Statement by Ohio Attorney General Betty D. Montgomery
House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises
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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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