

TESTIMONY OF BARUCH LEV*

**BEFORE
THE COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES**

**CONCERNING
THE REPORT OF THE BOARD OF DIRECTORS OF
THE FEDERAL HOME LOAN MORTGAGE CORPORATION**

September 25, 2003

* Philip Bardes Professor of Accounting and Finance, Stern School of Business, New York University.

My observations and comments concerning the July 22, 2003 report (Report) of the board of Freddie Mac (hereafter the Company) prepared by Baker Botts L.L.P. relate to two issues: (1) What, in my opinion, is missing from or not sufficiently emphasized in the report, and (2) the accounting regulatory environment, known as GAAP (generally accepted accounting principles). I would like to state at the outset that I find the Report thoughtful, insightful, and very well articulated.

I. Missing from the Report

1. If it complies with GAAP, it's fine.

The attitude of the former management of Freddie Mac toward financial reporting seems well represented by Mr. Parseghian (a former top executive): *“Parseghian has acknowledged that he was aware of the use of reserves to meet earnings goals, but understood that these reserves were being managed consistent with GAAP.”* (footnote 67). Thus, according to this view, financial information can be “managed” by elaborate devices aimed to make investors believe that the Company’s performance is different from reality (otherwise, why manage?), as long as the scheme is within the wide latitude allowed by GAAP. This exclusive GAAP concern is also echoed by the Company’s chief auditor: *“Arnall indicated to us that Arthur Andersen viewed its role as being focused on GAAP measures.”* (p. 85). GAAP is also the standard against which the Report evaluates the various schemes and transactions perpetrated by the Company (e.g., *“These errors appear to us to have been a good faith misapplication of GAAP...”* p. 53). Also, a closely-watched indicator which was manipulated by the Company—operating earnings—is somewhat mitigated in the Report, because it’s a “non-GAAP metric.”

For investors and other constituencies, GAAP compliance is of secondary importance. What these users of financial reports need is information that *complies with reality*. They need to be assured that the financial reports portray a truthful and unbiased picture of the Company’s real earnings, assets, and liabilities, rather than that management’s practices conformed with GAAP, known for its wide latitude and ease of manipulation.

The absence of a culture of honesty and integrity at the Company, manifested by the extensive efforts to manage the information conveyed to investors, some in compliance with GAAP and others not, is not sufficiently condemned in the Report.

2. What about investors?

While detailing the extensive schemes of the Company to manipulate its financial information, the Report does not elaborate on the damage inflicted on the information users. One, therefore, may get the impression that no serious harm was done. Thus for example, the Report states (p. 31): “The transactions discussed below did not compromise the Company’s risk management strategy...will not have an apparent effect on safety and soundness.” But what about compromising the multitude of investors who relied on the “managed” information? Surely, the Company’s managers would not have resorted to such elaborate and costly schemes as described in the Report, unless they believed that investors will react in an “undesired manner” to the truth. Tampering with information by a major player in capital markets such as Freddie Mac adversely affects resource allocation in the economy. Not a small matter.

3. The social cost of manipulation

Management and manipulation of financial information seriously damages investors and the resource allocation process of capital markets, and inflicts additional costs on society at large. The Report details the extent of the Company’s schemes: scores of high ranking employees from accounting, trade, legal, tax, shareholder relation and other departments were engaged for considerable time periods in a socially wasteful activity of managing information. This substantial time, effort and management attention should, of course, have been devoted to further the real objectives of the Company.

In addition to efforts and time, substantial monetary resources (legal fees, transaction costs) were wasted in structuring deals and financial instruments which, according to the Report, had no real business purpose. All this is a dead weight loss on society.

But, perhaps the most serious damage resulted from the climate of manipulation and intrigue that must have permeated wide echelons of the Company, and even spilled outside. Thus, for example, a Company’s trader speaking to a colleague explains that the reason for the trade is: “book expense now and get it back in six months.” He advises the trader to “keep that under your hat.” And states: “I don’t want to see any [expletive deleted] Bloomberg about this trade either.” (p. 75). One can only speculate about the adverse impact of a social climate, where employees are motivated to manage information (Dean’s performance evaluation, p. 45), on Freddie Mac’s business activities and performance.

