1) combinations between NFP organizations and (2) the acquisition of a for-profit business enterprise by an NFP organization.

*Method of Accounting for a Combination of NFP Organizations*

- The facts and circumstances of each combination of two or more NFP organizations should be reviewed to determine the extent to which the combination is a contribution or a bargained exchange. The proposed Statement should include guidance describing the types of facts and circumstances that should be considered in making that determination. A combination of NFP organizations in which no consideration is exchanged should be presumed to be a nonreciprocal transfer and accounted for in a manner similar to a contribution under Statement 116. A combination that includes the exchange of consideration should be presumed to be a bargained exchange and accounted for in accordance with Statement 141. When the facts and circumstances provide evidence that the combination is in part an exchange and in part a contribution, the contribution inherent in that transaction should be recognized by the acquiring organization in accordance with Statement 116.

- If the acquired entity is an NFP organization, the contribution recognized by the acquiring organization would be measured as the excess of the sum of the fair values of the identifiable assets and the liabilities assumed over the fair value of the assets transferred as consideration (if any). In those rare cases in which the sum of the fair values of the liabilities assumed exceeds the sum of the fair values of the identifiable assets acquired, the acquiring NFP organization should initially recognize that excess as an unidentifiable intangible asset (goodwill). The Board has decided that it will reconsider this tentative decision.

- If the acquired entity is a business enterprise, the contribution inherent in a combination should be measured as the excess of the fair value of the acquired business enterprise over the cost of that business enterprise.

- Communities neither own nor control NFP organizations and, therefore, a community's relationship with an NFP organization has no effect on the accounting for a combination of NFP organizations.

*Consideration Exchanged in a Combination of NFP Organizations*

- Generally, assets transferred (or liabilities incurred or assumed) by the acquiring organization as a requirement of a combination should be accounted for as consideration paid for the acquired entity, even if the asset transfer is a requirement imposed by a regulatory body. If the acquiring organization retains control over the future economic benefits of the transferred assets, however, the asset transfer should be reported by the acquiring organization as an asset-for-asset exchange. The proposed Statement should provide examples of the types of conditions that indicate that the acquiring organization has retained control over the future economic benefit of the transferred assets.

- Contingent consideration in a combination of NFP organizations should be accounted for in accordance with the guidance in Statement 141.

*Identifying the Acquirer in a Combination of NFP Organizations*

- In determining the acquiring organization, all pertinent facts and circumstances surrounding the combination should be considered, in particular whether one of the combining organizations has the ability to dominate the process of selecting a voting majority of the combined organization's governing body. Implementation guidance should be provided that would include a list of factors that should be considered when determining the identity of the acquiring organization.

*Collection Acquired in a Combination of NFP Organizations*

- The Board decided that when the assets acquired in a combination include collection items (as defined in Statement 116), the acquirer should follow the guidance in Statement 116 to account for the collection items acquired.

*Identification of Intangible Assets*

- The criteria in paragraph 39 of Statement 141 for recognizing identifiable intangible assets should be applied in the recording of combinations of NFP organizations.

***Recent developments and immediate plans.*** The Board decided that it would revisit its tentative decision that in a combination of NFP organizations, any excess of the fair value of liabilities assumed over the fair value of assets acquired should be considered

goodwill. The Board also decided to consider the recognition of goodwill separately for combinations of NFP organizations and combinations of mutual enterprises. The Board will continue its deliberations in the second quarter. We expect to issue an Exposure Draft in the fourth quarter of 2002.

***Combinations of Mutual Enterprises***

***Background.*** The effective date of Statements 141 and 142 is deferred for combinations between two or more mutual enterprises to allow the Board time to consider whether there are any unique attributes of mutual enterprises to justify an accounting treatment different from that provided in those Statements.

***Decisions in current phase.*** The Board has made the following decisions to date in this project. A more detailed discussion of the Board's decisions is available on the FASB website.

*Approach and Scope*

- The project approach presumes that Statement 141 (which supersedes Opinion 16) would apply to combinations of mutual enterprises unless a circumstance unique to those combinations is identified that would justify a different accounting treatment.
- The project's scope includes the accounting for combinations between two or more mutual enterprises.

*Method of Accounting for a Combination of Mutual Enterprises*

- The criteria in Statement 141 should be used to identify the acquiring enterprise in a combination of mutual enterprises.
- The criteria in paragraph 39 of Statement 141 should be used to recognize identifiable intangible assets acquired in a combination of mutual enterprises.

***Recent developments and immediate plans.*** The combinations of mutual enterprises project likely will become a joint effort between the Canadian Institute of Chartered Accountants Accounting Standards Board (AcSB) and the FASB. The FASB staff intends

to accelerate FASB's consideration of the issues associated with combinations of mutual enterprises in an effort to converge with the AcSB project, which has already deliberated several issues that the FASB has not addressed. Based on potential convergence, the FASB intends to issue an Exposure Draft on this project in the third quarter of 2002.

***Fresh-Start (New Basis) Issues***

***Background.*** The fresh-start (new basis) project is a joint project of the IASB and the FASB. This project focuses on those situations in which fresh-start (a new basis at fair value) recognition and measurement of all of an entity's assets and liabilities would be appropriate. One commonly identified candidate for application of this approach would be a multiparty business combination or other new entity formation in which no single preexisting entity obtains majority ownership and control of the resulting new entity. Similarly, joint venture formations also are candidates for this accounting treatment. Related issues include the recognition and measurement of goodwill and other intangible assets in combinations or other transactions accounted for by the fresh-start method.

In September 2000, prior to this project being designated as a potential IASB-FASB joint project, the Board approved a draft working principle to be utilized in determining the appropriateness of recognizing a new basis of accounting. The Board also decided that the scope of the project should include the issue of gain recognition in the financial statements of an entity that has transferred control over net assets to a joint venture.

During the fourth quarter of 2000, the Board discussed recognition of fresh-start accounting in connection with the formation of a joint venture. The Board decided that a change in control over net assets from unilateral control by one entity to joint or shared

control by that entity and one or more other entities should result in fresh-start accounting for those net assets in the financial statements of the jointly controlled entity. The Board also discussed gain recognition, as of the date of formation of a joint venture in the financial statements of an investor that transfers an appreciated (or previously unrecognized) asset to the joint venture. The Board decided that an entity that exchanges appreciated (or previously unrecognized) assets for an equity interest in a joint venture should recognize a gain on the assets exchanged.

***Immediate plans.*** The FASB staff has had initial discussions with the IASB staff principally concerning the background of the project and preliminary development of a joint scope for the project. Because of the pressures of other priorities for both Boards, this project temporarily is on hold.

***Reconsideration of Statement 72***

***Background.*** Paragraphs 5–7 of Statement 72, which apply only to certain acquisitions of financial institutions (or branches thereof), require that the excess of the fair value of the liabilities assumed over the fair value of tangible and identifiable intangible assets acquired ("the excess") be recognized as an unidentifiable intangible asset. Statement 72 also requires that the unidentifiable intangible asset be amortized over a specified period. Following the issuance of Statement 142, constituents asked the Board to consider whether the unidentifiable intangible asset should be accounted for differently than goodwill. In response to those questions, the Board decided in the fourth quarter of 2001 to undertake a limited scope project to reconsider the guidance in paragraphs 5–7 of Statement 72.

***Decisions in current phase and recent developments.*** The Board decided to reconsider application of the guidance in Statement 72 to combinations between mutual enterprises as part of its separate project addressing those transactions (page x). With respect to the acquisition of a stockholder-owned financial institution (or a branch(es) thereof) that are business combinations (as defined in Statement 141), the Board decided that the amount of the excess should be recognized as goodwill and accounted for in accordance with Statement 142. The Board decided that acquisitions that do not meet the definition of a business combination should be accounted for as asset acquisitions as described in paragraph 9 of Statement 142.

The Board also decided that the scope of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* should be amended to include long-term customer relationship intangible assets of financial institutions (including depositor relationship assets, sometimes referred to as core deposit intangible assets, and credit cardholder intangible assets). That means that those intangible assets will be subject to the same undiscounted cash flow recoverability tests and impairment loss recognition and measurement provisions that Statement 144 requires for long-term tangible assets and other finite-lived intangible assets held and used.

With respect to transition, the Board decided that the unidentifiable intangible asset recognized in past transactions should continue to be amortized unless all of the following conditions are met: (1) the unidentifiable intangible asset was initially recognized in connection with a business combination, (2) when the business combination was initially recorded, the acquiring enterprise recognized the acquired customer relationship intangible assets separately from goodwill, and (3) subsequent to

their initial recognition, the customer relationship intangible assets were accounted for separately from goodwill. The Board decided that when those three conditions are met, the carrying amount of the unidentifiable intangible asset would be reclassified as goodwill at the effective date of the proposed Statement, and subsequently accounted for in accordance with the provisions of Statement 142.

***Immediate plans.*** We plan to issue an Exposure Draft in April 2002 with a 45-day comment period. That Exposure Draft will be distributed primarily through the FASB website.

*Project chronology.* Added to agenda—August 1996. Special Report—June 1997. *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence:* Invitation to Comment—December 1998. *Business Combinations:* Statement 141—June 2001. *Goodwill and Other Intangible Assets:* Statement 142—June 2001.

### *Consolidations and Related Matters*

***Background.*** This group of related projects is intended to cover all aspects of accounting for affiliations between entities along with several other matters that raise similar or potentially related issues about financial statements. The Board is reconsidering issues relating to Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* The project on consolidation policy and procedures is considering both business enterprises and not-for-profit organizations and presently is focusing on the area of consolidation policy. The unconsolidated entities project is intended to address presentation in the investor's financial statements and other issues related to investments in noncontrolled corporations and partnerships, including joint ventures and undivided interests.

***Comprehensive Policy Guidance***

***Background.*** In February 1999, we issued a revised FASB Exposure Draft, *Consolidated Financial Statements: Purpose and Policy.* We received comments from 113 respondents. The proposed Statement would require business enterprises and not-for-profit organizations that control other entities to include those subsidiaries in their consolidated financial statements. *Control* would be defined as the nonshared decision-making ability of one entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities. In July 1999, the Board began a series of meetings to consider comments received on the Exposure Draft and to redeliberate conclusions reached in the Exposure Draft.

In January 2001, the Board determined that there was not sufficient Board member support to proceed to a final Statement on consolidation policy. The Board is concerned about the appropriateness of determining that nonshared decision-making ability can exist based on the anticipated nonaction by other holders of voting rights. The Board also is concerned about the effectiveness of the proposed treatment of convertible and option instruments that give the ability to obtain voting rights as well as the operationality of certain other provisions. However, the Board believes its effort to deal with consolidation policy issues should continue. Those efforts should include the need to develop effective guidance for special-purpose entities (SPEs), to deal with situations where control exists but is not apparent based on the form of the arrangement, and to provide guidance on partnership and other noncorporate structures. It also believes that the work to define *control* has been useful and that this effort should continue.

***Interpretive Guidance for Certain Situations***

***Background and plans.*** In November 2001, the Board discussed its assessment of the consolidation project and how to proceed with it. The Board decided to first concentrate on developing guidance for dealing with the following situations under the current consolidation approach:

- So-called strawman situations
- Entities that lack sufficient independent economic substance
- Convertible instruments and other contractual arrangements that involve latent control
- The distinction between participating rights and protective rights.

Effective guidance for those situations would resolve many problems encountered in present practice including some of the ones related to SPEs. We plan to issue an Exposure Draft of proposed guidance for dealing with entities that lack sufficient economic substance in the second quarter of 2002 and the other situations thereafter. The Board then will continue its consideration of the proposals in the 1999 Exposure Draft.

***Decisions in current phase.*** In the first quarter of 2002, the Board discussed and resolved most aspects of a draft of the first of those Exposure Drafts of a proposed Interpretation of FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* and ARB 51. The Board decided that an SPE should be consolidated by its Primary Beneficiary when the SPE lacks sufficient independent economic substance. An SPE is an entity that supports the activities of a Primary Beneficiary. A Primary Beneficiary is the entity that retains or obtains principal economic benefits and risks that arise from the activities of the SPE. An SPE has sufficient independent economic substance if, at all times during its life, it has the ability to fund or finance its operations without assistance from or reliance

on the Primary Beneficiary or a related party of the Primary Beneficiary. An SPE is considered to have that ability if its owner(s) is an independent third party that has:

- A substantive equity investment at risk in the SPE
- Substantive risks of variable returns that are generally characteristics of equity ownership
- The ability to make decisions about and manage the SPE's activities to the extent those decisions have not been predetermined for the SPE.

In March, the Board decided that the proposed Interpretation should provide guidance for identification of and accounting by the Primary Beneficiary of multi-seller/multi-lease conduits. The guidance for those conduits would include a provision for separation into separate SPEs if the transferors or lessees have the same risks and rewards they would have had if they were dealing with a single seller/lease SPE. Additionally, the proposed Interpretation would provide guidance for identification of and accounting by the Primary Beneficiary for other conduit structures.

***Procedures***

Certain issues related to consolidation procedures are being addressed in the projects on ***Business Combinations—Purchase Method Procedures*** (page x) and ***Financial Instruments—Liabilities and Equity*** (page x). The Board will consider resuming its discussions of other consolidation procedures issues after completion of its work on consolidation policy.

***Unconsolidated Entities***

We participated with the G4+1 to develop a Special Report, *Reporting Interests in Joint Ventures and Similar Arrangements.* That Special Report was issued in September 1999. The project is currently inactive.

*Consolidations projects chronology.* Projects added to agenda—January 1982. *Consolidation of All Majority-Owned Subsidiaries:* Statement 94—October 1987. *Consolidation Policy and Procedures:* Discussion Memorandum—September 1991. *New Basis Accounting*: Discussion Memorandum—December 1991. Completed consideration of issues related to disaggregated disclosures (segments)—June 1994. *Consolidation Policy:* Preliminary Views—August 1994. *Consolidated Financial Statements: Policy and Procedures:* Exposure Draft—October 16, 1995. Discontinued consideration of new basis issues as part of project—August 1996. *Disclosures about Segments of an Enterprise and Related Information:* Statement 131—June 1997. *Consolidated Financial Statements: Purpose and Policy:* Revised Exposure Draft—February 23, 1999.

### *Certain Costs and Activities Related to Property, Plant, and Equipment*

***Background.*** In April 2001, the Board agreed to issue an Exposure Draft of a proposed Statement that would amend certain APB Opinions and FASB Statements to incorporate changes that would result from issuance of a final AICPA Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment.* The Board also agreed that the Exposure Draft would propose to amend APB Opinion No. 28, *Interim Financial Reporting,* so that the provisions of the proposed SOP that would require certain costs to be charged to expense as incurred would apply also to interim periods. In June 2001, the Board approved for issuance FASB Exposure Draft, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment,* which was issued contemporaneously with the issuance of the proposed SOP by AcSEC. We requested comments on the Exposure Draft by November 15, 2001. Similarly, the AICPA requested comments on the proposed SOP by November 15, 2001.

***Plans.*** In the second quarter, AcSEC will begin to address the comment letters received on its Exposure Draft. The timing of the FASB's final document is dependent on the timing of AcSEC's final document, which is uncertain at this time.

*Project chronology.* Added to agenda—April 2001. Exposure Draft—June 29, 2001.

