August 26, 2004

Eugene H. Flegm, CPA, CFE 25041 Pennyroyal Drive Bonita Springs, FL, 34134 Letter of Comment No: File Reference: 1201-100

Date Received: 8-26-64

Re: Proposed Statement of Financial Accounting Standards – Fair Value Measurements File Reference No.1201-100

Attention: Technical Director

Dear Sir/Madam:

In 1976, the FASB issued three discussion memorandums covering a new conceptual framework for accounting. The memorandums were the direct result of the 1971 AICPA's Objective of Financial Statements based on the work done by a nine member committee which became known as the Trueblood committee after its chairman, Robert M. Trueblood, managing partner of Touche, Ross & Co.

Briefly, the memorandums proposed two radical shifts in financial accounting: The first was that the primary purpose of financial statements should be to provide investors and creditors in making rational decisions regarding their investments. (The long standing stewardship function of accounting was delegated to a secondary position.) The second was "earnings" should be determined from an asset/liability (balance sheet) view rather than the long-standing revenue and expense view. In short, earnings should be determined from an economist's rather than an accountant's view. In 1976, at the annual meeting of the American Accounting Association in Atlanta, Vice Chairman of the FASB, Robert Sprouse, during a debate with the Chief Accountant of the SEC, Sandy Burton, stated that there could be no question that IDEALLY earnings for a given period could best be determine by the discounted change in the values of the beginning and ending balance sheet. He went on to say that determining the rate to use was open to question, however. The irrepressible Mr. Burton promptly replied that he could not agree with the that approach and this debate has continued to this day.

It was apparent to many of us that the reason for this radical shift in financial accounting to a balance sheet view of income was to lay the groundwork for a move from the historic cost model to a fair value one with the eventual determination of income as Robert Sprouse had espoused in Atlanta. The most notable opposition was led by two partners from Ernst & Ernst, Robert K. Mautz, who had taught at the University of Illinois for 25 years before joining Ernst & Ernst and Albert A. Koch. These two gave a series of seminars in 1977 that were sharply critical of the project. The Committee on Corporate Reporting of the Financial Executives Institute took up the argument as well.

At that time I was a General Director of Corporate Accounting and Reporting on the corporate comptroller's staff of General Motors Corporation. Thomas A. Murphy, whom I had met and worked for when he became Corporate Comptroller in 1967, shortly after I had joined General Motors, was Chairman of the Board. He was also Chairman of the

newly-formed committee on accounting of the Business Roundtable. Mr. Murphy's undergraduate degree was in accounting from the University of Illinois and accounting remained of great interest to him all of his life. (Also see The Murphy-Kirk-Beresford Correspondence 1982-1996: Commentary on the Development of Financial Accounting Standards., JAI, Elsevier Science, Oxford, GB, UK, 2002) When the discussion memorandums on the conceptual framework were published he told me to "get into this in depth" and I did, eventually publishing a book: Accounting — How to Meet the Challenges of Relevance and Regulation, John Wiley & Sons, NY, NY, 1984 and republishing it with a new foreword in 2004 by Elsevier Science, Oxford, GB, UK. In that foreword I reiterated my opposition to a fair value accounting system and analyzed what has happened since the FASB set out upon the fair value path.

Now, after 28 years of the conceptual framework and a plethora of rules we have experienced the largest frauds by top management in history. Enron, WorldCom, Quest, Adelphia, Tyco, HealthSouth, Rite Aid, Global Crossing, Parmalat, and Ahold to name ten of the biggest. Six of these—WorldCom, Adelphia, Tyco, HealthSouth, Rite Aid and Ahold—were of the more mundane variety, e.g., falsifying Medicare claims at HealthSouth. However, the other four — Enron, Quest, Global Crossing, and Parmalat were related to the use of derivatives (with the cooperation of banks) in creating earnings. The escapades of Enron, and all of the other companies except HealthSouth, Parmalat and Ahold, are described in Infectious Greed: How Deceit and Risk Corrupted the Financial Markets by Professor Frank Partnoy of the University of San Diego School of Law, Henry Holt & Company, NY, NY, 2003. (HealthSouth, Parmalat and Ahold were discovered after the book's publication.)

