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on Banking, Housing and Urban Affairs

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Mr. Chairman and members of the Senate Banking Committee, I am honored that you asked me to testify today on the important issues of corporate governance raised by the Enron collapse.

My name is John Biggs and I am Chairman, President and CEO of TIAA-CREF, the system providing pensions and other financial products to the education and research community. We manage about $280 billion in assets through TIAA, a New York licensed insurance company, and CREF, the country's first variable annuity plan. Our company also offers to the general public life insurance products, trust services, mutual funds, and college tuition savings plans. As the CEO of TIAA-CREF, I am proud to report that our stock analysts covering the energy business could never understand how Enron could make enough money to cover its obligations--so our active portfolio held less than the benchmark level, resulting in relatively favorable results for our participants. We did unfortunately hold positions in our Index Funds since Enron once held a prominent position in the S&P 500.

My other experience relevant to your deliberations is as an independent public sector participant in financial regulation. I served for two years as a Governor of the NASD and some five years as a Trustee of the Financial Accounting Foundation, which funds the Financial Accounting Standards Board, or FASB, and appoints its members. I now serve as a Trustee of the Foundation supporting in a similar way the new International Accounting Standards Board (IASB). I was also a member of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. And currently I continue as one of the five trustees, all of us independent, of the Public Oversight Board. As you know, this Board will go out of business on March 31 of this year. I am not an accountant but did start my career as an actuary and earned a Ph.D. in economics along the way.

The Enron collapse and the intense interest the public and the Congress have taken raises a number of questions. I will focus on three primary areas where I believe America's corporate governance must be strengthened—and I will suggest ways in which the Congress might bring this about.

The three changes we have needed for some time and that bear directly on the circumstances of Enron are these: (1) a means of dealing with the widespread overuse and abuse of fixed price stock options; (2) the need for some basic common sense regarding auditor independence; and (3) the need for a strong regulatory model to oversee the accounting profession.

Overuse and Abuse of Stock Options

Several accounting professionals have attempted to lay the problems of Enron's accounting on the FASB. I believe they are seriously mistaken. In fact, during the late 80's and early 90's the FASB was aware of the very issues that Enron eventually faced. Among other things, the FASB addressed the absurd policy of accounting for stock options by which they appear to be "free" even though they form a central feature of executive compensation plans and obviously have very substantial costs.

Enron used such options extensively, covering all their management employees and granting large awards to their senior executives. Sixty percent of Enron employees had options. The cost of these options was never reported in Enron's earnings statements although the exercise gains were so great that in several years Enron paid no taxes.

The IRS allows as a deduction for compensation expense the difference between the option price and the stock's price when it is exercised (for most employee stock options). But in reports to shareholders that difference, or any other amount, has never been shown as an expense. Through its long, tedious, but open process the FASB explored all theoretical aspects of stock options. It put out tentative proposals, conducted exhaustive hearings so that all participants could comment, and heard arguments pro and con. The process took several years.

Many critics now say the FASB is too slow, but at other times critics have said it was too fast, especially when the issue was an unpopular one such as stock compensation or derivatives. The final proposal would have required a charge to expense for stock options given to employees as compensation. After extensive lobbying of Congress by companies and auditing firms, and following legislative threats to the existence of private sector standard setting, the FASB and the SEC capitulated. Arthur Levitt has publicly stated that he believes this was the greatest mistake made by the SEC during his chairmanship.

In capitulating, the FASB published a rule in 1995, known as Financial Accounting Standard 123, that offers the choice of expense recognition or disclosure in footnotes. If disclosure is chosen, the income statement will show expense for options only under certain circumstances required by the Accounting Principles Board (the predecessor to the FASB) in its Opinion No. 25 (1972). The FASB said the following in FAS 123, a statement with which I completely agree: “The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting.” (Paragraph 62) In other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations.

As you might expect, most corporations prefer to use the obsolete accounting model of 1972 which treats the fixed price stock option as “free” and treats performance

options as potentially very expensive. Significantly, most companies use virtually no other form of stock award than the fixed at-the-money option. Note that the Black-Scholes option-pricing model was created a year later, in 1973, and forms the basis for understanding financial transactions involving uncertainty. I can assure you that high-tech executives in Silicon Valley use the Black-Scholes model to value their own options. Most companies also use Black-Scholes to communicate total compensation to employees. Those same executives know that having to show the results of that calculation to shareholders would reduce or even eliminate the earnings of their companies.