### *Disclosures about Intangible Assets*

***Background.*** On January 9, 2002, the Board added to its agenda this project on disclosure of information about intangible assets. That decision was the result of a process including significant input from constituents, including 63 letters commenting on a proposal issued in August, 2001, and consideration of the available research findings and the resources needed for this and other present and proposed FASB projects.

Today, intangible assets that are generated internally, and some acquired intangible assets (those that are written off immediately) are not recognized in financial statements. This project aims to establish standards that will improve disclosure of information about those intangible assets. Intangible assets include brand names, customer relationships, artistic works, advantageous contracts, and patent rights, among others.

For many entities, the amounts of intangible assets not reflected in financial statements are very large. In a recent article in *Financial Executive* (March/April 2002, p. 35), a prominent researcher indicated that "in the late 1990s, the annual U.S. investment in intangible assets—R&D, business processes and software, brand enhancement, employee training, etc.—was roughly $1.0 trillion, almost equal to the $1.2 trillion total investment of the manufacturing sector in physical assets. Further, intangible capital currently constitutes between one-half and two-thirds of corporate market value." Generally, there is very little information—quantitative or qualitative—about those intangible assets in financial reports. This project would expand that information.

***Decisions in current phase and recent developments.*** The Board refined the project scope initially established as part of the agenda decision. The refined scope calls for

disclosure about intangible assets that would have been recognized if acquired in a business combination under Statement 141. That decision limits the scope to intangible assets that are either grounded in contracts or other legal rights or are separable from the enterprise. The scope also includes in-process research and development assets that, under FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method,* are written off to expense on the day they are acquired. That scope has the important practical advantage of relying on the definitions and scope recently set forth in Statements 141 and 142 and on the implementation guidance and practice that are being developed for those Statements. For constituents, this scope will result in one set of definitional standards and guidance to apply and learn to use, not two.

The Board also decided that the qualitative and quantitative information still to be specified in later meetings should be reported by classes determined using the principles of Statement 142. Statement 142 calls for disclosures about recognized intangible assets subdivided by intangible asset class, defined therein as "a group of intangible assets that are similar, either by their nature or by their use in the operations of an entity." The Board also decided to work toward required disclosures about intangible assets, rather than voluntary disclosures.

The Board began its consideration of whether to call for quantitative disclosures about intangible assets and, if so, what kind of quantitative information to call for. The Board considered several fair-value-based and cost-based approaches to disclosing quantitative information. Pending additional information, the Board decided to narrow the project's focus to possible disclosure of (1) the fair values of all intangible assets

(both recognized and unrecognized that fall within the scope) at the end of the current year(s), (2) disclosing expenditures in the current year(s) without distinguishing successful from unsuccessful efforts, or (3) both.

***Immediate plans.*** The Board and staff are gathering additional information from constituents before making a final decision about which, if any, quantitative disclosures to require. The staff also is continuing to research, with the assistance of a working group of constituents, what other "qualitative" disclosures to consider. The Board plans to resolve those and other remaining issues at meetings during the second and third quarters and to issue an Exposure Draft in the fourth quarter of 2002.

*Project chronology.* Added to agenda—January 9, 2002.

### *Financial Instruments*

The Board added this group of projects to its agenda in 1986 at the request of many constituents, including the auditing profession, the SEC, bank regulators, and some preparers. Those constituents expressed concerns about the lack of accounting guidance and the resulting inconsistencies in practice in accounting for financial instruments and transactions, especially for innovative and complex financial instruments, created during the preceding decade. Since 1986, the Board has completed several of the financial instruments projects. In later years, other projects were added to the group of financial instrument projects and are still active. Those active projects on measuring at fair value, liabilities and equity, and amending Statement 133 are discussed below.

***Measuring All Financial Assets and Liabilities at Fair Value***

***Background.*** The objective of this project is to provide guidance for reporting financial assets and liabilities at fair value. The Board has made a fundamental decision that fair value is the most relevant attribute for financial instruments. That decision was incorporated into FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which states in paragraph 334:

*The Board is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Techniques for refining the measurement of the fair values of all financial instruments continue to develop at a rapid pace, and the Board believes that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved.*

Although measurement at fair value has conceptual advantages, not all issues have been resolved, and the Board has not yet decided when, if ever, it will be feasible to require essentially all financial instruments to be reported at fair value in the basic financial statements. Constituents have suggested several means of providing information about fair values of financial instruments other than recognition and measurement in the basic financial statements. One alternative is to require presentation of a separate set of fair value financial statements. Another possibility is to enhance the disclosures currently required in notes to the financial statements.

The Board also participated in an international effort to develop a set of standards for reporting financial instruments at fair value. That effort was undertaken by an ad hoc

international group called the Financial Instruments Joint Working Group of standard setters (JWG). In December 2000, we published the Draft Standard, Application Supplement, and Basis for Conclusions prepared by the JWG in the form of an FASB Special Report, *Financial Instruments and Similar Items*. The FASB and standard setters in other jurisdictions represented by JWG members have shared the comments each received, and each will use those comments in its own separate project on financial instruments.

***Decisions in current phase and recent developments.*** We issued an FASB Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value,* on December 14, 1999. That Preliminary Views discusses the following three questions:

- What should be reported at fair value?
- What does fair value mean?
- How should changes in fair value be reported?

The Preliminary Views also requested comments on two other issues—whether to include in the project scope items that are similar to financial instruments and how to determine fair value if observable market prices include compensation for expected cash flows that are not contractually required.

The Board reaffirmed its ultimate goal of requiring essentially all financial instruments to be measured at fair value in the basic financial statements. The Board also reaffirmed the intermediate objective it established in February 2001, which is to work toward an Exposure Draft that would replace FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments.* The intention is to provide more specific

guidance on how to determine fair value for financial instruments, improve the form of the disclosures (possibly by requiring a financial statement format), and to add information about the changes in fair values.

In the first quarter of 2002, the Board continued to discuss measurement issues and made decisions about how to measure fair value for financial instruments.

***Plans for the replacement of Statement 107.*** When the Board continues its redeliberations of the planned replacement for Statement 107, it will begin discussing the scope of the proposed Statement. The scope issues include:

- The definition of financial instruments
- Nonfinancial instruments that may be included in the scope
- Financial instruments that may be excluded from the scope
- Contracts that are very similar to specific financial instruments.
- Other issues that will be addressed in the proposed Exposure Draft are:
- Form and content of the required disclosure including presentation of changes in fair value
- Disclosure of other matters, for example, risk exposures, measurement sensitivity, and valuation policies and methods.

***Liabilities and Equity***

***Background.*** In 1997, the Board decided to resume deliberations on issues raised in the 1990 FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both.* The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both.

***Decisions in current phase and recent developments.*** In December 2001, the Board began redeliberations of issues in the FASB Exposure Drafts, *Accounting for Financial*

*Instruments with Characteristics of Liabilities, Equity, or Both, and Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities.* (Copies of both Exposure Drafts are available from the FASB website.) The Board discussed certain questions relating to the issue of separating a compound financial instrument with characteristics of liabilities and equity. The Board decided that an entity that issues a financial instrument that contains characteristics of both liabilities and equity should identify and report those components separately. That decision reaffirms the guidance in the Exposure Draft requiring separation of financial instruments with characteristics of liabilities and equity and represents a change from current generally accepted accounting principles that require classification of the entire instrument based on the governing-characteristics approach. The Board also decided that an issuer of a financial instrument that contains components that, if freestanding, would be classified as assets should not report the asset component separately. In February 2002, the Board decided that the with-and-without method should be used for measuring components under certain models.

***Immediate plans.*** Below is a list of major issues that the Board will redeliberate and resolve. Those issues were addressed by respondents to the two Exposure Drafts. The redeliberation of some of the issues listed is dependent upon the conclusions reached by the Board on preceding issues. A more detailed discussion of the Board's redeliberation plan is available on the FASB website.

- Separating a compound financial instrument with characteristics of liabilities and equity into its individual liability and equity components
- The framework for the classification of financial instruments with characteristics of liabilities, equity, or both (definition of liability)

- Disclosures
- Earnings per share
- Transition and effective date
- Balance sheet classification of the noncontrolling interest in a consolidated subsidiary.

The Board will continue redeliberations of those issues in the second quarter of 2002 with a goal of issuing a final Statement in the fourth quarter of 2002.

***Amendment to Statement 133—Beneficial Interests Arising from Securitization Transactions***

***Background.*** This project is considering various approaches for resolving questions raised in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," which addresses the application of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* to beneficial interests issued in securitization transactions subject to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* In addition, it also is considering the application of Statement 133 to instruments involving leverage. The staff is working with a task force of individuals associated with the Derivatives Implementation Group.

***Decisions in current phase and recent developments.*** In the first quarter, the Board took the following actions:

- Discussed comments received on the guidance included in the following five implementation issues, which were initially posted for comment in October 2001, regarding Statement 133:

Issue A20 Application of Paragraph 6(b) Regarding Initial Net Investment

Issue B12 Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities

| | |
|---|---|
| Issue C17 | Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization |
| Issue D2 | Applying Statement 133 to Beneficial Interests in Securitized Financial Assets |
| Issue E21 | Continuing the Shortcut Method after a Purchase Business Combination. |

- Decided to proceed with the issuance of an Exposure Draft to amend Statement 133 that would incorporate amendments arising from various Statement 133 Implementation Issues.

- Did not object to the staff's posting on the FASB website, concurrent with the Exposure Draft, the five related Statement 133 Implementation Issues noted above, as well as new Statement 133 Implementation Issue No. BX, "Bifurcation of Embedded Credit Derivatives."

- Did not object to the staff's posting the draft questions and answers related to the application of certain provisions of Statement 140 on the FASB website.

*Effective Date*

- Decided that the final Statement to amend Statement 133 should be effective beginning on the first day of the first fiscal quarter beginning after November 15, 2002, except in the following situations:

1. Entities should continue to apply the amendments that resulted from the Derivatives Implementation Group process in accordance with their respective effective dates.

2. Qualifying SPEs that are not grandfathered or newly created structures that issue beneficial interests after the issuance of the amendment to Statement 133 must apply the provisions related to the amended definition of a derivative and related bifurcation guidance upon issuance of the final Statement.

*Transition*

- Decided to require that entities that had not accounted for a contract as a derivative in its entirety or that had not bifurcated an embedded derivative but would be required to do so under the proposed Statement should account for the effects of initially complying with the proposed Statement prospectively for all existing contracts as of the effective date of the proposed Statement and for all future transactions. Also, entities that had previously accounted for a contract as a derivative instrument that would not be accounted for as a derivative instrument under the proposed Statement would not be required to change that accounting treatment.

*Disclosures*

- Decided to require that SPEs that are considered qualifying under Statement 140 that would no longer be qualifying after applying Statement 133 disclose in financial statements issued after the issuance of the amendment to Statement 133 the amount of assets and liabilities that are currently off-balance-sheet in those structures that would not qualify as qualifying SPEs if both Statements 133 and 140 were applied absent the grandfathering provision.

***Immediate plans.*** We plan to issue an Exposure Draft, primarily through the FASB website, early in the second quarter of 2002 for a 60-day comment period.

*Financial instruments projects chronology.* Initial project added to agenda—May 1986. Liabilities and equity project separated as next phase—April 1989. *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both:* Discussion Memorandum—August 1990. *Recognition and Measurement of Financial Instruments*: Discussion Memorandum—November 1991. Measuring at fair value project separated as next phase—April 1989. *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value:* Preliminary Views—December 14, 1999. *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both:* Exposure Draft—October 27, 2000. *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities:* Exposure Draft—October 27, 2000. Amendment of Statement 133 project added to the agenda—September 2001.

## *Financial Performance Reporting by Business Enterprises*

***Background.*** On October 24, 2001, the Board considered constituents' comments in response to an August 17, 2001 proposal for a potential agenda project on reporting information about the financial performance of business enterprises. The Board decided, consistent with suggestions of its constituents, to add the project to its agenda with the objective and scope described in that proposal.

The primary objective of the project is to (1) improve the quality of information displayed in financial statements so that investors, creditors, and others can better evaluate an enterprise's financial performance and (2) ascertain that sufficient information is contained in the financial statements to permit calculation of key financial

measures used by investors and creditors. Several of the respondents to the August proposal suggested that this project, although limited to the display of items and measures in financial statements, is especially timely because the proliferation of alternative and inconsistent financial performance measures is undermining high-quality financial reporting, which is essential to well-informed investment decisions and efficient capital markets.

The project will focus on form and content, classification and aggregation, and display of specified items and summarized amounts on the face of all basic financial statements, interim as well as annual. That includes determining whether to require the display of certain items determined to be key measures or necessary for the calculation of key measures (for example, depreciation and amortization, research and development expense, and income taxes). The project will not address management discussion and analysis or the reporting of so-called pro forma earnings in press releases or other communications outside financial statements and does not include segment information or matters of recognition or measurement of items in financial statements.

The project plan contemplates coordinating, to the extent feasible, the FASB activities and approach for this project with the activities of a similar project being conducted jointly by the IASB and the U.K.'s Accounting Standards Board. That coordination and cooperation with other standard setters is directed at seeking opportunities to resolve issues in ways that also increase convergence of standards worldwide.

***Recent developments and immediate plans.*** In February 2002, members of the FASB and its staff completed a series of interviews of 56 individuals who use financial

statements—investors, creditors, and their advisors (equity and credit analysts) to assist the FASB in identifying key financial measures that they use in evaluating the performance of an enterprise. A summary of the findings resulting from those interviews is available on the FASB website. On February 26, the Board discussed the results of its user interviews with its project task force as well as the implications of those results for the project's objectives, plans, and the issues to be addressed. Several task force members suggested that the Board consider addressing certain specific issues on a faster track while the project proceeds with its comprehensive undertaking of the issues.

The Board discussed the project plans, scope, and approach. The Board affirmed the project scope and approved revising the project plan to move to Board deliberations leading to an Exposure Draft of a proposed Statement, rather than a neutral discussion document. The Board also began discussions about addressing certain specific issues on a faster track and sought further advice from members of its advisory council, on March 26, and from other constituents about specific issues for which a fast-track effort might be both desirable and feasible. Those discussions are continuing. The Board plans to begin its discussions of the project issues during the second quarter.

*Project chronology.* Added to agenda—October 2001.

### *Guarantor's Accounting and Disclosure Requirements for Guarantees*

***Background and recent developments.*** The Board's decision to undertake this project was made in conjunction with its discussion of interpretive consolidation guidance related to identifying and accounting for SPEs. Although guarantees are commonly found in SPE situations, they also are found in non-SPE situations. Accordingly, the Board decided in February 2002 that a separate project is warranted to provide interpretive guidance for the reporting of guarantees by guarantors.

The issuance of a guarantee imposes on the guarantor the following two obligations:

- An obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur
- A contingent obligation to make a future sacrifice (such as future payments) if those triggering events or conditions occur.

