TESTIMONY OF

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CORPORATE ACCOUNTING PRACTICES

Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

Committee on Financial Services

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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

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[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.

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[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

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[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.