I serve as a Director of the Boeing Company, which is the only major U. S. company to adopt FAS 123 expense, in order to report to its shareholders the true cost of its stock compensation plan. Boeing's executive compensation plan is based heavily on tough performance tests which are prohibitively expensive under the 1972 accounting model used by all other companies. For the record, Boeing adopted its plan and FAS 123 in 1996, before I became a director.

I might mention a further example of the strong-arm tactics of U. S. corporations. Last year the Financial Executives International issued a press release threatening to withdraw funding for the newly formed International Accounting Standards Board if the Board dared to study the issue of accounting for stock-based compensation. The use of options and stock as employee compensation is a growing phenomenon overseas, with little or no accounting guidance in place. I am happy to say that both Paul Volcker,

Chairman of the Foundation supporting the IASB, and Sir David Tweedie, Chairman of the IASB, are standing their ground, and the project is proceeding.

The use of questionable accounting methods for stock options has several negative results:

(1) Explosive growth in the use of stock options since 1995—huge, indeed, incredible awards to CEO's and in some companies awards to every employee. For several years, this practice has been a major concern addressed by TIAA-CREF's corporate governance program.

(2) The serious distortion of earnings statements so that some companies report large earnings at the same time that no taxes are paid. This is because of peculiar accounting that results in fixed price stock-options as zero "cost" in public income statements while allowing the employee gain to be shown as a "cost" for the tax return.

(3) Unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees. When excessive stress is placed on company accountants and their auditors, malfeasance may result. Business ethics experts wonder if potential "whistle blowers" are intimidated by their colleagues' or their own concern for their stock options.

(4) The dramatic decline in dividends is a direct result of so much recent attention to stock options. A dollar per share paid to a shareholder as a dividend reduces the stock price by a dollar. Can anyone wonder why corporate managers find many reasons to justify a reduction or elimination of the dividend?

(5) In many companies, stock options have replaced pension plans entirely. When we protested the action of IBM in abandoning its defined benefit plan, the company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

(6) There has been an almost exclusive use of the fixed price stock option in employee compensation plans. More desirable stock compensation plans could be devised that would better align management and shareholder interests. Such plans are effectively prohibited by the 1972 rules because they require that management show an expense for them. For example, a plan that requires performance better than the general market performance is not considered a “fixed price option” and results in truly onerous accounting treatment under 1972 rules. FASB Statement 123 provides sensible expense accounting for performance plans.

I have long been a strong advocate for the principle that the private sector (i.e. FASB or GASB (the Governmental Accounting Standards Board) or IASB) should set accounting standards. Congress, through the political process, should not enter into such technical issues, but it should demand a fair and open process. I stand by that view. Some expression of support by your Committee, or by the full Senate or House of Representatives—the form of which you understand better than I—might make it possible for the IASB to study the issue, and for the FASB to reopen the question.

I believe that history would see this action as an extraordinary benefit coming out of the many lessons to be learned from Enron.

Auditor Independence

My company has two important provisions in its Audit Committee Charter. (1) Our auditors may not do any work for TIAA-CREF other than what is directly related to the audit function (this exclusionary rule also applies to our tax work); and (2) rotation of the auditor is considered after a five- to ten-year period. The first rule was heatedly contested by our auditors at the time we imposed it; our current auditors knew the rule when they began working for us in 1997 and now accept it. We have had two auditor rotations since I have been Chairman, and each has been not only successful but also highly energizing for our financial management work.

I testified before your Committee in the fall of 2000 in favor of the SEC proposal to move partially to our first rule on independence. I was startled by the vehement opposition from several accounting firms and especially from their trade association. I thought much of their testimony was deeply suspect, especially the claims that few companies used their auditors for other work and that, when they did, it was a minor use. The facts revealed since the SEC required disclosure reveal the truth to be very different.

At TIAA-CREF, we are currently considering shareholder resolutions to be filed with several companies on auditor independence. We are particularly concerned about the following relationships between companies and their audit firms: (1) Have they used the same audit firm for a very long time, say 20 to 30 years? (2) Does the audit firm have a high ratio of non-audit fees to audit fees? and (3) Is the Chief Financial Officer, the Chief Accounting Officer, or any other financial manager a former employee of the audit firm?