The Board decided that at the time a guarantor issues a guarantee, it should recognize a liability at fair value for its obligation to stand ready to perform under the guarantee. However, a guarantor would continue to recognize a liability for its contingent obligation to make a future sacrifice under FASB Statement No. 5, *Accounting for Contingencies.* The Board also decided to require the guarantor to make the following disclosures, even if it is probable that the guarantor will not need to make any payments under the guarantee:

- The nature of the guarantee, including how the guarantee arose and the events or circumstances that would require the guarantor to perform under the guarantee.
- The maximum potential amount of loss under the guarantee (that is, the excess of (1) the maximum amount of future cash payments the guarantor could be required to make over (2) the current carrying amount of the liability for the guarantor's obligations under the guarantee). That maximum potential amount of loss should not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee.
- The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) the nature of any

assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover any of the amounts paid under the guarantee. The guarantor should indicate the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of loss under the guarantee.

Regarding the scope of the proposed Interpretation, the Board decided that contracts that meet any of the four following characteristics would be included in the scope of the proposed Interpretation and would be subject to its disclosure requirements and initial recognition and measurement provisions:

- Contracts that contingently require the guarantor to make payments (either in cash or in kind) to the guaranteed party based on changes in an underlying that is related to an asset or liability of the guaranteed party
- Contracts (performance guarantees) that contingently require the guarantor to make payments (either in cash or in kind, including services) to the guaranteed party based on another entity's failure to perform under an obligating agreement
- Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party based on the occurrence of a specified event or circumstance
- Contracts that are indirect guarantees of the indebtedness of others, as that phrase is used in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others,* even though the payment to the guaranteed party is not based on changes in an underlying that is related to an asset or liability of the guaranteed party.

However, the Board decided that the following three types of guarantees should be excluded from being subject to the proposed Interpretation even though they meet the characteristic-based scope above:

- Product warranties, including separately priced extended warranties and product maintenance contracts
- A guarantee or indemnification contract that is issued by either an insurance company or a reinsurance company and is accounted for under the specialized accounting principles for those companies
- A lessee's guarantee of the residual value of the leased property at the expiration of the lease term, provided the lease is accounted for by the lessee as a capital lease.

Furthermore, the Board decided that guarantees that are accounted for as derivatives and obligations arising from a business combination to pay contingent consideration would be subject only to the disclosure requirements in the proposed Interpretation.

The Board decided that (1) the disclosure requirements in the proposed Interpretation should be effective for financial statements of quarterly or annual periods ending after September 30, 2002, and (2) the initial recognition and initial measurement provisions of the Interpretation should be applied to existing guarantees in the first fiscal year beginning after September 15, 2002, with a cumulative-effect-type adjustment reported in the first interim period of that fiscal year.

***Immediate plans.*** We expect to issue early in the second quarter, primarily through the FASB website, an Exposure Draft of a proposed Interpretation for a 30-day comment period.

*Project chronology.* Added to agenda—February 13, 2002.

### *Obligations Associated with Disposal Activities*

***Background.*** In August 2001, the Board approved for issuance FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* The Exposure Draft that preceded Statement 144 included issues on the accounting for costs associated with a disposal activity, but in completing Statement 144, the Board decided to deal with those issues separately. The current phase of the project focuses on the accounting for costs associated with a disposal activity. The Board believes that this phase of the project is necessary principally because some liabilities for costs associated with a disposal activity are recognized under current accounting pronouncements, in particular, EITF Issue No.

94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)," that do not meet the definition of liabilities in the Conceptual Framework.

***Decisions in current phase.*** The Board began redeliberations of issues on the accounting for costs associated with a disposal activity during the fourth quarter of 2001. The Board has made the following tentative decisions to date in this phase of the project. A more detailed discussion of the Board's tentative decisions is available on the FASB website.

*Scope*

- The Board decided to expand the scope of the Exposure Draft to include costs to terminate an obligation under a contract that existed prior to an entity's commitment to a disposal plan and that is not an operating lease. Thus, the project will reconsider all of the guidance in Issue 94-3 as it relates to a disposal activity. A *disposal activity* refers to (1) an exit (restructuring) activity that does not arise from a business combination, (2) the disposal of a long-lived asset or a component of an entity that is a discontinued operation covered by Statement 144, or (3) the termination of employees.

*Recognition and Measurement*

- The Board reconsidered its decision that a liability for a cost associated with a disposal activity should be recognized and measured based on its fair value when the likelihood of future settlement is *probable,* as that term is used in Statement 5. The Board decided that because the liability is measured based on its fair value, in most cases, the liability should be recognized when it is incurred. Thus, in determining whether to recognize and in measuring the fair value of a liability for a cost associated with a disposal activity, the guidance in Statement 5 and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* does not apply. The Board affirmed that a liability is incurred when the definition of a liability is met, thereby eliminating the exit cost notion in Issue 94-3.

- The Board modified the recognition requirements for one-time termination benefits. If the benefit arrangement requires employees to render future service beyond a "minimum retention period," a liability should be recognized as employees render service over the future service period, even if the benefit formula used to calculate an employee's termination benefit is based on length of service. If the benefit arrangement does not require employees to render future service beyond a "minimum retention period," a liability should be recognized at the communication date. The minimum retention period would be based on the legal notification period, or if there is no such requirement, 60 days.

- The Board reconsidered the approach for recognition of costs to terminate an obligation under an operating lease that existed prior to an entity's commitment to a disposal plan. The Board concluded that, conceptually, the liability for those lease termination costs is incurred at the inception of the lease. However, the Board decided for practical rather than conceptual reasons that the liability should be recognized when the leased property ceases to be used in operations, not at the date of an entity's commitment to a disposal plan, as under Issue 94-3. The Board decided that the same approach should apply for other contract termination costs.

***Immediate plans.*** The Board plans to substantially complete its redeliberations of issues addressed in the Exposure Draft during the second quarter of 2002. We expect to issue a final Statement in the third quarter.

*Project chronology.* Added to agenda—August 1996. Exposure Draft—June 30, 2000. *Accounting for the Impairment or Disposal of Long-Lived Assets:* Statement 144—August 2001.

### *Rescission of Statement 4*

***Background.*** In August 2001, at the request of several constituents, the Board added a project to its agenda to rescind FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.* When Statement 4 was issued in 1975, the Board indicated that the accounting it would require represented a practical solution and was intended to be temporary. Recently constituents expressed concern that automatically classifying gains and losses associated with the extinguishment of debt as extraordinary items could be misleading to users of financial statements because debt extinguishment is a regular part of their strategy for managing interest rate risk in their debt portfolio. In October 2001, the Board completed its deliberations on the proposed Statement to rescind Statement 4 and FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers,* and Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements,*

and to make various technical corrections to existing authoritative accounting pronouncements. On November 15, 2001, the Board issued the Exposure Draft, *Rescission of FASB Statements No. 4, 44, and 64 and Technical Corrections.*

***Recent developments and immediate plans.*** In February 2002, the Board redeliberated the provisions of the Exposure Draft, and in light of comments received it decided to add a substantive amendment of FASB Statement No. 13, *Accounting for Leases,* to the project. On February 14, 2002, the Board issued a limited revised Exposure Draft through the FASB website to seek comments on that change. We requested comments by March 18, 2002, and we received nine comment letters. We plan to issue a final Statement early in the second quarter of 2002.

*Project chronology.* Added to agenda—August 2001. Exposure Draft—November 15, 2001. Revised Exposure Draft—February 14, 2002. (Comment deadline—March 18, 2002.)

### *Other Technical Research Activities*

In addition to the formal agenda of technical projects, we have a number of other technical issues that we are studying and developing. Some of these will be developed into future projects for the Board. Others may help us to expand our understanding of financial reporting issues and may affect formal agenda projects indirectly in various ways. Issues currently under consideration are discussed below.

***Pre-Agenda Proposal Research—Liabilities and Revenues.*** At its meeting on January 9, 2002, the Board discussed the objective and scope of a potential major project on the recognition of revenues and liabilities in financial statements. The need for that proposed

agenda project arose from difficulties that the Board encountered in addressing issues involving liabilities in three projects (asset impairment and disposal issues, asset retirement obligations, and financial instruments—liabilities and equity) and that the EITF and SEC staff encountered in addressing a variety of issues involving revenues. Because matters of revenue recognition can conflict with liability recognition, that project would lead to a new accounting standard on revenue recognition generally, and it also would involve amending the related guidance on revenues and liabilities in certain of the Board's Concepts Statements. The Board issued that project proposal primarily through the FASB website, for public comment with a 60-day comment period. We requested comments by March 29, 2002. After discussing the letters received, the Board will decide whether to add the project to its agenda. That decision is expected to be made in May.

***Codification and Simplification.*** In January, the Board agreed to undertake the following actions in response to concerns raised by constituents about the quantity, complexity, and lack of easy retrievability of the body of U.S. accounting literature including guidance issued by the EITF, AICPA, and SEC. Recent staff activities on the actions are noted below:

*Simplification*

- Evaluate the feasibility of issuing standards that are less detailed and have few, if any, exceptions or alternatives to the underlying concepts. (This topic was discussed with FASAC at its March 2002 meeting.)
- Work with the EITF, AICPA, and SEC to more clearly define their roles in setting accounting standards with an eye toward streamlining certain activities.
- Improve the quality of the cost-benefit analyses prepared as part of the due process for new standards. (The staff is in the process of developing guidelines to be used in all FASB projects.)

*Codification/Retrievability*

- Explicitly address all related EITF, AICPA, and SEC literature in new standards. (The staff is in the process of developing guidelines to be used in developing all future FASB standards.)
- Include references to all of the applicable U.S. accounting literature in the FASB's *Current Text* (a compilation of all FASB accounting standards categorized by subject). (The staff currently is working on this effort and hopes to have it completed by the end of this year.)
- Partner with others in developing an online database that will include all of the U.S. accounting literature. (Our publications department is continuing its discussions on this effort.)

*Disclosure Overload*

- Provide support to the SEC on its initiative to modernize financial reporting and disclosure. (An FASB staff member has been assigned to assist the SEC staff on its initiatives.)

A more detailed discussion of those actions is available on the FASB website.

***Financial Instruments—Derivatives Implementation Group (DIG).*** The objectives of the Implementation Group were to identify issues related to the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and to develop recommendations to the Board on how to resolve those issues. The Implementation Group previously met every two or three months with members of the Board and staff to discuss implementation issues related to Statement 133.

We plan to continue working on the various unresolved issues and consulting with individual Board members and DIG members as appropriate. At this time we do not have specific plans for any future DIG meetings. As implementation issues arise, we will assess the alternatives available for resolution of those issues.

A total of 158 issues have been cleared by the Board to date for inclusion in a staff Implementation Guide in a question-and-answer format. Information about DIG issues is available on the FASB website.

***Emerging Issues Task Force.*** The FASB's EITF assists the Board in the early identification of emerging issues affecting financial reporting and of problems in implementing authoritative pronouncements. Additionally, the Task Force's discussion of issues and the relevant accounting pronouncements help us better understand the emerging issues and, when a consensus is reached, may indicate that no immediate action by the FASB is needed because diversity in practice is not likely to evolve.

During the first quarter of 2002, the Task Force met twice and discussed 14 issues. The next EITF meeting is scheduled for June 19 and 20, 2002.

Descriptions of recently discussed EITF issues are posted on the FASB website. A summary of EITF issues and their resolution or other status is published in an FASB loose-leaf subscription service, *EITF Abstracts,* which summarizes the Task Force proceedings. The service includes a summary of each issue discussed by the Task Force and any conclusions reached along with a comprehensive topical index.

Issue summaries and related attachments, which are discussion materials distributed to each EITF member, and the official minutes of each EITF meeting also are available from the FASB order department at 1-800-748-0659.

***International.*** The Board is active in many international accounting activities and participates in meetings of many international accounting organizations, such as the IASB. General information about FASB international activities can be obtained from the

FASB website. A detailed report on the FASB's specific recent international activities is reported in the Chairman's Report on the FASB website.

Information about how to order the FASB Report, *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP,* is available on the FASB website. Copies of the FASB Report, *International Accounting Standard Setting: A Vision for the Future,* can be downloaded from the FASB website.

***AICPA Documents.*** In the first quarter of 2002, the Board reviewed the following documents and took the action described below:

- Prospectus for a proposed SOP on accounting for risk transfer in mortgage reinsurance arrangements that involve participation of mortgage lenders. The Board did not clear the Prospectus and requested that AcSEC consider increasing the scope of the Prospectus to include the accounting for the arrangements by the mortgage lenders.

- Exposure Draft of a proposed AICPA Statement of Position (SOP), *Clarification of the Scope of Investment Companies Audit and Accounting Guide and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.* The Board objected to issuance of the Exposure Draft and recommended that AcSEC consider certain changes. Further, the Board expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the Guide. Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments.

- Prospectus for a proposed SOP on reporting the costs of soliciting contributed services that do not meet the recognition criteria for contributions in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* The Board objected to AcSEC's undertaking a project to address the reporting of costs of soliciting contributions of services that do not meet the criteria for recognition as contribution revenue in Statement 116. The Board believes a project is not necessary to clarify the existing GAAP that addresses this issue. The Board believes that paragraphs 26–28 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* require that information about expenses be reported by functional classification and that fund-raising activities include soliciting contributions of services from individuals, regardless

of whether those services meet the recognition criteria for contributions in Statement 116. The Board also observed that the definition of fund-raising activities in paragraph 13.35 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations,* conforms to paragraphs 26–28 of Statement 117 and provides that costs of soliciting donors to contribute services (time) should be reported as fund-raising activities regardless of whether those services meet the recognition criteria for contributions in Statement 116. (That conclusion also is articulated in the March 2000 AICPA Technical Practice Aid No. 6140.11, *Costs of Soliciting Contributed Services and Time That Do Not Meet The Recognition Criteria in FASB Statement No. 116.*) The Board suggested that AcSEC consider how best to communicate the final resolution of this issue in the next edition of the Guide.

We expect to address the following documents in the second quarter of 2002:

- Proposed SOP, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations*
- Prospectus of a proposed SOP on accounting for purchase business combinations involving insurance enterprises including certain reinsurance transactions that are in substance business combinations
- Proposed SOP, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts.*

## *Effective Dates*

***FAS 141,*** *Business Combinations,* effective for all business combinations initiated after June 30, 2001. The provisions also are applicable to all business combinations accounted for by the purchase method (regardless of the date initiated) for which the date of acquisition is July 1, 2001, or later. However, for combinations between two or more mutual enterprises, the effective date is deferred until interpretative guidance related to the application of the purchase method to those transactions is issued.

***FAS 142,*** *Goodwill and Other Intangible Assets,* effective for fiscal years beginning after December 15, 2001, except for mutual enterprises and not-for-profit organizations. However, certain provisions are applicable to goodwill and intangible assets acquired in transactions completed after June 30, 2001.

***FAS 143,*** *Accounting for Asset Retirement Obligations,* effective for financial statements issued for fiscal years beginning after June 15, 2002.

***FAS 144,*** *Accounting for the Impairment or Disposal of Long-Lived Assets,* effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years.

