Statement of Charles L. Hill, CFA
Director of Research, Thomson Financial/First Call
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Subcommittee on Capital Markets, et al
Examination of Recent Reports of Accounting Problems
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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.