We will ask the Audit Committee members to report on, and sign their names to, a statement that they have considered the circumstances, including competitive bids from other audit firms, and that they believe their audit firm is independent and represents the shareholders and not management. We will also ask for a rationale for that belief.

I am astonished at the number of companies my colleagues have identified that have all three relationships with their auditors. This is not to say that such companies have produced inappropriate financial reports. In reality, I believe most corporations have the right "tone at the top." It is well known in these companies that the CEO and CFO simply will not condone inappropriate accounting. Nevertheless, when that tone is wrong, as it appears to have been at Enron, the auditor will have to exhibit extraordinary strength to stand up to management and say, "you cannot do this." Such auditors do exist, of course, but investors cannot count on their luck to be represented by such an auditor.

Of course, Arthur Andersen's relationship with Enron was "embedded" to say the least. But it went even further. Enron management proposed to Arthur Andersen, and Andersen's senior leadership agreed, to replace Enron's internal auditors with Andersen personnel. Enron outsourced its internal audit function to its external auditor, Arthur Andersen. Shouldn't warning bells have gone off at either Andersen's head office, or at the Enron Board, that this was an inherent conflict? In the last couple of months, the major accounting firms and the AICPA have said that firms should not provide internal audit services to audit clients and financial systems design services.

Finally, and perhaps most significantly, Arthur Andersen appears to have played the role of both tax counsel and investment banker to Enron, devising the questionable tax and off-balance-sheet strategies that ultimately imploded, but which the independent auditor—Arthur Andersen—was supposed to review. Again, where was the "tone at the

top" at Andersen? Didn't anyone in Chicago say this was going too far? Were the millions in additional fees for such "high value" services, and "high margins," too tempting to resist?

There seems to me a widespread lack of sensitivity to conflicts for auditors that must be addressed. And there need to be more examples of lucrative opportunities turned down than there are.

I applaud the recent changes made by the accounting profession on limiting the types of non-auditor work. Several of the firms saw the public need to do this in 2000 when the SEC proposed limitations. The others have grudgingly assented, arguing, to my astonishment, that the Andersen-Enron relationships had no independence problem.

A far more powerful antidote to this blindness to conflicts of interest would be to require auditor rotation every five to seven years. Such a requirement will be fiercely opposed by the accountants and the companies, who will see only additional costs of having to make such changes. But I can vouch from my experience that the costs can be managed and that there are many positive benefits. Even if the cost-benefit ratio were unfavorable, which I doubt, isn't such a simple solution worthwhile, given the importance to our capital markets of confidence in financial reports?

Consider the advantages of rotation for the issues of independence that concern us.

First, rotation reduces dramatically the financial incentives for the audit firms to placate management. If the audit firm has a kind of virtual perpetuity of millions in fees every year (from whatever source), the present value of that relationship is enormous: in the Enron case, probably over a half-billion dollars, given that total fees paid to Arthur Andersen for fiscal year 2000 were $52 million. That amount could be even higher if one considers the potential growth in "cross sold" services. On the other hand, if the audit firm has a limited term, the present value is cut by two-thirds or more. And in the final year of a five-year term it has little value. Economic incentives are important, especially to accountants trained to understand them. Rotation would help contain financial incentives to manageable levels.

When overseen by the Public Oversight Board, peer reviews have been useful in improving quality controls in audit firms. Typically, they are conducted carefully by serious professionals, and they have been expensive. But peer reviews are a weak self-regulatory tool, and they appear to be universally criticized as inadequate.

Consider the peer review aspects of mandatory rotation. Had rotation been in effect at Enron in 1996, and Arthur Andersen had known that a new auditor would be appointed for 1997, and that the new auditor would do an exhaustive review of the former audit work papers, it is likely that Arthur Andersen would have assured that

transactions and documentation were fully transparent. A thorough “real-time” peer review would be truly effective. A strongly constituted, independent, and authorized regulatory board to oversee the auditing profession might also ask for a brief, signed peer review report from the new auditor. None of this would be costly unless there were troubles, as there were at Enron.

Clearly, had Enron been required to rotate its auditors every five to seven years, it is unlikely that misleading financial reporting would have continued or that the Board’s Audit Committee would have been kept in the dark, as they claim they were. It is also conceivable that, if they had been confronted by a group of different non-compliant auditors, senior management might have hesitated to engage in some of the financial manipulation they appear to have carried out. Honest financial reporting from the beginning also would likely have resulted in more reasonable stock valuations.