***The FASB Report***

The FASB welcomes feedback on *The **FASB** Report*
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**Statements, Proposals, Other Documents, and Current Projects Responsive to the AICPA Report**

**Summary of Recommendations**

**Financial Statements and Related Disclosures (Chapter 6)**

**Recommendation 1: Improve disclosure of business segment information**

Statements

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997)

**Recommendation 2: Address the disclosures and accounting for innovative financial instruments**

Statements

FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (October 1994)

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (June 1996)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998)

FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise* (October 1998)

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (February 2000)

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

Outstanding Proposals

Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* (October 2000)

Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* (October 2000)

Other Documents

Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (December 1999)

Special Report, *Financial Instruments and Similar Items* (December 2000)

Other Current Projects

Guarantor's Accounting and Disclosure Requirements for Guarantees

**Recommendation 3: Improve disclosures about the identity, opportunities, and risks of off-balance-sheet financing arrangements and reconsider the accounting for those arrangements**

Statements

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (June 1996)

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

Outstanding Proposals

Exposure Draft, *Consolidated Financial Statements: Policy and Procedures* (October 1995)

Revised Exposure Draft, *Consolidated Financial Statements: Purpose and Policy* (February 1999)

Other Documents

Special Report, *Reporting Interests in Joint Ventures and Similar Arrangements* (September 1999)

Other Current Projects

Consolidations and Related Matters: Interpretative Guidance for Certain Situations

Guarantor's Accounting and Disclosure Requirements for Guarantees

**Recommendation 4: Report separately the effect of core and non-core activities and events and measure at fair value non-core assets and liabilities**

Statements

FASB Statement No. 130, *Reporting Comprehensive Income* (June 1997)

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (February 2000)

Other Documents

Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (December 1999)

Special Report, *Financial Instruments and Similar Items* (December 2000)

Other Current Projects

Financial Performance Reporting by Business Enterprises

**Recommendation 5: Improve disclosures about the uncertainty of measurements of certain assets and liabilities**

Statements

FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (October 1994)

AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (December 1994)

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

**Recommendation 6: Improve quarterly reporting by reporting on the fourth quarter separately and including business segment data**

None

**Recommendation 7: Standard setters should search for and eliminate less relevant disclosures**

Statements

FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (December 1996)

FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (February 1998)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998)

Other Documents

Business Reporting Research Project, Steering Committee Report, *GAAP-SEC Disclosure Requirements* (2001)

**Excerpts from the Powers Report**

Page 5 "Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting."

Page 15 "Rather than take that loss, Enron 'restructured' the Raptor vehicles by, among other things, transferring more than $800 million of contracts to receive its own stock to them just before quarter-end. This transaction apparently was not disclosed to or authorized by the Board, involved a transfer of very substantial value for insufficient consideration, and appears inconsistent with governing accounting rules. It continued the concealment of the substantial losses in Enron's merchant investments."

Pages 15-16 "As we stated above, in 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation. At the same time, Enron and Andersen also concluded that the LJM1 SPE in the Rhythms transaction failed the same threshold accounting requirement. In recent Congressional testimony, Andersen's CEO explained that the firm had simply been wrong in 1999 when it concluded (and presumably advised Enron) that the LJM1 SPE satisfied the non-consolidation requirements."

Page 58 "Accounting standards for revenue recognition generally require that the services be provided before recording revenue. It seems doubtful that the management services related to the 'required payment' (covering 1998 to 2003) had all been provided at the time Enron recognized the $25.7 million in income. If those services had not been provided by March 1998, Enron's accounting appears to be incorrect."

Pages 97-98 "In three of the four Raptors, the vehicle's financial ability to hedge was created by Enron's transferring its own stock (or contracts to receive Enron stock) to the entity, at a discount to the market price. This 'accounting' hedge would work, and the Raptors would be able to 'pay' Enron on the hedge, as long as Enron's stock price remained strong, and especially if it increased. Thus, the Raptors were designed to make use of forecasted future growth of Enron's stock price to shield Enron's income statement from reflecting future losses incurred on merchant investments. This strategy of using Enron's own stock to offset losses runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement."

Pages 125-126 "Enron had accounted for the Enron shares sold in April 2000 to Talon (Raptor 1), in exchange for a $172 million promissory note, as an increase to 'notes receivable' and to 'shareholders' equity.'...Enron made similar entries when it sold Enron stock contracts in March 2001 to Timberwolf and Bobcat (Raptors II an IV) for notes totally $828 million. This accounting treatment increased shareholders' equity by a total of $1 billion in Enron's first and second quarter 2001 financial reports....In September 2001, Andersen and Enron concluded that the prior accounting entries were wrong, and the proper accounting for these transactions would have been to show the notes receivable as a reduction to shareholders' equity....The correction of the error in Enron's third quarter financial statements resulted in a reduction of $1 billion ($172 million plus $828 million) to its previously overstated equity balance."

Page 129 "Proper financial accounting does not permit this result [Enron's hedging itself through the Raptors]. To reach it, the accountants at Enron and Andersen—including the local engagement team and, apparently, Andersen's national office experts in Chicago—had to

surmount numerous obstacles presented by pertinent accounting rules. Although they apparently believed that they had succeeded, a careful review of the transactions shows that they appear to violate or raise serious issues under several accounting rules...."

Pages 197-199 "FAS Statement No. 57 required Enron to provide '[a] description of the transactions,...and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.' We think that Enron's related-party transaction disclosures fell short of this goal....First, Enron lacked the factual basis required by the accounting literature to make the assertions in each SEC filing concerning how the LJM transactions compared to transactions with unrelated third parties....Second, the publicly filed financial statement disclosures omitted a number of key details about the transactions."

Testimony of Robert E. Litan[1]

Before The

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises of the

House Financial Services Committee

May 14, 2002

I am pleased to testify before you today on issues relating to corporate disclosure that I believe ultimately are of greater importance to investors and to financial policy makers than the immediate issues that have arisen out of the failure of Enron. I know this is a bold statement, but I hope that before this hearing is over the members of the Committee also believe it to be accurate. Indeed, the fact that the Committee has called for these hearings on the future of the current corporate reporting model in today's business and investment culture provides strong evidence of why investors and policy makers should be interested in disclosure beyond the immediate concerns raised by Enron.

I was asked to testify today because of research I conducted on these subjects in conjunction with Peter Wallison of the American Enterprise Institute, reflected in *The GAAP Gap: Corporate Disclosure in the Age of the Internet*, published by the AEI-Brookings Joint Center on Regulatory Studies in 2000. I believe the Committee has copies of this book, but one can also be easily downloaded from the Joint Center's website (aei.brookings.org).

I now will highlight several important conclusions from this study and the policy implications I believe flow from them. I will not address, however, issues relating to auditing and enforcement – topics that this Committee and indeed the full House have already addressed in legislation authorizing the creation of a new Public Regulatory Board to oversee the auditing profession.

**Summary of Findings**

Central to functioning of all capital markets is the continuing flow of accurate, relevant and timely information. Enron reminded a number of well known companies of this simple truth when their stock prices plummeted because commentators and investors feared that they were not disclosing sufficient information to enable the market to understand their businesses and the risks (and opportunities) they presented.

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[1] Co-director of the AEI-Brookings Joint Center on Regulatory Studies. The required biographical

Information is critical because equity markets price the future. The price of a share of a stock at any point time reflects the collective judgment of investors who have most recently traded it about the cash flows the company can be expected to generate in the future, and how uncertain or risky those cash flows may be. Other things being equal, the higher the projected cash flows and the less risky they are deemed to be, the higher the price of the stock relative to its current or projected earnings.

The financial information that companies now routinely report to investors – balance sheets and income statements prepared according to the Generally Accepted Accounting Principles (GAAP) set by the Financial Accounting Standards Board (FASB) – is important, but also of increasingly limited value for understanding the future prospects of many companies. This is so for several reasons:

First, recent financial reports inherently are backward looking, especially so because, for the most part, assets and liabilities are recorded at historical costs, not current market values. To be sure, many analysts and investors use most recently disclosed earnings reports in particular to extrapolate into the future. But as the recent market turmoil has demonstrated, this can be very dangerous since the future for many firms may not look at all like the past. In any event, we are not the first to point to the backward looking nature of financial statements: as early as 1994, the AICPA issued a report making the same observation. Yet unfortunately, not much has happened since in the profession or the SEC, for that matter, to ensure that investors are provided with more useful, forward-looking information. To the contrary, in the meantime, "the future" has become what the analyst community says it is, with firms under increasing pressure to hit or exceed analysts' earnings projections. For many, this pressure leads to the widely derided practice of "earnings management," or the manipulation of reported revenues and expenses in ways that generate reported earnings that do not disappoint market – or more accurately, analysts' – expectations.

Second, much of the value the market assigns to many companies cannot even be found on their balance sheets (or income statements). This is because that value is *intangible* and cannot be easily bought and sold in the marketplace independent of the company itself. Here I refer not just to intellectual property – patents, copyrights, trademarks, and trade secrets – but also the value of a company's workforce, its customer base, its name brand, and all other intangibles that contribute to its ability to generate earnings.

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statement is attached at the end of this testimony.

Contrast all of these items with fixed assets like plant and equipment that can be sold and are the staples of the asset side of balance sheets for most companies.

Intangibles are important not only for so-called high-tech companies, but also for many "old economy" enterprises that may have unique production processes, highly trained work forces and stable customer bases. How do we know that intangibles are so important? Because they market tells us so. As Baruch Lev reports in his book *Intangibles*, published recently by Brookings, at the end of the 1990s, the market value of the stocks in the S&P exceeded their book values by 6 times, up from 3 earlier in the decade. Even though stock prices have receded somewhat since, they still generally remain far above book values – striking proof that we are in a new intangibles-based economy.[2]

Third, non-financial information relevant to pricing the future that may never directly show up in any financial report is constantly being generated, and in any event much more frequently than quarterly and certainly annually, whose disclosure is important, and indeed critical, to investors. A few examples: the gain or loss of new customers, insider sales or purchases of the company's stock, changes in management, new patents, and so forth. To its credit, SEC has proposed that more such information should be disclosed in so-called 8-K filings by companies, and more rapidly (within 2 days rather than 5-15) than ever before. In addition, companies increasingly are webcasting their analysts conferences on the Internet so that anyone can get the same information, at the same time, as the analysts (a situation required under the SEC's controversial, but I believe commendable, Regulation FD).

Fourth, the development of new computer-based technologies, especially the Internet, may soon make it possible for investors on their own – or through independent advisers – to manipulate company-specific information so that they need not rely on the GAAP-based financial statements that companies now produce. Specifically, I refer here to the development of a new computer language, XBRL, based on another more general language XML, that allows firms to place "tags" or identifiers on all kinds of financial and non-information in their possession.[3] With these tags, users can then manipulate and

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[2] There is a growing literature in economics on the sources of this intangible value, with increasing evidence that one driving factor is information technology and the ability IT gives to firms to reorganize their operations in more efficient ways. This argument is fleshed out in a forthcoming paper in the *Brookings Papers on Economic Activity* by several leading researchers in this field, Erik Brynjolfsson of MIT, Lorin Hitt of the University of Pennsylvania and Shinkyu Yang of New York University.

[3] XBRL is being pursued jointly by the accounting profession, largely through the AICPA, and a growing number of publicly held firms around the world.

rearrange firm-provided data in any manner that they see fit. This is simply not possible with the current HTML-based text that companies now release on the Internet, which is fixed and cannot be rearranged. I will have more to say about XBRL shortly.

In short, by their very nature, GAAP-based financial statements are inherently limited in the kinds of information they provide to investors and on what schedule. The critical question for firms, their accountants, the investing public, and policy makers like you, is what steps should be taken now and in the future to provide the markets with more useful, relevant information that improves the ability of all market participants to better judge the future prospects of individual firms. The more effective that process is, then the more efficient our capital markets will be in allocating funds to those companies that most deserve it, while reducing the costs of raising capital for all those firms that need it.

**Implications**

These conclusions have several policy implications.

First, what should be done about the growing importance of intangibles? One natural response could be to require firms to put values on their various intangible assets, and perhaps even more ambitiously, estimate how those values might increase or deteriorate over time, with the changes reflected in income statements. This is an understandable, but ultimately impractical, reaction however. Precisely because there are few, if any, organized markets for intangible assets, there are no objective ways for firms and – more importantly in light of the recent events surrounding Enron – their auditors to verify most, if not all, of these values (unless the assets or purchased, or valued at cost).

To be sure, some accounting adjustments might improve matters. In particular, accounting standards-setters should be more flexible in allowing companies to capitalize certain investments that lead to the creation of intangible value. One of my favorite examples from our book is when AOL was incorrectly, in our view, required by the SEC to expense its marketing costs – largely the distribution of free diskettes. In retrospect, the handing out of free disks was a critical investment by the company in building up its customer base, which today ranks among the most important assets of the company. AOL should have been allowed to capitalize this investment, not write it off as the disks were handed out, thus depressing earnings in each of those years.

Improvements in financial reporting can only go so far, however, in doing a better job of capturing intangible value. Ultimately, a more productive course is for firms to disclose more *non*-financial information that may give rise to intangible value. Here I refer to measures of consumer or worker satisfaction, product or service quality, successful innovation, education and experience of the workforce and management, and a variety of other non-financial indicators that individually or collectively, can shed far more light for investors on the future ability of firms to generate earnings or cash flow than GAAP-based financial reports. Various experts, including individuals who are testifying before you today, have worked to develop lists of these non-financial indicators.[4] In the *GAAP Gap* we urge the SEC use its powers of persuasion in this area, perhaps by beginning to convene working groups of experts from different industries, to encourage firms to make more of these disclosures, and to do so consistently and repeatedly.

A second policy challenge is how best to harness the power of technology – computers and the Internet – to facilitate more complete and more rapid corporate disclosure. Once the XBRL-based tags are fully developed and implemented by companies, a wide range of users – not just sophisticated ones like financial analysts -- will be able easily to take very detailed data from companies and reconfigure it in multiple ways, using widely available spreadsheet programs. But here, too, there is a role for the SEC: to encourage this project and do what it can to publicize its importance and encourage companies to participate in the process of developing tags for information that may be industry-specific. The Commission may also want to consider ways in which it could encourage companies to use the tags at the earliest possible date. One possibility: require EDGAR submissions to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting, but not just the events required as part of the 8-K filings. With the Internet, many companies now or may soon have the ability to make available to the public their *financial reports* much more frequently than on a quarterly basis – weekly, if not daily. Indeed, financial institutions already typically balance their books every night. Why not then consider ways to have this financial information communicated in the same time frame?

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[4] See, e.g. Robert K. Elliott, "The Third Wave Breaks on the Shores of Accounting, " *Accounting Horizons* 6(2) (1992), pp. 61-85; *Improved Business Reporting – A Customer Focus*, American Institute of Certified Public Accountants, February 21, 2000 (www.aicpa.org/members/div/acctstd/ibr/appiv.htm); *Value Reporting Forecast, 2000, 1999* (PriceWaterhouseCoopers); Robert S. Kaplan and David P. Norton, *The Balanced Scorecard* (Harvard Business School Press, Boston, 1996).

There will be objections to encouraging companies to make available unaudited financial information more quickly, but I believe these objections can be met. As it is now, quarterly financial data are unaudited and will remain that way unless the SEC or a new Public Regulatory Board (whose creation the full House has recently authorized) come up with guidelines for more limited audits for more frequently reported data.[5] In any event, the capital markets would become much more volatile if investors came to believe that all unaudited financial information were useless. Even in the wake of Enron, the financial data produced by the overwhelming preponderance of public companies still have use; if this weren't true, stock prices would be well below where they are now. Accordingly, if in an age of computers and the Internet companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

I believe there is a potential side benefit to more frequent financial disclosure, and it is related to the problem of earnings management to which I referred earlier. If companies routinely reported their financial results much more frequently than every quarter, it is conceivable that investors and analysts would lose interest in the quarterly figures. It is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a chance that more frequent reporting could reduce incentives of managers – and their auditors – to engage in earnings management.

