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**Statement of the Honorable Armando Falcon, Jr., Director of OFHEO,
before the House Subcommittee
on Commerce, Trade, and Consumer Protection
on
Freddie Mac's Accounting Restatement:
Are Accounting Standards Working?**

January 28, 2004

Mr. Chairman, Ranking Member Schakowsky, and Members of the Subcommittee, I appreciate the opportunity to discuss with you OFHEO's Report of the Special Examination of Freddie Mac. My prepared testimony will summarize the key findings and conclusions of the report, focusing largely on the accounting issues, and I request that the Committee include it as well as the full text of the report in the record. My testimony expresses my own views and not necessarily those of the President or the Secretary of Housing and Urban Development.

Mr. Chairman, OFHEO is an independent agency, chartered by Congress in 1992 and funded by assessments on the government sponsored enterprises it supervises, Fannie Mae and Freddie Mac. OFHEO's mission is to ensure the safe and sound operation of the Enterprises. As do other safety and soundness regulators, OFHEO employs a full range of supervisory and enforcement tools including examinations, capital standards, and prompt corrective action procedures.

A year ago, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods would be reaudited. A switch in external auditors – from Arthur Andersen to PricewaterhouseCoopers – had triggered a reevaluation of Freddie Mac's accounting policies, especially those relating to hedge accounting treatments for derivatives occasioned by implementation of FAS 133. However, the reaudit and restatement process itself raised questions beyond merely the choice of accounting policies.

On June 7, as Freddie Mac prepared to announce the abrupt departure of three of its principal officers, I ordered a special examination of the conditions and activities that led to the accounting failures and management changes.

Although some aspects of the special examination are not yet complete, the bulk of the work was finished this past fall. OFHEO issued a report of the examination containing the findings and conclusions, along with appropriate recommendations, in December.

Since the early 1990s Freddie Mac promoted itself to investors as "Steady Freddie," a company of strong and steady growth in profits, and developed a corporate culture that placed a very high priority on achieving such results. The special examination showed that, to do so, Freddie Mac used means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie Mac changed auditors in 2002.

Improper Management of Earnings

The Report of the Special Examination of Freddie Mac reveals how Freddie Mac manipulated its reported earnings and disclosed other financial information in a misleading way in 1999 through 2002. The Report provides a chronology of relevant events, reviews the strategies that Freddie Mac employed to manipulate earnings, and indicates that the Board was made aware of transactions whose sole purpose was to shift income. The Report also shows how the executive compensation program of Freddie Mac, particularly compensation tied to earnings per share, influenced accounting and management practices during that period.

In the period covered by the special examination, senior management at Freddie Mac placed an inordinate emphasis on achieving steady, stable growth in earnings per share.

Freddie Mac adopted the goal of steady earnings growth in the early 1990s after some investors told management that the Enterprise needed to communicate clear and simple messages that the public could easily understand. Fifteen to sixteen percent earnings growth, or "mid-teens earnings growth," was the simple message that management began to communicate. That goal was fairly easy when Freddie Mac was primarily a securitizer of mortgages. However, as the retained mortgage portfolio of the Enterprise grew and its earnings became more sensitive to interest rates, steady mid-teens growth became a more challenging goal.

On January 1, 2001, Freddie Mac, along with other financial institutions, was required to implement FAS 133, *Accounting for Derivative Inst ruments and Hedging Activities* . Given the large size of Freddie Mac's derivatives portfolio, FAS 133 presented management with many operational challenges relating to systems, documentation, and accounting infrastructure. However, in addition to the operational challenges, FAS 133 was problematic to Freddie Mac with respect to steady earnings. Specifically, FAS 133 required management to record a transition adjustment based upon any embedded gain or loss in its derivatives portfolio upon adoption of the standard. Freddie Mac's derivatives portfolio, in particular its portfolio of interest-rate swaptions, had substantial gains that had to be recognized on the transition date. Management sought to minimize this transition adjustment, in part to minimize the appearance of volatility on its balance sheet, as well as to shift derivative gains into future periods and recognize them gradually into income.

