TESTIMONY OF

PHILIP D. AMEEN
VICE PRESIDENT & COMPTROLLER
GENERAL ELECTRIC COMPANY

ON BEHALF OF

FINANCIAL EXECUTIVES INTERNATIONAL

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AT A HEARING ON

PROMOTION OF INTERNATIONAL CAPITAL FLOWS THROUGH ACCOUNTING STANDARDS

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My name is Phil Ameen. I am Vice President and Comptroller of General Electric Company, and Chairman of the Committee on Corporate Reporting of Financial Executives International (FEI). FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the United States and Canada.

It is my pleasure to share FEI's views on the role of accounting standards in the allocation of capital in global markets. There is no longer any debate that one set of international accounting standards is inevitable; this will be the lingua franca for the digital age of the global securities market. Cross-border securities transactions have been growing at an accelerating pace over the past decade as institutional investors seek new frontiers for investment returns. Yet without the transparency

that arises from high quality application of global accounting standards, the markets are not as efficient as they need to be. Consequently, the so-called "flight to quality" can ruin economies and companies and lay waste to the best global strategies. We believe that transparency and comparability of financial reporting are necessary to achieve rational markets.

But having answered the threshold issue affirmatively, the second-order questions are much harder: What should these global accounting standards be and how should we best transition to them? The short answer is that much depends, as it always has, on the people and the processes applied to the task. Our long history of largely successful standards setting in the United States is instructive.

I believe we must first acknowledge that accounting standards and financial statements are, at best, modern versions of 15th century devices. By the turn of the 22nd century, it is hard to imagine my successor at GE worrying about closing the books and drafting footnotes. Rather, management's pulse on the business will be achieved by immediate signals from distributed electronic agents which will monitor orders, shipments, and electronically transferred funds. Despite what will be a tense debate, investors will be granted access to the same electronic agents, and will make investment and credit decisions based on assembling those data, interpreted under rules of their own devising. Debates about how pension surplus or derivatives or leases affect "net earnings" will seem as amusing then as the handwritten ledgers of the 1900's seem to us now.

In the world of 2100, much of what I did 100 years earlier will similarly be transformed. Today's financial reporting requires those who know the firm best – management – to accumulate and report transactions under an enormously complex rule set of about 100,000 internally inconsistent pages of accounting guidance, with only the most primitive of indices. From a reliability perspective, two features must be noted. First, the only parties who have sufficient knowledge about the enterprise to prepare its financial statements are also among the most biased with respect to the reported results. Second, markets are willing to absorb

only relatively modest assurance (audit) costs, so errors inevitably occur. Fortunately, the error rate is far lower than one would expect in these circumstances, as evidenced by the front page banner headlines to announce mistakes that, while unfortunate, rarely jeopardize the affected enterprise. Also, both the assembly and the testing of financial statements impose a second-order but very severe cost – delay in the distribution of information.

In this world, one can rightly pose the question of whether all the energy spent on accounting principles really matters. While we can observe market reaction – sometimes overreaction – to rumors of accounting misstatement, I also must acknowledge the analysts who are certain that, when GE stops amortizing goodwill at the beginning of next year and adds over $1 billion to net earnings, the stock will not react at all.

In a perfect world, we would not need an International Accounting Standards Board (IASB) or Financial Accounting Standards Board (FASB) because accounting standards would be developed through direct negotiation between corporate management and share owners (or analysts serving as their proxies). All elements of financial reporting from recognition and measurement to disclosure would therefore be investor-focused and responsive to specific, identified user needs at costs that preparers are willing to bear. Obviously, that approach is not realistically achievable. Neither reporting enterprises nor analysts have the energy or resources to build this model for each company, so standard setters necessarily serve as the intermediary. But today, preparers and users – the two parties that have an economic stake in the answer – are not a majority of any standard-setting body. Instead, standard-setting bodies contain a majority of conscripted auditors, whose backgrounds provide no experience with the economic value of perfect, timely, cost effective data. Indeed, auditors have incentives to develop quite the opposite type of standard, a standard with more complexity, application of which demands expensive audit expertise. There are predictable failures that arise from this standards-setting algorithm, and U.S. experience illustrates this phenomenon.

The United States provides the most ideal conditions imaginable for a standard setter: one business language, one regulatory environment, one national tax code, one government, a small number of highly-developed capital markets and sophisticated, involved professionals from all disciplines that care very deeply about improving the quality of financial reporting. Due process in this environment ought to produce robust, high quality final standards every single time.

The reality is quite different. As good as U.S. standard-setting appears to be relative to the rest of the world, it nevertheless has produced a surprising number of failures:

- Shortly after its formation in 1973, the Financial Accounting Standards Board (FASB) issued a statement – their eighth – related to foreign currency translation. This statement required that all changes in currency exchange rates be reported as gains and losses – this just as the U.S. left the gold standard and the world adopted floating exchange rates. When the Board surveyed constituents to see how they were doing as a standard setter, this standard drew pointed criticism. FAS 8 was rescinded just six years after it was issued and replaced with FAS 52, which appropriately limited gain/loss recognition to transactional exposures. And the FASB discontinued the formal constituent survey.
- In 1987, the FASB issued FAS 96 on accounting for income taxes, which required companies to schedule the reversals of transactions that were to be recognized in different periods for tax and book purposes. While the FASB's approach was conceptually pure, it did not consider the costs and was practically impossible to implement. Most companies never adopted FAS 96 and waited instead for its much simpler replacement, FAS 109, which was issued in 1991.
- For the new millennium, we have FAS 133, accounting for derivatives, which is built on a phenomenal maze of requirements that govern qualification for hedge accounting. Users, meanwhile, have shown no interest in the reported results. Given the failure of this standard to pass any cost/benefit test, we

believe that it will soon join FAS 8 and FAS 96 in the category of rescinded standards.

If you ask my peers what went wrong in each of these cases they will tell you that the standards ignored issues that were important to companies, investors or both.

The due process of international standards setting is far more nuanced than its U.S. counterpart. And, speaking parochially, there is a very real risk that the economic interests of the United States will get lost in the avalanche of feedback that the new International Accounting Standards Board will face. We have a saying at GE that your product is unsatisfactory if it does not delight your toughest customers. In the arena of global accounting standard setting, the toughest customers are right here in the United States. With all due respect for our global associates, it is clear that the U.S. leads the way with the most innovative transactions and structures that the world has ever seen. But U.S. concerns will carry relatively modest weight with members of the new IASB. And inevitably, representatives from simpler environments, environments without the transactions that test the limits of a proposed accounting standard, will be hard-pressed to cast knowledgeable votes. It will take a very careful approach to due process on the part of the new IASB to ensure that meaningful standards are issued.

The IASB was launched with great hopes and tremendous challenges. It is essential that all of us ensure that the IASB does not stray too far from its core mission: to develop accounting standards that are representative of the financial reporting rules that investors and companies would have negotiated on their own had they been given the chance.

This completes my prepared remarks. I would like to thank the Chairman and the members of the Subcommittee for allowing FEI the opportunity to testify. I would be pleased to answer any questions.