Of course the primary cause of these huge frauds was not the FASB. Instead it was the general decline in the ethical values in the past 30 years which included the business community as well as public accounting. Dennis Gioia, Professor of Organizational Behavior in Penn State's Smeal College of Business spoke of this decline at the Academy of Management in August 2002 in relation to the MBA programs. "...the call of the share price...as assessed by Wall Street, is very strong. ...if the returns are not substantively there, then at least the appearance of returns has become a corollary imperative. (This) has led people to lie, to cheat, to steal, to hide information and to behave in patently unethical ways..." Professor Arthur R. Wyatt, speaking at the annual meeting of the American Accounting Association in August 2003 spoke of the decline in ethics in the public accounting profession. He pointed out how the action of the Federal Trade Commission in 1979 (forcing public accountants to compete) coupled with the rise of the consulting sector of accounting led to public accounting firms aggressively seeking the more profitable consulting work over the now less lucrative audit work. As he put it, "Just as greed appears to have been the driving force at many of the companies that have failed...greed became a force to contend with in the accounting firms."

However, while the decline in ethics was the primary cause of the many frauds we have experienced, there were several enabling factors. One was Congress and its reluctance to provide the SEC with adequate staff as well as allowing the Glass-Steagall Act to lapse thus giving the investment banks a free rein; (See the result in "The Investigation" by

John Cassady in The New Yorker, April 7, 2003 where he describes how New York Attorney General, Eliot Spitzer's investigation of the ten largest banks in the world led to a \$1.4 billion fine for improperly "hyping" stocks during the dot.com boom.) Certainly the corporate boards and audit committees were too lax in many cases.

However, insofar as accounting itself is concerned, the two principal enablers were the steady move to fair value accounting by the FASB and the decline in professionalism cited by Mr. Wyatt. One has only to read Chapter Ten of Professor Partnoy's book to realize how the highly subjective pricing of long tern natural gas contacts or the pricing of "dark" fiber was an open invitation to unethical, greedy people (of which there are too many) to manipulate earnings. Or consider Mariner Energy, an oil and gas offshore exploration company in which Enron held a controlling interest. Under the FASB's rules they had to use fair value accounting. This meant that any increase or decrease in the value of Mariner's oil reserves had to be reflected in earnings. This was too good an opportunity to miss. A Business Week article, February 15, 2002, reported that the Enron Risk Assessment & Control group began offering valuation ranges for management to use. The range Mariner was \$80 to \$350 million. The SEC filed a civil action on October 9, 2003 (litigation Release No. 18403) charging Wesley H. Colwell, the former CAO of Enron NA with fraud. The charge states in part, "Enron, through Colwell and others, fraudulently inflated the value of its largest private merchant asset Mariner Energy, Inc., an oil and gas exploration company. In the Fourth quarter of 2000, Enron needed an additional \$100 million of earnings to achieve budget targets that formed the basis of its earnings per share objective for the quarter. To meet this need, Colwell and others fraudulently increased the recorded value of Mariner by approximately \$100 million. Colwell and others knew that Mariner's fourth quarter 2000 valuation was an amount arbitrarily selected to generate fictitious mark-to-market earnings sufficient to meet Enron's targets."

The problems with such valuations began with the conceptual framework. The Trueblood committee dealt with not only an economist's world but a utopian one as well. They never took into account that a certain percentage of people are dishonest, are unethical, and sometimes get into positions to take advantage of the honest people in the world. Furthermore, they chose to ignore the responsibility any standard setter has to aid both the public accountant as well as the company accountant in their work by reducing the subjectivity of accounting as much as possible. THE STANDARD SETTER SHOULD BE A PART OF THE SOLUTION NOT A PART OF THE PROBLEM. The FASB has chosen instead to remain aloof to the problems of subjectivity faced by those practicing accounting. Instead they approach accounting as a valuation process employing esoteric formulas that would be more in place in a PhD doctorate thesis.