At the same time, *mandating* more frequent reporting at this point is premature. Many firms simply may not be able to comply with such a requirement, even over a period as long as a month. Or the cost of compliance may be prohibitive. The challenge is to find a way to provide incentives to the firms that *are* able to report more frequently than quarterly to do so. Here, too, the Committee could play a constructive role by asking the SEC to review the options, and at the very least, lead a visible campaign to encourage more rapid reporting more suitable to the Internet age.

**The Future of Accounting Standards**

Finally, what future is in store for accounting standards? There is a view that the growing use of XBRL, among other developments, could make them irrelevant. After all, if investors and analysts are

[5] If this happens, some thought needs to go into adjusting liability thresholds to reflect any differences between the kinds of audits.

better able to manipulate and compare both financial and non-financial data themselves, it is conceivable that there will be less demand for standardized reporting.

I do not subscribe to this view, or at least have not yet been persuaded that the publication of more non-financial information, available in easy-to-use computerized formats, will make reporting standards obsolete. At the very least, there is a role for standards-setters to define what constitutes certain reported items, such as revenue, expenses, and the like. Otherwise, investors have no way of making valid comparisons of financial data across companies. More broadly, for the same reason, I believe there will continue to be at least some demand for standardized reporting as well as standardized definitions.

This brings me to the controversial issues surrounding FASB standard-setting. One set of questions relates to the operation of FASB itself: how, if at all, the development of its standards can be accelerated and better insulated from undue political interference. Another key question is whether U.S. policy should continue to require all firms listing their shares in U.S. exchanges to report under GAAP, or to reconcile their financial statements to GAAP if they report under International Accounting Standards (IAS).

I'll conclude with a few thoughts on each of these issues.

The slowness of FASB's standard-setting could be addressed by having the SEC impose deadlines on rule changes, with the threat that the SEC would take action by a date certain if FASB didn't (as former SEC Chief Accountant, Lynn Turner, has proposed). Although I'm clearly not enthusiastic about the SEC taking over the standards-setting function altogether -- which could interfere with the other functions the Commissioners perform and not guarantee any better outcomes – there may be value of having the *threat* of occasional SEC rulemaking as a way of keeping FASB's feet to the fire. The SEC could also become more proactive in reviewing, if not actually setting, FASB's rulemaking agenda on a regular basis, which could also help speed things up.

The downside of more active SEC involvement, however, is that it could result in even greater political interference in FASB's activities than already exists -- most recently, with respect to FASB's efforts to set standards relating to the expensing of stock options and the accounting treatment of derivatives. There is a respectable view that politics is inherent in any rulemaking process, especially one that is supposed to be in the public interest, and so we should simply live with the fact. Moreover, it can be

reasonably claimed that setting accounting standards is not a science and we should stop pretending that it is something so pure that it shouldn't be affected by the views of the profession that applies them nor of the firms that have to abide by them.

At the same time, however, we should remember that the main purpose of accounting standards – at least for publicly held companies – is to protect the interests of *investors*, not accountants and not the firms themselves. Accounting standards should help investors understand all relevant financial facts that will enable them, if they want, to make projections about future cash flows. Where the standards are changed or not implemented out of concern for affected firms rather than investors, who tend not to be organized and who in any event can always choose not to invest in the companies that may be lobbying the Congress or FASB on a particular rule, then the outcome may not be socially desirable.

In short, it is not that politics should be kept out of the rulemaking process – it probably never can be – but that the current system, at times, can too heavily favor narrow interests over the interests of investors as a class (of course, this a problem that is not unique to accounting standards). In theory, putting more investor or public representatives on FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, then there is little that even a more balanced FASB can do.

Similarly, moving the standards-setting function to the SEC is not a panacea because Congress still exercises oversight of the SEC. The same would be true if FASB members were chosen directly by the Commission. As long as the SEC oversees FASB in some way and Congress oversees the SEC, I don't see how politics can be taken out of accounting standards-setting.

In principle, the only option I believe would have a chance of at least making some difference is to move standard-setting to an international body like the International Accounting Standards Board and thus accept international accounting standards (IAS), which the United States thus far has refused to do – largely out of the belief that U.S. GAAP is superior to IAS. Of course, this is not the rationale for moving to international standards that is typically cited. Instead, the case for IAS rests largely on the view that a single set of accounting standards worldwide would eliminate discrepancies in accounting standards across countries, thereby facilitating cross-border movement of capital. In addition, removing sources of uncertainty generated by differences in national accounting conventions should reduce the cost of capital.

In the wake of Enron, others also have argued that a system like the IAS that allows accountants more discretion is superior to the heavily rules-based system of U.S. GAAP which seemingly invites circumvention. (Precisely the opposite argument can made, of course, *against* a system that allows more discretion, and thus potentially more freedom for managements to manage their earnings than already exists.)[6]

Whatever the merits of all of these arguments, the key point is that another potential, and possibly unrecognized, advantage of replacing U.S. GAAP with IAS is that it would dilute the political power of American interests – whoever they may be – to influence the outcome of the standard-setting process. Take, for example, the fight over expensing stock options, which FASB was about to implement several years ago before it was stopped by a powerful lobbying campaign from the U.S. high-tech community. If standards were set solely by the IASB, our high-tech firms would make their views felt, but they could well run into significant opposition from standard-setters from other countries. Indeed, it is just for this reason that moving away from U.S. GAAP to IAS, if it were ever seriously considered, almost certainly would arouse strong opposition in this country.[7]

Accordingly, I do not believe that replacing U.S. GAAP with IAS is a politically viable option, even if the IASB, under the strong leadership of Paul Volcker and David Tweedie, among others, convincingly updates IAS in a way that persuades many in this country that the international standards are superior to U.S. GAAP.[8] I hold this belief for another reason: Even if U.S. GAAP were replaced, it is possible, if not likely, that FASB or something like it would continue to exist in order to issue interpretive rulings of the broader principles-based international standards. If this were the case, and I suspect there would be strong pressure to ensure that it would be if U.S. GAAP ever were replaced by IAS, then FASB's interpretive rulings would gradually lead to a U.S. version of IAS, as well as the "international version". If other countries did the same thing, IAS could fragment over time back into multiple national standards.

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[6] A widely noted reason for the greater specificity of U.S. GAAP is that it is a response to the greater pressure of securities litigation in the United States than in other countries. If the United States adopted IAS, it is possible, if not likely, that our representatives would push the IASB to make IAS more specific over time for the same reason.

[7] Those who fear a loss of "financial sovereignty" also presumably would weigh in against any move to a single world standard-setter.

[8] Volcker is chairman of the trustees of the International Accounting Standards Board and Tweedie is the chairman of the IASB itself.

It is possible, of course, that fragmentation would not occur – that national accounting bodies such as the FASB would simply fade away. Whichever view is right – fragmentation or monopoly – I lean toward a different approach, one that would allow all firms listing on U.S. exchanges to choose which set of standards, IAS or GAAP, they wanted to report under without having to incur the expense of reconciling the reports under the two standards. Like any monopoly, whether private or public, a single standard-setting organization can stultify and be slow to adapt to market developments. Sound familiar? That's one of the main complaints about FASB. With competition, each standard-setter would have a market-based incentive to keep up with the times and not drag its feet. Furthermore, if it really is true that any move to international standards would eventually break down into national versions of those standards (or at least a U.S. version), then some competition is inevitable. Why not simply recognize that to be the outcome right now?

Wouldn't there be a "race to the bottom" if competition in standard-setting is allowed? The post-Enron experience suggests the opposite would occur. Ask GE, IBM, Tyco or any number of other companies whose stock prices were pummeled by investors after the Enron affair became public. Investors (prompted to some degree by the business media) looked at the financial statements of these companies and apparently found their disclosures inadequate. The market encouraged each to become more forthcoming in its disclosures. Based on this most recent experience, I believe it is reasonably likely (although I admit not certain) that if firms had a choice in reporting standards the market eventually would punish the standard that analysts, academics and financial commentators would view as the weaker one from an investor protection point of view. For the same reason, I also believe there is also a reasonable chance that competition in standards could weaken (although not entirely eliminate) political influence on standard-setting.

What if after a reasonable period of competition one of the standards was driven out of the market, much as has happened in the markets for computer operating systems (for Intel-based personal computers) or video cassette tapes? If that is the result, then so be it. But given the international movement away from U.S. GAAP and toward IAS, it is likely that the loser in any competition would be U.S. GAAP, leaving IAS. But if national standard-setters nonetheless continued to issue interpretations of IAS, then the market would not have moved to a single standard.

There are less radical proposals than pure competition that could nonetheless bring greater competition to the setting of standards. One variation of pure competition, for example, would be to allow firms listing here to choose the standard but then reconcile only the "material" differences between their accounts under GAAP and IAS (if they chose IAS). The SEC could launch a rulemaking to define what subjects might trigger reconciliation – such as the treatment of stock options, differences in revenue recognition, and the like. This option may be more politically palatable in this country than pure competition, although it would inhibit to some degree the listing of foreign companies on U.S. exchanges. This option would also blunt some of the virtues of pure competition between IAS and U.S. GAAP.

Another variation is the mutual recognition approach used in Europe for the regulation of financial institutions. Under this option, U.S. firms listing on a U.S. exchange still would be required to report under U.S. GAAP, but foreign firms would be able to list their shares reporting under IAS. This model would promote more competition than currently exists, but it may not be politically viable unless accompanied by some kind of reconciliation requirement for material matters.

One way to surmount the political problems relating to reconciliation would be to urge both FASB and the IASB to narrow at least some of the differences that now exist between U.S. GAAP and IAS. Without some kind of external pressure to ensure that these differences do get narrowed, however, this approach may not guarantee quick results. Furthermore, while the narrowing of differences would promote harmonization of standards, it would also detract from competition.

The key point on which I wish to conclude, however, is that some variation of competition in reporting standards between U.S. GAAP and IAS would be an improvement over the current situation. It would be likely to encourage standards-setters on both sides of the Atlantic to keep up more rapidly with events in the corporate world, while also serving the interests of investors. Furthermore, notwithstanding the changes in the business environment that call for new kinds of corporate disclosure, I do not believe that the demand for standardized financial reporting will disappear. Indeed, if competition in financial standards survives a market test, I believe there is a good chance that standards-setters eventually will extend their reach into the definition and refinement of the kinds of non-financial measures that are likely to be used more often in the future to better inform investors of the future financial prospects of the companies whose shares they hold or may want to buy.

ValueReporting Testimony

## Introduction to ValueReporting™

Good afternoon, Mr. Chairman and members of the Committee.

My name is Ellen Masterson, and I am a partner with the independent accounting and auditing firm of PricewaterhouseCoopers (PwC, the Firm). My specific role within the Firm is serving as the Global and US Leader of Assurance Methodology, and as the Global Leader for ValueReporting. ValueReporting™ is an approach to performance measurement and corporate reporting, developed by PricewaterhouseCoopers, to help companies meet the information needs of the capital markets, and is the topic about which I have been asked to speak with the committee today. I thank you for this opportunity.

By way of background, I joined the Firm in 1973 and, after a short leave-of-absence to complete my MBA at Southern Methodist University in 1978, and became a partner in the Firm in 1985. My area of greatest experience is in the financial services industry, primarily in the insurance sector, although through my career, I have served as an auditor for clients in a variety of businesses. In 1997, I left the Firm to become the Chief Financial Officer of American General Corporation, based in Houston, Texas. I returned to PwC after two years and have had successive roles in assurance service innovation and methodology in the US and on a worldwide basis, including my involvement with ValueReporting.

PricewaterhouseCoopers L.L.P. is a professional services firm of 48,000 partners and employees offering accounting, auditing, tax and management consulting services to a wide variety of private and public sector clients in approximately 100 U.S. cities. Through its international affiliates, it serves clients in 150 countries.

I first became aware of the ValueReporting initiative of PricewaterhouseCoopers while I was with American General, and my response to the thought leadership going on in the firm was that it was "right on point". So, when I was asked to become involved in this

initiative after returning to the Firm, and in particular to bring the perspective of a former CFO to the discussion, I was pleased to do so. It was shortly after I became involved that, in the summer of 2000, we began work on the book about which I have been asked to speak with you today – ***The ValueReporting Revolution, Moving Beyond the Earnings Game***, published by Wiley in February 2001. The named authors of the text are Dr. Robert G. Eccles, a former tenured professor at the Harvard Business School and currently a Senior Fellow of PricewaterhouseCoopers; Robert H. Herz, one of my partners whom I am sure you are aware will assume the leadership of the FASB on July 1 of this year; E. Mary Keegan, a former PricewaterhouseCoopers partner who now serves as Chairman of the UK Accounting Standards Board, and David Phillips, one of the initial ValueReporting thought leaders in our firm from London. As indicated in the foreword, the impact of my own personal contribution to the writing of the book was primarily to assist these authors in understanding just how difficult it can be, in practical terms, to achieve greater transparency from the corporate reporting perspective. With two of our authors either serving, or about to be serving, as the leaders of the UK and US accounting standards making bodies, respectively, we hope the recommendations contained in the book will receive greater attention.

I have included with my written testimony today a Book Summary prepared by getAbstract, a company that specializes in business book summaries, as well as a summary of "frequently asked questions" that can be helpful in understanding the basic concepts promoted in the text, and perhaps some of your own queries that we might not get to today. What I would like to do here is to highlight the major concepts that I believe the committee would find of interest in light of the recent spotlight on the subject of transparency– recognizing that at the time of our writing of The ValueReporting Revolution, Moving Beyond the Earnings Game, the topic of transparency was not as "vogue" as it is today.

In the early 1990's, our firm became interested in exploring the effectiveness of corporate reporting in meeting the needs of investors and analysts around the globe. Research

began on a country-by-country basis, and after 14 country surveys of investors, analysts and management (primarily CFO's) regarding the information that each group believed was most important to the creation and assessment of long-term value, a clear picture had emerged. There was great consistency across country borders, demonstrating that investors in most parts of the world were interested in much the same information, and that their information needs were not being met by current corporate reporting practices.

From this extensive research of over 1000 investors and analysts across the 14 countries, we also learned that:

- 33% of companies believed that they were undervalued in the market place;
- investors and company managers had a surprisingly consistent view on what information is important;
- managers, for a variety of reasons, felt unable to communicate more than is demanded by the regulatory model;
- despite the widespread use of corporate reports in the investment community, less than 30% of both investors and analysts regarded them as useful;
- the market is excessively focused on short-term earnings; and
- companies would benefit significantly, in the opinions of investors and analysts surveyed, by improving their disclosure practices, including higher share prices where warranted.

Out of this research, PwC drew two significant conclusions:

1. The perceived gap between management's view of a company's value, and the market valuation can be explained, at least in part, by a lack of relevant, credible information in the marketplace. I will come back to this "gap" analysis in a moment.
2. The information that the marketplace wants and needs can be codified in what we call "the ValueReporting Disclosure Model", covering the information that all three groups – investors, analysts and managers – agreed was important to understanding the long-term value creation potential and activities of a corporation.