Rotation, furthermore, reduces the problem of cross-selling other services and is likely to eliminate the revolving door that allows former auditors to become the top financial officers of the audited company. For example, by the time the former KPMG partner becomes CFO, the new auditor might be PricewaterhouseCoopers, Deloitte & Touche, and so on.

I believe rotation of auditors will not become a practice without explicit action by Congress. I strongly urge this Committee to consider the benefits such a change would make in the U. S. financial world.

A Strong Regulatory Model

The Public Oversight Board (POB) on which I have served for the past several months, attempted to oversee a bewildering array of monitoring groups. One was the Quality Control Inquiry Committee (QCIC) that reviews auditor performance in contested audits (i.e., where a lawsuit had been filed). A second was the Peer Review Board that participates in inter-firm peer reviews.

There were others as well. The POB oversaw the Professional Ethics Executive Committee (PEEC) that reviews members' actions in all types of ethical issues. It oversaw the Auditing Standard Board (ASB) and the SEC Practice Section (SECPS). Finally, the POB had the opportunity to raise questions with the FASB if accounting standards seemed in need of repair.

Being a non-accountant and an independent director, I found the POB very hard work, especially for a sitting CEO. The other four members were retired, and I succeeded Paul O'Neill who, as you know, moved from retirement to a very active position. What was often most frustrating was our lack of authority if we found something that we thought should be changed. While the major firms and the AICPA were outwardly cooperative when the SEC demanded action, they were unwilling to change in response to any significant POB initiative. At one point, the AICPA

threatened to withhold funding from the POB, but was finally forced by the SEC into an unwilling marriage, documented by a new charter that gave us assurance of being able to pay our staff. No one will really miss us after March 31.

In short, we need something better for a regulatory body. Elements of Chairman Harvey Pitt's proposal certainly move in the right direction, but I believe the proposed entity needs more authority. And that authority can come only from Congress.

The investigative authority of a new accounting regulatory body needs to be clear-cut and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from cooperating with this new agency. Of course, it must have the ability to keep the information gathered out of the hands of the litigating lawyers. And it must have the authority to discipline firms and individuals without the delays of an AICPA investigating process.

The new agency must have licensing authority, beyond that of the states, for individuals who will practice at the SEC bar. It should have authority, I believe, to approve or disapprove business affiliations of licensed practitioners—for example, is it appropriate for American Express or H&R Block to become major players in providing audit services? Should accounting firms with an SEC audit practice be allowed to go into all the major financial businesses that the Big Five have now entered?

The new agency should also have a reliable funding source that does not come from the accounting profession on a voluntary basis. Nor should it come from the business community through the “tin-cup” process now used by the Financial Accounting Foundation and the Foundation for the International Accounting Standards Board.

Concerning this point, I have served on fund-raising committees for both the FASB and the ASB. I can assure you that voluntary giving to support the regulation of the auditing profession will not work. Raising money for a much more benign purpose—for instance, establishing accounting principles in the private sector—has been a very tough sell. Those of us asking for the money feel compromised. The unspoken question is this: “If I give, will I have more influence on FASB decisions?” The investment community has largely refused to support either the FASB or the IASB, with a very few exceptions to that rule. The usual contributors are those with a strong sense of community interest—the major banks, investment banking concerns, and several large global businesses.

We should devise instead a fee on stock market transactions, or registrations, or some other financial activity that will be devoted to paying for auditing oversight, the work of the Financial Accounting Foundation, and perhaps even the American share of the IASB’s needs.

Given the welcome demise of the POB, the ball is squarely in the court of Congress and the SEC to define a strong regulatory body. It should have real teeth, adequate funding (without membership fees from the very institutions the new body will regulate), and a fair chance of bringing a new ethic and culture to a profession that needs to change.

It is my hope that we will succeed in these three areas: First, that we can make companies provide transparent accounting for stock options; second, that we can assure greater independence of auditing through auditor rotation; and third, that a strong regulatory body can be created. If these goals are reached, I believe we may look back on Enron as being a short-term financial tragedy for its employees and the holders of its securities, but a major long-run benefit for the U. S. capital markets.

Thank you for giving me the time to express my views on these important matters.