All of us practicing accounting recognize that the basic financial statement is the balance sheet. In fact, it was the only statement for much of accounting history. We recognize that the income statement is really the detail of the retained earnings section of the balance sheet and that the funds statement is recast of the balance sheet accounts. However, we also realize that with the growth of the stock markets and public offerings of stock in the 20th century, the emphasis of those using the financial data shifted from an

emphasis on the balance sheet to the income statement and earnings per share as a "short-hand" estimate of future cash flows. Unfortunately, the emphasis has also shifted to the short term investor as well. The FASB has fed the short term investor with its promises of valuations of a company's future. One board member told me at a lunch meeting at the FASB in 1978 at which I was the GM representative, that the life work of the FASB should be to lay the basis for an orderly capital market so as to maintain the free enterprise system. That certainly is a noble goal and one that I agree with. However the way to do just that is to reduce the subjectivity in accounting. This is why the historic-cost model as held up so long under attacks by the economic-oriented threoreticians. Cost gives the auditor a solid base upon which he/she can form an opinion.

The principal problem that financial accounting should deal with is TOP MANAGE-MENT FRAUD. One has only to look back over history to see that when we faced a crisis in financial accounting it was due to top management fraud e.g., Krueger and Insull in the 1920s (along with fair value accounting); McKesson & Robbins in 1930s; Equity Funding, Watergate, and Lincoln S&L (and the use of appraisals of real estate) in more recent years. Again and again we have attempted to control such frauds with legislation—the 1933 & 34 Securties & Exchange Acts; the Foreign Corrupt Practices Act and, most recently, the Sarbanes/Oxley Act. The last Act should at least give the suggestions of the COSO report teeth. But we have failed to realize that we need an accounting base that is at least auditable. Congress formed the PCOAB but its thrust is towards auditing standards and oversight of the public accountants. The latter is certainly needed, however, auditing standards are not the problem—execution of the standards certainly is. The larger problem is with the accounting standards themselves as they place more and more pressure on the accountants and auditors to judge values without any solid basis for such an evaluation.

Much is made of "management of earnings". And yet the FASB often persists in helping unscrupulous business people in this regard. For example: Statement #87 requires companies to include in their earnings the earnings of the employee's pension trust which of course the company has no right to. When this Statement was adopted in 1985, Richard LaBombarde, a research actuary at Johnson & Higgins was quoted in the April 4, 1986 New York Times to the effect, "If the new accounting rules had been used in 1984, pension costs of those 700 corporations that have defined benefit plans which amounted to \$21.3 billion, might have been reduced to between \$16 and \$17 billion." During the stock market boom pension expense was understated by probably one third. Of course, the reverse is now true in a flat market. Thus the effect of Statement #87 has been to overstate earnings in good times and understate them in bad times. The new standard on goodwill now gives management as much latitude as they choose as they evaluate the future benefit of the goodwill. Such standards do not make the accountant's or auditor's job easier.

And they need help. As a part of the huge frauds mentioned earlier, we have seen the tragic collapse of one of the greatest public accounting firms in the world. Earlier, I quoted Professor Arthur Wyatt on the decline of the public accounting profession. The auditor has moved from being a tough umpire to being a willing participant in too many

cases. The auditors have always had to deal with the inherent conflict of interest involved in having the person they are auditing pay the bill (or have the power to fire them). It will not help them do their work if the application of fair value measurements force them to substitute their judgment for the clients on a regular basis.

As much as I would like to believe that accounting is the center of the business universe I hold no such illusions. It is a vital part of keeping our system functioning but it can do this by providing reliable data free of subjectivity to the extent possible. The key financial drivers that intelligent investors are interested in are market share, market growth, speed to market, competition, and, most importantly, responsible, ethical management and people. Nothing can quantify the early Sam Walton or Michael Dell. The accountant or auditor can only attest to the performance of such managers through the financial results of their efforts.

KEEP IN MIND THAT THE FASB SHOULD BE PART OF THE SOLUTION NOT A PART OF THE PROBLEM.

The FASB should take a long, hard look at what they can do to make the accountant's and auditor's job easier and the financial reports more reliable. THEN they will be RELEVANT.

My answer to your question, "Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other valuation standards and generally accepted valuation practices?" "If not, what additional guidance is needed?" You cannot get there. Prices are set by independent buyers and sellers not be guesses and hopes.

Yours truly,

(signed) E. H. Flegm