First, let me address the communication gaps, which we believe contribute to investors' placing an incorrect value on a company today. This assumes a rational market, which in the presence of 100% of the information needed, would appropriately arrive at the value of the enterprise, based on future cash flows discounted at a reasonable rate of expected return for the business risk involved.

From our research, we defined five underlying communication gaps driving the Value Gap between management's assessment of value and the market's assigned value. A graphical depiction of these five underlying gaps is found in Exhibit 7.4 on page 130 of the book. In brief, the five underlying gaps are as follows:

The Information gap: investors want information about the performance of the company that they are not receiving

The Reporting gap: management recognizes that there is important information about the performance of the business that they are not reporting

The Quality gap: while management agrees certain performance information is important, they either don't have the information or they have it but are not comfortable that it is of adequate quality for public dissemination.

The Quality Gap often underlies the Reporting Gap: management doesn't report information because they don't have it, or don't believe it is of sufficient quality for external reporting.

The above are the three most significant gaps underlying the Value Gap.

The good news is that the other two gaps are of less significance:

Understanding gap: investors/analysts and management differ on the importance of information

Perception gap: management believes they are communicating the information more or less than investors/analysts believe they are getting it.

It is truly significant that these gaps are small, because it means that outsiders and insiders are fairly well aligned on what information is important, and how well it is currently being communicated.

The most troublesome gap described above is the Quality Gap. After much consideration of the reality that internal information used by management is often not subjected to the same level of rigor and control that is ascribed to publicly disseminated information, we concluded that our recommendations to close the Value Gap by reporting more relevant information externally could actually lead to Better Managed Companies. This follows the adage, "you can't manage what you can't measure". If external reporting will improve the quality of internal measures, then higher quality measurement can actually improve the quality of management.

So, let's move to the kind of information that causes the Information Gap for investor/analysts, remembering that, by and large, managers agree this information is important but not communicated. The ValueReporting Framework emphasizes four categories of information needed for investors, analysts and managers to fully understand the value of the enterprise:

1. Overview of the **Markets** in which the company operates
    - Competitive Environment
    - Regulatory environment
    - Macro-economic environment
2. The Company's **Strategy** for creating value for the investor
    - Goals
    - Objectives
    - Governance
    - Organization
3. How the Company **Manages for Value**

Financial performance metrics
Financial position measures
Risk management practices
Segment performance

4. The **Key Drivers of Value** in the Company's Business Strategy
   - Innovation
   - Brands
   - Customers
   - Supply Chain
   - People
   - Reputation
     - Social
     - Environmental

After these initial conclusions, at the request of two of our clients in the insurance and banking industries, respectively– we began to conduct similar research by industry sector, and different results began to emerge. Today, after completing 8 global industry sector research surveys of investors, analysts and companies, with 6 more in various stages of progress, we have compiled industry-specific versions of the ValueReporting Framework which differentiate primarily among the value drivers that carry the greatest importance in different industries. The four categories of the Framework have held true, but within each category, the key performance indicators and the drivers of value will differ. In ***The ValueReporting Revolution, Moving Beyond the Earnings Game***, we highlight the results of one of those industry surveys, the High Tech industry, to demonstrate how the Framework can be used in practice to improve corporate disclosures to investors and analysts, increasing the relevancy of the overall information flowing to the capital markets.

So, if investors, analysts and managers all agree that there is important information needed to fully value companies today that is NOT being communicated in the marketplace by management, why don't they do something about it? There are likely many answers to this question, for example, the following:

- It's not required.
- It's competitive information that should be guarded.
- The information on non-financial value drivers, if used internally, isn't as reliable as it should be (i.e., Quality Gaps are real).

- By the time we get through complying with the complex accounting rules and requirements of US GAAP, the last thing we have time to do is sit back and ask ourselves, "what do investors really need to know?"
- Who else is doing it? We don't want to go first.
- There are no standards for this kind of information, so what good would it be anyway?
- The more we disclose, the greater our exposure to legal liability, particularly if it is forward-looking information, and we miss our targets.

We recognize the arguments, we've heard them all by now. And, yet, we haven't met a CEO or a CFO who doesn't basically agree that the results of our research make basic sense, and believes that, eventually, the market will probably approach something like we are recommending. And, there are some global companies who are leading the way. In our ValueReporting Forecast 2002, we showcase examples of 61 companies in 17 countries, which we have identified as "best practices" in the various categories of the ValueReporting Framework. We are currently at work on Forecast 2003, which I am certain will show even greater progress in voluntary disclosures by leading edge companies who see the value in transparent reporting.

So what is this value? In the spirit of transparency, we have no conclusive and incontrovertible evidence that better disclosure will lead to more "accurate" stock prices. We should also note that the real point is performance, not transparency per se. However, better disclosure of lousy performance will likely lower a company's stock price; better disclosure of good performance will likely raise it. That said, intuition and financial theory both say that increased transparency decreases risk to investors, and we have persuasive evidence from our country and industry-based surveys of analysts and investors that better disclosure offers some clear benefits. The results of these surveys suggest that the most important benefits of greater transparency to companies are: (1) increased management credibility, (2) increased management accountability, (3) more

long-term investors, (4) greater analyst following, (5) improved access to and lower cost of capital, and (6) more accurate share prices.

But not all the benefits accrue to the companies who choose to pursue ValueReporting. There are benefits to investors as well. Simply put, ValueReporting would give investors the information they need to make better investment decisions. Of course, this really only applies to investors who take a reasonably long-term view. It is doubtful that day traders and momentum investors will care much about ValueReporting. But investors who want to know whether a company is performing well along the value drivers that will produce a return in the future should be great champions of ValueReporting. Our research indicates that investors will reward those companies that practice ValueReporting with a lower cost of capital, because of the lower uncertainty discount that will result from better information.

So, with all these benefits, why does it take a revolution? As I said, I have attached a Frequently Asked Questions section, but this particular question, I would like to address here.

The reason we believe a revolution in corporate reporting will be needed to achieve the objectives of ValueReporting is that it is based on a philosophy of complete transparency, requiring dramatic changes in management and board behavior which will be fueled by powerful new technologies, and at the same time challenges the existing regulatory regime by bringing more relevant information to the marketplace on a voluntary basis.

In recent hearings, the Committee has looked at the role of the board and the audit committee in corporate reporting and corporate governance. The board has the ultimate responsibility for representing shareholders' interests–and that includes clear communication from management in order to realize the true value of their investment. It follows, then, that the board is responsible for making sure that ValueReporting happens. The board also needs the kind of information that ValueReporting provides to properly evaluate the management team. And the board has a responsibility to make sure that the

investors, whose interests it represents, get such information as well. Just as senior management needs the information for running the company, so does the board need it to perform its role.

The audit committee can play a key role in ensuring that relevant information about tangible and intangible assets is developed, including information about the relationship between risks taken and return realized. If the audit committee accepts responsibility to oversee "information" and not just "financial information," it positions itself not only to protect the company from downside risks, but also to support management's pursuit of the upside. This enables the audit committee to take a broader view of risk as well and to ensure that information about the company's risk management practices explicitly articulates the risks being taken in the pursuit of value, what the expected value is, and how the downside will be managed.

With heightened awareness of the need for greater transparency in corporate reporting, I would like to also give the committee an update on our continued thought leadership in this area at PwC. In 2000, we called for industry-based voluntary disclosure, which others, such as the FASB were also promoting. In light of recent occurrences, however, we do recognize that the groundswell for standard setting in this area is being accelerated.

We continue to believe that this should be driven by industry-based coalitions, globally organized in responding to investor needs. We also do not believe that the historical financial reporting model should be expected to incorporate all the information needed by those participating in the capital markets. In this age of easy access to real-time information, we encourage the preparers and users of information in the capital markets to create new venues for reporting the information that is important to the proper valuation of companies, stretch the boundaries beyond traditional financial reporting and open their minds to a greater sharing of information about the real drivers of value in the business with those whose capital management deploys. Information partnerships between the suppliers of capital and the users of capital should be the goal.

Thus, we do not propose that ValueReporting will make traditional financial reporting less relevant. High-quality historical financial information delivered on a timely basis remains critically important. But the traditional financial reporting model neither meets investors' *complete* information needs, nor does it support today's market valuations. Neither are we advocating putting lots of intangibles on the balance sheet. Thinking in terms of the balance sheet misses the real point. What the market wants is *information* on intangibles. We don't advocate a lot of changes in existing accounting rules or adopting new ones to accomplish this – in fact, we favor simplification of accounting rules and consideration of an international principles-based approach for reporting historical results.

For the additional information the market needs, we simply say that companies should give the market reliable and relevant information, and the market will figure out what to do with it. Investors need more, and more meaningful, information than they now get. Companies should supplement their GAAP-based financial statements with timely, equally high-quality nonfinancial information. Analysts already run non-GAAP information—provided by companies, or estimated through their own research—through their models to make recommendations to investors. If investors lose money, however, they often include the GAAP accountants and auditors among the culprits. It's in our interest as professional auditors and accountants, as well as in the interest of companies and their shareholders, to make sure that all reported information is relevant and reliable for end-users. If companies and investors ultimately hold us accountable for that anyway, we might as well do it up front.

Before I conclude my remarks, I would be remiss if I did not address in brief the subtitle of the book: ***Moving Beyond the Earnings Game***. It was no surprise that our market research confirmed what every participant in the capital markets already knew: the market is too obsessively focused on short term earnings, which has caused management to spend too much time managing expectations when they could be managing their businesses for greater value over the long term. The Earnings Game, as outlined in the text, follows seven rules:

1. Deliver a track record of consistent earnings growth
2. Manage earnings expectations carefully
3. Slightly beat earnings expectations
4. Make business decisions to meet or beat expectations
5. Hammer stocks that fail to meet expectations
6. Listen carefully for the whisper number
7. Hammer stocks that fail to meet the whisper number

The energy of top management expended in this cycle each quarter is energy that could be put to better use in crafting strategies that benefit long-term value-based investors. The Game is Real.

One of the consistent themes in all of our firm's country-based and industry-based research is that investors need more information about the Quality of Management. One might question how companies can better communicate this particular driver of value. Certainly it is not reduced to a simple metric. Or is it? Isn't that what the market uses the Earnings Game for? In the absence of other, long-term information about management, the markets they choose to operate in and their strategies for growing the value of investor's hard-earned money, short-term earnings will continue to be used as a proxy for how reliable management is in feeding the Earnings Game.

Our book was intended to be provocative, and hopefully, my remarks have been as well. For those of you who read the full text, you will see that we have been fairly critical of all those who participate in what could be called the "corporate reporting supply chain" – from management and the board, to the auditors and the analysts. We all have a role to play, and it must start with properly reporting and analyzing the historical performance of the business in the prevailing GAAP model. We must also push beyond the boundary of regulatory reporting in order to meet investors' needs for additional information, and provide all relevant information needed to inform the capital markets, with a strong rigor for quality.

ValueReporting Testimony

I appreciate the opportunity to be with you today and to share some of the results of our research, our interpretation of these results in the area of improving corporate reporting, and I would be pleased to answer any questions from the members of the committee.

I have structured the following portion of my written testimony as "Frequently Asked Questions and Answers" which we have found to be an efficient way to present information on this topic. I would encourage members of the Committee to read our book, ***The ValueReporting Revolution: Moving Beyond the Earnings Game*** for a more detailed understanding of the underlying research and methodology.

## I. ValueReporting in General

1. **What is ValueReporting?**
   ValueReporting is an approach to performance measurement and corporate reporting, developed by PricewaterhouseCoopers that helps companies be more appropriately valued in the capital markets. It addresses the gaps between the current financial reporting model and the demand by investors and other stakeholders for more information on market dynamics, strategy, and the intangible, nonfinancial drivers of shareholder value. ValueReporting provides greater clarity and transparency to investors and other corporate stakeholders and supports better decision making by managers.

2. **What are the key components of this approach?**
   An important part of the overall concept of ValueReporting is the ValueReporting Framework. This framework has four major elements that provide a comprehensive way for a company to evaluate and structure its communications to the market:
   (1) Market Overview describes competitors and their competitive positions, assumptions about the macroeconomic environment and industry growth, views on the regulatory environment, and perceptions about current and future technologies.

(2) Value Strategy describes the company's overall corporate strategy and its strategies for major business units, as well as how the company intends to implement these strategies in terms of organization and governance structures and processes.
(3) Managing for Value describes the measures the company believes most closely reflect inputs to and changes in shareholder value, actual income statement and balance sheet results compared to targets and benchmarked against competitors, segment information, and information on risk and risk management.
(4) Value Platform provides information on the critical value drivers in the company's strategy, typically the leading indicators of future financial performance, including innovation, intellectual capital, customers, brands, the supply chain, people, and reputation.

3. **What information beyond the company's own performance does ValueReporting take into account?**
A lot of variables other than the company's own intrinsic performance can affect its stock value, the investor's ultimate interest. For example, strong operating results will likely have a lesser effect on stock price if all the company's major competitors did even better. Similarly, industry conditions—growth rate, margin pressures, new competition for example—and macroeconomic conditions—such as growth rate, inflation rate, and exchange rates—can also significantly affect stock prices. Management should report explicitly its own views and expectations about such external factors and how they will affect their company's and their competitors' performance. Clearly, the latter involves providing information on competitors, through benchmarking for example. Although investors can find virtually all this external information themselves if they are willing to expend enough effort, ValueReporting argues that management serves its own best interest by presenting a complete, coherent picture and shaping the message the market hears.

4. **How does ValueReporting differ from other models that provide evaluations of stock price?**
There are various financial models in the market for evaluating a company's stock

price and how management decisions can affect it. They are typically based on financial measures such as sales growth rate, cash tax rate, cost of capital, fixed investment efficiency, capital investment efficiency, time period of positive yield returns, and working capital investment efficiency. These models focus specifically on value creation, while ValueReporting takes a much broader view. It addresses the company's business model—versus a pure financial model—and includes both financial and nonfinancial value drivers. It also emphasizes the importance of reporting this information both internally and externally. Although ValueReporting culminates in value realization, it is integral to the activities that lead to value creation and value preservation.

Another approach in the marketplace is called Value Dynamics, which focuses on internal decision making to improve value creation. Reporting this information externally is something of an after-thought. ValueReporting quite explicitly focuses on how companies can realize their appropriate value in the capital markets by reporting more and better information to shareholders and other stakeholders. Still, ValueReporting has its foundation in a robust internal performance measurement system—the first step in implementing the new reporting model—that will improve internal decision making as well. Furthermore, the discipline of external reporting should improve internal decision-making—you can't manage what you don't measure, as the saying goes. ValueReporting, therefore, opens up a positive feedback loop to value creation as well.

5. **What in your mind makes ValueReporting so critical? What problems will it solve?**

   Traditional financial measures provide less and less of the information that the markets consider important in determining stock prices, particularly over the long term. Of critical importance, but missing from traditional financial reporting, is adequate information on intangible assets and the nonfinancial value drivers that are leading indicators of future financial success. Although executives recognize this and

have made good progress in improving their internal performance measurement systems—through "balanced scorecards" for example—they have changed very little in what, how much, and the way in which they report information to the market. The internal evolution in performance measurement requires a corresponding external revolution in corporate reporting for stakeholders to realize the full value of the company. After all, if managers find such information useful in making value-creating decisions, the market will also find it useful in evaluating just how much value has been and will be created. This will help solve the problem of inaccurate stock price valuations. Better information will also reduce volatility by lowering investor risk through a better understanding of small deviations between actual earnings and carefully managed earnings expectations and "whisper numbers."