To maintain Freddie Mac's image as a smooth and steady earnings machine, never perturbed by changes in interest rates, mortgage volumes, or other economic factors, it is now clear that management went to extraordinary lengths to transact around FAS 133, and at times failed to comply with GAAP. One example of this was the "Coupon Trade-Up Giant" transaction, referred to in the Report as "CTUG." The purpose of the CTUG transaction was to move securities with embedded losses from the held-to-maturity portfolio (where losses are unrecognized) to the trading portfolio (where losses would be immediately recognized in net income and would offset derivative gains), and then into available-for-sale portfolio (where securities gains and losses only hit "other comprehensive income," not "net income"). The last step was accomplished with the help of Salomon Smith Barney Holdings, which is now part of Citigroup, and involved combining $30 billion in mortgage-backed securities into four "Giant" securities. Management wanted the benefit of having its securities in a trading account but only for enough time to realize a loss and offset its derivative gains.

However, the transfer to the available-for-sale portfolio was unwound during Freddie Mac's re-audit in 2003. In addition to numerous operational problems caused by trying to move $30 billion in mortgage-backed securities in a short period of time, and the fact that Salomon Smith Barney only took possession of the securities for a few hours before shipping them back to Freddie Mac, a reaudit ultimately concluded that the classification from Trading to Available-for-Sale should not have been permitted. Transfers into or from the trading category should be rare, and "rare" is generally interpreted to mean "never" both in practice and by the SEC. The first transfer to trading was permissible under FAS 133 transition values, but not the second transfer. That transfer would have required substantive trades. However, Freddie Mac did not obtain a legal true sale opinion on these transactions. CTUG was a transaction with little or no economic substance that Freddie Mac manufactured to obtain a particular accounting result. Indeed, the economic aspects of the deal were negative when one considers the operational hazards created by the transaction, which compounded Freddie Mac's accounting and control weaknesses.

The Report of Special Examination also detailed the use of a dubious method used by Freddie Mac to value its swaption portfolio in order to minimize its derivatives gain at the time of the FAS 133 transition. The Report describes how the head of Freddie Mac Market Risk Oversight unit worked with Freddie Mac's derivatives desk to reverse-engineer a justification for a lower value for the swaptions portfolio. The revised swaption valuation method contributed to a $730 million misstatement of the 2001 financial results of Freddie Mac. The fact that the head of Market Risk Oversight worked hand-in-glove with a unit he was responsible for overseeing to craft a dubious valuation methodology is illustrative of the culture at Freddie Mac at that time and highlights the willingness at all levels of management to disguise earnings.

The FAS 133 transition was not the only episode of improper earnings management activities. For example, in January 2001, the shape of the yield curve began to change dramatically in favor of Freddie Mac, as the Federal Reserve began to lower its target for the Fed funds rate, which resulted in a much steeper yield curve and a windfall of net interest income for the Enterprise. This windfall was made larger by derivative positions put in place at the end of 2000 that benefited from the steeper yield curve. In order to shift some of this windfall from 2001 into the future, management executed the first of several interest-rate swap transactions that are referred to in the Report as the "linked swaps." The terms of each pair of swaps substantially offset each other and were virtually riskless for Freddie Mac and their counterparties. The swaps also had little effect on GAAP income but the negative cash flow from the first swaps in each pair was reflected in operating earnings, a non-GAAP metric that Freddie Mac highlighted for the investing public. The linked swaps, in aggregate, moved approximately $450 million in operating earnings from 2001 into later years. Handwritten notes from Freddie Mac's Board meeting in September 2001 show that management informed the Board that derivatives were being used to shift income.