4. Report too forgiving

A theme that runs through the Report is that the Company's management "just" wanted to portray reality. Apparently, no intention to deceive. Thus, the Report says: "Freddie Mac sought to avoid making any disclosure that would require subsequent explanation or lead investors to draw any conclusion other than the one management believed best reflected the economics of the Company's business." (p. 53).

This is admirable, if not for the numerous, detailed descriptions in the Report of different managerial objectives, such as to portray a steady growth of earnings; to eliminate reported volatility; to meet analysts' forecasts; to hide large gains until "needed" in the future, and so on. Obscuring earnings volatility, and making investors believe that the Company meets prescribed targets does not strike me as just intended to reflect "the economics of the business."

II. GAAP Deficiencies

In addition to exposing the reader to what transpired within Freddie Mac, the Report *implies* volumes about GAAP, the framework of accounting and reporting rules governing public companies' financial reporting. In particular, the Company's nefarious activities shed light on two major GAAP deficiencies: extreme complexity, and vulnerability to manipulations. These deficiencies were, of course, evident in the numerous corporate scandals that surfaced during the last three years, yet they did not receive adequate attention by policymakers.

1. GAAP Complexity

The Report comments repeatedly on the complexity of GAAP, and in particular the FASB statements on financial instruments—the trigger of much of the Company's manipulations (e.g., "The errors...resulted in large part...from inadequacies in responding to complex accounting rules..." p. V). GAAP developed over time to become an incredibly detailed set of rules and instructions, stretched over tens of thousands of pages, constantly changing in an attempt to prescribe the accounting and reporting of every new event and business development. By its nature and the long deliberation process, GAAP is always "behind events," because once a new rule emerges, business contracts are changed to "transact around" the rule. Freddie Mac's Report provides telling examples of financial instruments and deals structured and executed solely to thwart GAAP.

The extreme complexity, detail, and the constant change of GAAP have various unintended consequences. One of the most serious is that the complexity gives significant advantage to those, like the Company, who intend to misuse the rules, because those people and entities have sufficient incentives to invest the time and money required to comprehend GAAP. It is well known that crooks thrive in complex environments (e.g., the World Wide Web).

Sarbanes-Oxley attempted to deal with this issue by instructing accounting regulators to move away from rules-based and toward a principles-based accounting system. My impression is that such a move did not reach far. In fact, GAAP complexity marches on.

2. Vulnerability to manipulation

Laymen are generally under the impression that accounting is all about facts. Few things are farther from the truth. Accounting is about some facts, and a lot of judgments, estimates, and outright guesses. The measurement processes underlying the determination of earnings and the valuation of asset is replete with estimates, such as the provisions for depreciation and amortization, bad debts, pension expense, warranties, asset impairments, and so on. The current move of accounting regulators toward “fair value accounting” enhances considerably the role of estimates in financial reports. Thus, the Report (p. 47) quotes from GAAP concerning the fair value of financial instruments which affects both earnings and asset values: “If quoted market prices are not available, management’s best estimate of fair value may be used...” The Report is explicit about how the Company’s management “best estimated” fair values.

Extensive research has shown that accounting estimates are: (1) widely used by managers to manipulate financial reports, and (2) systematically deceive investors and thwart resource allocation in capital markets. The reason: good, honest estimates cannot be regulated, or audited effectively, nor is it straightforward to prove after the fact that an estimate, even widely far off the mark, was intentionally misleading.

One can get an idea about the current prevalence of earnings management by large U.S. corporations, mostly by misusing estimates, from the startling data (obtained from Thomson’s First Call) that during the last four quarters, over 40% of the S&P 500 companies met to the penny, or beat by a penny the consensus earnings forecasts by financial analysts. It is virtually

impossible for a large, complex business enterprise, operating in a volatile environment, to meet to the penny an external earnings forecast, without some “management.”

The vulnerability of GAAP to manipulation by misusing the multiple estimates underlying accounting is amply demonstrated in the Report. This vulnerability, with its adverse economic and social consequences has not received the required policymakers’ attention.

III. Postscript

Freddie Mac adds to the variety of recent corporate scandals the case of a company that understated, rather than overstated its earnings. This, however, is not a mitigating factor. Understated earnings today, are often used to overstate earnings tomorrow. The accounting manipulations described in the report are serious and require remedial actions. But one should not lose sight of the bigger picture: the events described in the Report point once more at fundamental vulnerabilities of GAAP, which so far have not been adequately addressed.