6. **Is ValueReporting only relevant for publicly listed companies?**
   No. ValueReporting begins with better internal management decisions. This is as important to private companies as it is to public ones. Furthermore, private companies often have investors (e.g., venture capitalists), lender (e.g., banks) or other stakeholders that will find the information that results from ValueReporting as useful as shareholders in publicly traded companies do.

7. **Does ValueReporting offer particular benefits in certain situations?**
   Although ValueReporting has relevance to *all* companies, it proves especially beneficial in circumstances when: (1) the market significantly under- or over-values a company, (2) a company experiences a sudden decline in market value not justified by the underlying economic reality, (3) a new CEO or CFO wants to diagnose and improve how the company communicates with the market place, (4) the market needs help in understanding the implications of a major M&A transaction, and (5) a newly listed company needs to build awareness and credibility in the capital markets.

8. **Will "perfect" information result in "perfect" markets?**
   Of course not. The information companies report will never be perfect. It can, however, become a whole lot better than it is. Even if perfect information existed,

structural features in the markets—such as momentum investors, day traders, and rumors and gossip—introduce a certain element of irrationality regardless of how much high quality information companies provide for strategic investors. In reality, even though executives can strongly influence stock prices by providing more information, factors beyond their control will always affect their company's market valuation.

9. **Does the relevance of ValueReporting vary between bull and bear markets?**

ValueReporting has relevance in both types, but it takes on particular importance in bear markets. When companies can no longer rely on a simple, strong earnings growth story, and the rising tide lifts all ships, executives have a stronger incentive to provide as much information as possible to help raise their stock price. They also have a different view of the risk/return equation in providing such information. Because their stock is already down, providing more information has a greater upside benefit than downside risk. In a bull market, however, executives tend to feel that more information will actually depress their stock price—particularly if they believe their stock is overvalued, which few really do. ValueReporting isn't a silver bullet that can prevent a company's stock from declining in a bear market, but if a company practices ValueReporting, and the market has more information about a company, we believe that company should fare better than competitors that don't practice ValueReporting.

10. **Isn't ValueReporting really just about the New Economy? What does it have to do with Old Economy companies?**

As long as intangible assets and nonfinancial value drivers are important, so is ValueReporting. Although intangible assets may have less importance in Old as compared to New Economy companies, nonfinancial value drivers certainly don't. For example, all companies have customers, market share, employees, and such. Furthermore, as the distinctions between Old and New Economy companies continue to blur, New Economy metrics are quickly becoming relevant to all. Even Old Economy companies, in the insurance industry for example, acknowledge the importance of innovation, brands, and customer service in building shareholder value.

This is especially the case for high-achieving companies.

**II. Global Issues**

11. **How does ValueReporting play out around the world?**

Very well. Issues like valuation and volatility apply to any stock market. That said, basic financial reporting is better developed in some markets than in others. Certain Asian and many nascent capital markets must still work hard on getting the basics right in terms of financial transparency; they have to do this before they can seriously pursue ValueReporting. However, priorities differ around the world. U.S. companies emphasize shareholders and the realization of value in the capital markets. European countries have more openly embraced the triple bottom line approach, discussed in Question 18, with its expanded emphasis on the larger, more diverse issues of all stakeholders.

**12. Don't European companies already practice many of the principles that ValueReporting espouses?**

Some certainly do, often driven by a greater concern in Europe than in the United States for other stakeholders. But because the issues that other stakeholders care about overlap so much with the nonfinancial value drivers that shareholders care about, satisfying the information needs of other stakeholders takes companies farther along the path of ValueReporting.

**III. Corporate Reporting in General**

13. **Should companies start practicing "real-time" reporting?**

If you mean, "Should companies report information soon after management receives it?" the answer is "yes." How frequently management gets any particular information is a function of how often it is important in managing the company, and the costs and benefits of speed. The faster management needs information, the sooner the market should get it. Management already gets and uses certain types of information on a real-time basis—orders, shipments, and reject rates for instance. Investors might find such information useful as well in valuing their future potential return on a real-time basis.

14. **What is "triple bottom line" reporting?**

The triple bottom line refers to achieving balance in how a company performs in three areas: economic, social, and environmental. These areas are typically considered to be the foundation for "sustainability." The proponents of sustainability say that in order to create long-term economic value, including long-term shareholder value, companies must perform well and deliver acceptable results against all three triple bottom line measures. Furthermore, once they have created this value for both shareholders and other stakeholders, sustainability calls on companies to report their triple bottom line performance. Royal Dutch Shell, a company cited extensively in *The ValueReporting Revolution*, has totally embraced this concept. In *The Shell Report 2000*, for example, the company reprinted a report signed by both PricewaterhouseCoopers and KPMG verifying "health, safety, and environmental statements and graphs" and statements and data "relating to the systems and processes Shell has put in place to manage social performance."

15. **How does ValueReporting relate to the triple bottom line?**

ValueReporting embraces the concept of the triple bottom line, although it does not require companies to adopt it. Rather, ValueReporting calls on them to identify all relevant stakeholders and to make sure their information needs are met. If a company uses a multi-stakeholder model, it should incorporate the principles of ValueReporting in its triple bottom line reports. Executives should also explicitly articulate their views about the relative importance and relationships among different stakeholder needs.

16. **How far will companies have to go in terms of disclosure?**

The core philosophy is the spirit of transparency: If information is good for management, it's good for the market. This philosophy stands in stark contrast to the prevailing practice where companies report only what regulation requires, and then report more only as compelled to do so. ValueReporting advocates starting from a position of complete transparency (i.e., all indicators used by top management to assess and manage the

performance of the business) and then ratcheting back to deal with sensitive competitive information or performance measures that lack enough reliability to be put into the public domain. How far companies will go depends on how quickly they embrace this philosophy of complete transparency and realize its benefits. While we can't predict how far and how fast companies in general, let alone any particular company, will go in this direction, we can confidently predict that doing so puts them on a one-way street. The future is all about greater transparency. There is no turning back.

17. **Should the financial reporting rules change as well?**

    Some change would be a good thing. Our research indicates that there is little, if any, variation in the information needs of investors on a country-by-country basis, indicating that we truly are operating in a global capital market, where information is concerned. Most important, therefore, having a truly global set of international accounting standards would be quite useful. Short of this, getting as much reconciliation among the International Accounting Standards Committee and the major national standard setters would be helpful. Simplifying the incredible complexity of U.S. GAAP would be a good place to start.

18. **How much and what types of risk does ValueReporting require companies to disclose?**

    Risk is a central aspect of ValueReporting and an area where companies have a lot of work to do. First, executives should recognize the three dimensions of risk: opportunity, hazard, and uncertainty. Second, they should develop valid measures and strategies for each. Third, they should report on all of them to the market in an integrated way. This means that instead of discussing in very different places the opportunity aspect of value creation (in the MD&A section of the annual report, for example) and internal and external hazard risk that can destroy value (in the 10K, for example), management should present information on both together. This should include the upside of the risks being taken, the downside and how the company is managing it, and the level of certainty that management has about its estimates of

both the upside and the downside.

**IV. Companies, Executives, Boards**

19. **How many companies really practice ValueReporting today?**
It depends on the definition of "practice". If we are referring to "companies that are approaching complete transparency" as described in our book, *The ValueReporting Revolution*, the answer is probably none. If we mean "companies that are beginning to voluntarily provide a lot of other value-relevant information they aren't required to report," the answer is "more and more." While we can't give you an exact number, you may wish to review the *ValueReporting Forecast 2001* and the *ValueReporting Forecast 2002* for some interesting examples.

20. **What are some examples of where ValueReporting has actually had a direct impact on a company's stock price?**
The answer to this question builds on the previous two answers. Because there are no examples of companies that have fully embraced ValueReporting, its direct impact on stock price simply can't be verified empirically. But remember, ValueReporting reflects more than PricewaterhouseCoopers' thinking on corporate reporting. It also reflects the findings of rigorous research in which both companies and investors agreed that better disclosure would contribute to the proper valuation of stocks. Finally, some recent independent empirical research, including a study by three Harvard Business School professors, has shown statistically significant relationships between greater transparency and higher stock prices. Interestingly, research done on the Singapore Stock Exchange showed that more frequent disclosure of the same information (i.e., historical results) can actually lead to greater stock price volatility, while a broader disclosure of performance based information has the opposite effect.

21. **What are some specific examples of measures that companies should report in practicing ValueReporting?**
Such measures fall into categories like customers, innovation, human capital, and

brands. They also tend to be somewhat industry-specific, and company-specific, based on a company's unique strategy for value creation. But to give you a concrete example, here are seven measures that high-tech company executives, analysts, and investors all agree are important, just as they agree that the market isn't getting much information on them: strategic direction, market growth, quality/experience of the management team, market size, competitive landscape, speed to market (first to market), and market share. If a high-tech company aggressively provided information on these measures—along with earnings, cash flow, and gross margins—it could be said to be practicing ValueReporting.

22. **Are companies naturally resistant to ValueReporting?**

Yes. Voluntarily increasing disclosure to the market, let alone to other stakeholders, is an unnatural act for many executives. They will focus more on the downside than the upside in doing so. Like any other major innovation in management practice, ValueReporting's early detractors will vastly outnumber its early advocates. This is particularly true of ValueReporting. It's not an experiment, like reengineering, that companies can test away from the market's eyes and reveal only if the results are good. ValueReporting requires revelation. Based on our research results, companies that are performing well and that step forward first into the ValueReporting arena will reap benefits. They will also exert enormous pressure on their competitors to follow suit. What will analysts and investors do when they can get more value-relevant information from a company's competitors but not from the company itself? We rather doubt this will be to the non-reporting company's advantage because, in the absence of such information, the perceived risk to investors will be higher. The thing for us to keep in focus in speaking with clients about ValueReporting is that it is ultimately about reducing investor risk—thereby reducing the theoretical or practical discount rate that savvy investors apply to future values, resulting in higher current valuations. It's not about reporting *better* results—but *actual* results, whatever they are, as a means to achieving better valuation through lowering risk.

23. **How quickly are companies actually put ValueReporting into practice?**
It is not happening overnight, although the current environment has opened many eyes relative to the possibilities for greater in transparency. Most companies should anticipate a three-year program of getting their internal measurement act together, figuring out what shareholders and other stakeholders want to know, developing reliable measurement methodologies, using this new performance measurement information to run the company (thereby testing its validity), and then starting to report more information to the market. This, of course, is a never-ending process, but within three years most companies will legitimately be able to say that they are practicing ValueReporting.

24. **Will companies have to develop new "systems" to practice ValueReporting?**
There are really three "systems" kinds of things that need to happen. First, companies can simply recalculate information that already exists in their current systems, for example, financial measures of intangible assets. Second, they will need to develop systems that pull together data that already exist, but which reside in disparate systems, such as when many divisions do business with the same customer; when customer penetration is a significant driver of value; and when management, therefore, needs to know total customer penetration, sales, or profitability. Third, they will, at some point, need to develop new measurement methodologies, often with new IT support, for such measures as customer retention or market penetration.

25. **Can ValueReporting actually put companies at greater risk of liability and litigation?**
It depends. Obviously companies in the United States face the greatest risk. There, executives should use the appropriate Safe Harbor disclaimers, especially when providing "forward-looking information" or information that could be construed as such. We can't promise, however, that this will suffice. As long as there are lawyers, there will be lawsuits. Better Safe Harbor legislation would certainly help. Even so, we believe that while downside risks certainly exist, the potential upside benefits more often than not justify taking the risks. Furthermore, as companies report more

information, investors must assume more responsibility for using it wisely.

26. **Does the relative importance of ValueReporting vary across industries?**
Yes. While the basic principles of ValueReporting apply across all industries, some can reap especially large benefits. In general, this applies to any industry in which there are large market-to-book ratios and/or where the information that managers use to run the company differs significantly from what they report to the market. ValueReporting is least applicable to very Old Economy, hard asset, commodity, non-branded industries where the traditional financial reporting model remains quite relevant. After all, traditional financial reporting was developed when such Old Economy companies were the New Economy companies at that time. Nonetheless, some Old Economy companies, such as General Electric, have successfully leveraged intangible assets like brands and people as important dimensions in how they create value. For such companies, ValueReporting has as much importance as it does for New Economy companies.

27. **What implications does ValueReporting have for highly diversified firms?**
Each distinct business should have its own distinct "ValueReport" because the most important nonfinancial measures will vary business-by-business. And even when those measures are the same, they will be based on different methodologies and therefore will not "roll up" into a single, consolidated, corporate-level number. The only measures that roll up are the financial ones. Some have come to refer to it as segment reporting "on steroids".

**V. Institutional and Individual Investors**

28. **Will ValueReporting actually enable individual investors to make better investment decisions?**
We think so. Many individual investors have already proven themselves to be sophisticated consumers of the information that they currently have available to them, both from the companies themselves and from other sources. The possibility does

exist, of course, that individual investors will be overwhelmed with the amount of information ValueReporting will make available to them and won't really be able to make sense of it. On the other hand, this creates an obvious opportunity for savvy enterprises to provide assistance in the form of software, individual advice, research reports, and more. If such analytical assistance will help individuals make better investment decisions, they will be willing to pay for it.

29. **What effect will ValueReporting have on day traders?**
In an immediate sense, none. Day traders don't really care about value. Over time, however, greater transparency should result in less volatile markets and diminish day traders' arbitrage opportunities, because stock prices will respond less to rumors and gossip and more to information about real performance.

**VI. Standards and Regulators**

30. **Does ValueReporting imply that regulators are really regulating the irrelevant?**
No, just that they are not regulating all that is relevant in terms of the overall value ascribed to companies today and, therefore, the additional information investors need. Regulators still have a useful role to play in financial reporting, although we are on record supporting less complex regulations, particularly with respect to U.S. GAAP.

*31.* **Should regulators require companies to report on nonfinancial measures?**
This may well happen, but we need to move carefully down this path. We believe that the first step is industry-based initiatives to identify the relevant nonfinancial measures and to develop the best methodologies for measuring them. Leading companies, acting in their own self-interest and in the interests of their shareholders and other stakeholders, will start reporting this information, and standards will evolve. Analysts and investors will demand more of this information, and companies will have to respond to these market forces. Already the U.K. Accounting Standards

Board and the AICPA are looking at the possibility of recommending other measures for companies to report to the market. At the time we wrote *The ValueReporting Revolution,* the failure of Enron had not yet occurred, and calling for expanded reporting as a requirement would have been foolhardy; today, it is more likely to happen if standard setters reflect on the contribution of transparency to investor protection and move in this direction.

32. **Should standards be developed? If so, who should develop them and how?**
Eventually standards will be needed to enable investors to compare "apples and apples" the way they do with financial measures. The best way to develop standards is through industry-based consortia that include executives, accounting firms, analysts, investors, and other experts. Once standards have been developed and broadly adopted by an industry in external reporting, regulators might naturally play an important role in ensuring that all companies report this information and that the standards are being enforced.

33. **Should/could common standards apply across industries?**
This is a complicated issue. No doubt some nonfinancial measures, employee turnover for example, could be measured the same way across all industries. In other cases, measuring a certain aspect of performance, customer penetration for instance, will probably require an industry specific standard. Just having standards for nonfinancial measures by industry will be an enormous stride forward; it isn't necessary that standards apply across all industries. If that happens eventually, all the better.

34. **Should there be global standards?**
There certainly should be global standards for all nonfinancial measures within a given industry. Most of the major competitors are multinational companies competing on the global stage. Where a company happens to be headquartered is, after all, only an historical accident. For companies to benchmark their performance against each other and for investors to do the same, global standards within an industry are needed.

Global financial reporting standards across all industries, along the lines of International Accounting Standards, would also be a good thing.

**ROBERT E. VERRECCHIA**
Putzel Professor of Accounting
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Prepared Testimony for The Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
May 14, 2002

In the brief time that I have to testify, I would like to offer the perspective of someone who wears the proverbial "two hats." That is, first I would like to offer the perspective of someone whose instruction material touches on many of the issues that are central to the debate about the process that promulgates accounting standards and firms' adherence to those standards. Later, I would like to offer the perspective of the researcher who has attempted to document the economic benefits of increased disclosure and greater transparency.

With regard to pedagogy, it is at least a partial indictment of the financial reporting process that one of the most popular elective classes in the Wharton MBA program is an accounting class whose chief purpose is to discuss how firms gerrymander their financial statements to conform to the letter of various US-Generally Accepted Accounting Principles (US-GAAP), but not necessarily the spirit. Further, one of the most popular executive education programs sponsored by Wharton is one in which the financial reporting peccadilloes of firms are brought out into the open and put forth for ridicule. Many of the instructors at Wharton are sensitive to the concern that in regaling students with tales of financial reporting chicanery, we may also be promoting this behavior on the part of our graduates. In our conceit, we rationalize our way around this dilemma by

arguing that in any accounting Armageddon, it is important for our students to be better armed than the students from our peer institutions.

In short, viewed from the rarified air of academe, the accounting standard setting process appears structured in such a fashion as to produce the occasional accounting debacle. Industry and financial groups, and their auditors, sponsor a private sector agency, the Financial Accounting Standards Board (FASB), to offer accounting pronouncements and guidance from which the very same corporations and their auditors will either benefit or suffer. In other words, it is a process that, at best, seems fraught with moral hazard problems and, at worse, results in accounting opinions that appear to pander to the worst aspects of corporate America. These problems are only exacerbated when auditors who lobby the rule-making process in behalf of their corporate clients are then asked to implement the rules. In an environment like this, should we have expected anything less than the occasional Enron/Andersen misadventure?

Part of the problem in the rule-making process is the failure to be guided by two broad principles: 1) wherever practical, all publicly traded firms should be required to adhere to a regime of full and fair disclosure; and 2) wherever effective control is exercised over an entity, financial results of that entity should be fully consolidated into the controlling firm. Unfortunately, all too often in the rule-making process corporations through their lobbyists appear to employ a variety of self-serving arguments to circumvent these principles. This problem is further exacerbated by the fact that the rule-making process itself seems more absorbed in the detailed minutiae of accounting transactions than in the

economic substance of the transactions. Opponents of the recognition of substance employ these arcane debates to frustrate rule making at all levels. No better example of this exists than the treatment of employee stock options.

But from a research perspective, the real tragedy of recent financial reporting deficiencies is the failure of all representatives in this debate to recognize the clear and obvious economic benefits of increased disclosure and greater transparency: lower costs of capital for firms, increased liquidity for firm equities, greater participation in the capital generation process by the public, etc. Recently, contemporary accounting research has attempted to document these benefits. While somewhat nascent, this research nonetheless is consistent with prevailing notions that increased disclosure is beneficial to the capital generation process. Commitments to increased disclosure on the part of firms do indeed result in lower costs of capital, increased liquidity, etc. The research results are clear and compelling, and buttress traditional claims that greater transparency enhances access to capital markets.

But if contemporary research can document the benefits of increased disclosure, why do publicly listed corporations not embrace it to the fullest extent? One rationale for less than full disclosure is that disclosure may require disseminating information about a firm's proprietary business model, management expertise, technology, etc. This, in turn, may work against the interests of a firm that reports publicly, and to the benefit of firms that compete against it. To the extent to which these competitors are based outside the U.S., or report under accounting standards other than US-GAAP, this provides powerful

political leverage for less disclosure. But in a sense, a call for greater disclosure is no different from a variety of welfare arguments. While full disclosure and full consolidation may lead to both winners *and* losers in capital markets, indisputably increased disclosure serves the greater good.

In short, the thought with which I would like to leave the committee is that the rule-making process be governed by an ideal of full and fair disclosure, and full consolidation. Perhaps stated differently, arguments in favor of anything *less than* full and fair disclosure, and full consolidation, should require a high burden of proof. While full and fair disclosure and full consolidation will not eliminate failures that result from fraud, flawed business models, and/or unexpected industry and economic downturns, they will work to ensure that the failures are not the result of reporting systems that give firms and their managers unwarranted discretion to obfuscate an entity's overall financial condition.

TESTIMONY OF
STEVEN M.H. WALLMAN
CHAIRMAN, FOUNDER AND CEO
FOLIO*fn*, Inc.

BEFORE THE

**SUBCOMMITTEE ON**
**CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES**
**OF THE COMMITTEE ON FINANCIAL SERVICES**
**U.S. HOUSE OF REPRESENTATIVES**

MAY 14, 2002

1) **Introduction**

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you today. You are examining a subject to which I dedicated significant effort while serving as a Commissioner of the Securities and Exchange Commission.

Well-functioning capital markets are an essential element of our market economy . I remain passionately committed to finding the right answers to the difficult question of how best to provide information to investors, so that our markets will work efficiently and fairly. I appear before you today solely in that capacity. I represent no one but myself.

Our capital markets are the means by which capital flows from those who have it to those who need it. I start with the proposition that no capital markets work better than ours, and ours have never worked better. But recent events have underscored how much better they need to work.

Our capital markets rely on public disclosure to work efficiently. Financial statements, along with other mandated and voluntary disclosures made under our securities laws, are the bedrock of our capital market's disclosure system.

Generally Accepted Accounting Principles are the language of financial statements. More than half a dozen years ago it was apparent that GAAP was beginning to fail, and materially so in important ways, in its essential purpose – to provide useful, timely and relevant disclosure to investors. I have written extensively on these issues and am submitting for the record some of my writings that discuss these ideas in more detail.

2) **Today, let me recap five ways in which GAAP falls short, and suggest some reforms**

a) First: What is Measured
   i) Accounting principles are geared to measure bricks and mortar -- when intangibles like human capital and intellectual property are increasingly important, and in many cases far more important, as drivers of wealth.
   ii) Accounting principles primarily view intangibles and other drivers of wealth only as measurable if acquired, when for many if not most entities they are generally created internally, not acquired.

b) Second: Who is Measured
   i) The boundaries of the firm used to be clearly delineated. You could tell what a firm owned in terms of bricks and mortar and what they did – what they made. Not any more.
   ii) Off-balance-sheet activities, derivatives, partnerships and various contractual arrangements have blurred the boundaries of the firm.

c) Third: Timeliness of Measurement
   i) Things move more quickly now. Even quarterly reporting is deficient; it is too backward looking.
   ii) More forward-looking disclosure and reporting is needed, but much of that is perceived as anathema to accounting concepts, even though reserves and other items clearly are forward-looking.

d) Fourth: Access to Information
   i) Accounting standards require information to be aggregated for presentation according to the language of GAAP.
   ii) Those who wish to understand what is truly going on have to investigate the information that's presented and undo the aggregation to get the information they need.
   iii) Moreover, the language of GAAP is now so esoteric and specialized that it is its own. Clearly it is no longer plain English, although it really never was. It is hard to understand by those not trained in its intricacies and nuances, and it now even has its own dialects for different industries, different instruments and different circumstances. Increasingly beyond comprehension for the lay and even many professional investors, we require the issuance of financial statements to all, maintaining the pretense that all should find them useful. At base, we mislead when we suggest that financial statements are being distributed widely because they are widely understandable. They are not. It would be like asking a layperson to read a medical chart, or interpret a foreign language they have never heard before.

e) Fifth: How it is Measured
   i) Accounting requirements have become too rules-oriented – they are more concerned about being able to ensure that preparers complied with the rules and less concerned with whether they really make sense.

ii) Accounting principles need to be principles, not rules. The need for more "goal oriented" regulatory approaches extends, of course, to the SEC and its rules as well.

3) The current scandals really highlight how outdated GAAP really is, even as they also highlight illegal behavior. The current scandals would have been mitigated if the issuers had adhered strictly to GAAP, but they likely would not have been avoided entirely because it has been possible to adhere to the letter of GAAP while evading the spirit of fair presentation. There should be no mistaking that one is not the answer to the other – eliminating bad behavior will not make GAAP better, and at base it is in part to blame. We have seen numerous times now where the accounting can be perfectly permissible – but the financial picture presented is as misleading as can be.

4) We have also seen perfectly reasonable issuers make the point that current accounting, when followed explicitly and well, still presents a very untrue presentation of a company's financial position. And we have seen such entities as Standard & Poors and others create their own form of pro forma financial statements to reflect -- more conservatively or more liberally, it doesn't matter – just differently, a company's financial position. So what's a company that's actually trying to do the right thing do?

5) On the other hand – we still remember that our capital markets generally do in fact work well, and they are still the envy of the world. But that success should not lead to arrogance about the future. Times continue to change and now, more obviously than perhaps it was to some a half dozen years ago, we need to do far better by investors.

6) **Conclusion**

a) GAAP needs to be revamped to address these issues.
   i) FASB and SEC have taken some important steps to address intangibles and other key issues.
b) But rule changes are not the only issue. Rules, no matter how carefully crafted, are continually overtaken by new facts. That's why we are in the position we are in now with GAAP.
c) Accounting profession and the companies they audit need to be re-educated about the goals of accounting disclosure – fair presentation of the firm's finances to investors.
   i) Technical compliance with GAAP, no matter how much improvement FASB and SEC may be able to make to update the rules should not be a substitute for the ultimate duty of fair presentation.
   ii) The notion that there can be a rule covering every situation is unrealistic and counterproductive. The notion that every situation can be rolled up into just a few numbers is also, in my opinion, unrealistic and counterproductive. By trying to simplify and having everything be boiled down to just one or a few

numbers we create an impression that those numbers – like net income – can somehow capture all the nuances there are to capture. We need to recognize that matters will get more complex before they get easier – but the solution is more and clearer and better disclosure, not more rules attempting to dictate how everything rolls up to one number.

iii) This is antithetical to current approaches. Over time, technology will cure the issue: as the entire exercise of taking disaggregated information and aggregating it so that others can then spend their careers attempting to disaggregate it, goes away. Eventually, technology will allow for the distribution of large amounts of data that can then be processed by investors to create their own personalized financial statements. But that day is a long time in the future.

iv) In the meantime, there are incremental steps to be taken. They range from:

(1) providing more disclosure and information as to the primary accounting judgments and issues driving the financial statement presentation, as currently proposed by the SEC and Chairman Pitt;

(2) to more in depth disclosures as I proposed a half dozen years ago relating to different levels of information depending on their reliability ("colorized accounting");

(3) to re-educating the profession and the issuers, as well as regulators, as to the need for more "goal-oriented" principles instead of rules-based principles, a task admittedly hard, perhaps even impossible to do in a compelling way, without also addressing the after the fact second guessing that also leads to enforcement actions and securities lawsuits – a topic that most, for good reason, are loathe to reopen or even discuss;

(4) , to proposals regarding procedure, such as requiring the equivalent of a concurring partner – but from a different firm – to sign off on the primary and significant accounting judgments and issues noted above and perhaps report independently to a company's audit committee– a less expensive and perhaps more effective means to assure high quality audits than various other proposed actions that ultimately increase costs in a manner that may outweigh benefits.

(5) Other suggestions are described more fully in the papers submitted along with this testimony.

Thank you.

OFFICE OF
THE CHIEF ACCOUNTANT

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

June 13, 2002

The Honorable Brad Sherman
U.S. House of Representatives
1524 Longworth House Office Building
Washington, DC 20515

Dear Congressman Sherman:

During my May 14, 2002 appearance before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, you asked that I furnish for the record (1) the sanction rendered in the Commission's enforcement action against Caterpillar, Inc., and (2) my view of the accounting for a fact pattern that you described in the hearing.

During the hearing, I cited the Commission's enforcement action, *In the Matter of Caterpillar, Inc.*, Accounting and Auditing Enforcement Release No. 363 (March 31, 1992), as an example of a case where, even though the accounting was correct, a company was sanctioned for misleading disclosures in the Management's Discussion and Analysis ("MD&A") section of its reports. In this case, the MD&A in Caterpillar's 1989 annual report on Form 10-K failed to discuss the significant impact that Caterpillar's Brazilian subsidiary had on its overall results of operations. For example, it did not explain that the Brazilian subsidiary accounted for approximately 23 percent of Caterpillar's net profits or that a number of non-operating items contributed to those profits. These items included currency translation gains, export subsidies, interest income, and Brazilian tax loss carry-forwards. The MD&A section also did not discuss the risk that the subsidiary would have materially lower earnings in the coming year.

The Commission alleged that this annual report, as well as the company's Form 10-Q for the first quarter of 1990, violated section 13(a) of the Securities Exchange Act of 1934. In a settled proceeding in which Caterpillar neither admitted nor denied the Commission's allegations, the Commission issued an Order pursuant to section 21C of the Securities Exchange Act of 1934 ("Exchange Act") that Caterpillar permanently cease and desist from committing or causing any violation, or any future violation, of section 13(a) of the Exchange Act. The Commission also ordered Caterpillar to implement and maintain procedures designed to ensure that the company complies with the MD&A disclosure requirements.

Although no monetary penalty was assessed in this 1992 case, the Commission has imposed more severe penalties in recent years. For example, in a recently settled action, Xerox Corporation, without admitting or denying the Commission's allegations that the company violated the anti-fraud and other provisions of the securities laws,

consented to a special review of its accounting controls and to the payment of a $10 million civil money penalty. In other cases, criminal sanctions have been imposed on corporate officers who have violated the securities laws and related provisions. These sanctions are discussed in the following articles in CFO Magazine: *Stiff Sentences for C-level Criminals* (April 12, 2002); *Aurora's Former CFO Gets Jail Time* (January 15, 2002); *Jailhouse Shock* (September 1, 2000); and *Guilty As Charged: The former CFO and CEO of California Micro Devices are going to jail. Others who commit accounting fraud may follow* (April 1, 1999).

Regarding your second request, you described a fact pattern in which a company has an investment portfolio that, on a mark-to-market basis, has lost value. You also indicated that the company has a derivative instrument issued by another entity that would pay the company an amount equal to the company's losses on the portfolio. You further indicated that in the event the entity makes such a payment to the company, the company in-turn must give to the entity's parent shares of the company's stock that have a value equal to the amount of that payment.

Later in the hearing, you stated, "I didn't make this one up completely. I mean this is the loophole that Enron thought they found. They think it works." Because the Commission currently is investigating these matters, I must respectfully decline to provide my views on the fact pattern you have described.

I hope that this letter is helpful to you. Please do not hesitate to contact me at (202) 942-4400 if I may be of further assistance.

Sincerely,



Robert K. Herdman
Chief Accountant