Other earnings management techniques involved keeping the level of loan loss reserves higher than allowed by GAAP, and maintaining a reserve account to cushion fluctuations in premiums and discounts resulting from mortgage prepayments. That reserve, known at Freddie Mac as the FAS 91 reserve, was not allowed by GAAP, but Freddie Mac's outside auditor, Arthur Andersen, chose to look past it. When Arthur Andersen began receiving negative publicity in late 2001 and early 2002 for its work with Enron, the Chief Operating Officer of Freddie Mac resisted pressure from the Board to change auditors, since he was aware that hiring new auditors could result in increased "restatement risk." Ultimately, the Board insisted on hiring new auditors, and his fears of restatement were realized.

Executive compensation

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, also contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future.

Disclosure

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise.

Within Freddie Mac, no one took responsibility for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such a lack of assigned responsibility reflected the low regard executive management had for that function.

Board of Directors

For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive Directors allowed the past performance of those officers to color their oversight. Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age or beyond. Conversely, the service periods of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board.

Weak Accounting, Auditing and Internal Controls

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the Enterprise led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls, and an over reliance on manual systems. Given the size of the company and its role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the Enterprise.

Accounting Personnel and Expertise

The staffing levels and experience in the financial accounting reporting functions were insufficient throughout the restatement periods. The key finance functions over this period were unbalanced with major gaps either left unfilled or filled with interim personnel with inadequate skills. This shortage of staff and experience caused key person dependencies in crucial control areas. The need for skill and experience is heightened when the process is complex, as is the derivatives and securitization accounting process at Freddie Mac. Many of the strategies and transactions during this period were not GAAP compliant; therefore, Freddie Mac was faced with one of the largest restatements in corporate history.

The primary responsibility for an entity's financial statements rests with management. Part of that responsibility is to assure that staffing levels in financial accounting are sufficient to support a control environment within the financial reporting process to ensure that significant errors are either prevented or detected at an early stage. Senior management and the Board failed to provide adequate resources to the corporate accounting function even though they were being continuously told about the weaknesses.

Senior management simply ignored warning signs about problems in Corporate Accounting and/or did not consider the problems important enough to provide adequate supervision, funding and or insist on a timely resolution. The lack of attention to staffing, skill set and resources led to weak or non-existent accounting policies, weak accounting controls, over reliance on manual systems and over reliance on the external auditor. Each of these areas will be discussed in turn.

Accounting Policies

A thorough review and update of accounting policies had not occurred at Freddie Mac in over twelve years. Accounting policies should be researched and documented regularly to assure proper accounting treatment of existing and new business transactions. They should be used as a mechanism to keep employees informed of how to account for new and recurring transactions. Many of the transactions and policies that have been investigated at Freddie Mac did not have established accounting policy guidance and/or the policies in place were outdated, insufficient or incorrect, leading to misapplication of GAAP and, ultimately, to the need to reaudit and restate its financial statements.

Freddie Mac's accounting errors during this time period had been pervasive and persistent; occurring in more than 30 different accounting issue groups. The weaknesses in accounting policies created an environment that allowed for and even encouraged transacting around GAAP. These weaknesses also encouraged an over reliance on Arthur Andersen, the external auditor, a situation which led to questions as to auditor independence.

Management used the weak accounting policy group and the non-existent process surrounding the setting of accounting policies to justify accounting practices after transactions had taken place rather than allowing the group to set "best practice". Freddie Mac, as part of the restatement process, has rewritten and/or reviewed 150 accounting policies.

Over Reliance on Arthur Andersen

Freddie Mac's shortage of accounting staff, inadequate expertise and weak or non-existent accounting policies led to an environment that encouraged reliance on the external auditors for basic accounting functions and decisions. This dependency led to the external auditor acting in a first-line management capacity, taking part in day-to-day operations, and, to an extent, and auditing its own work.

In 2001, Arthur Andersen received $1 million for its audit work and $3.7 million for its consulting fees, of which $1.5 million related to FAS 133 consulting. OFHEO believes that Arthur Andersen's independence as an auditor may have been compromised by the size of the consulting fees compared to the fees charged for the audit work.

SEC requirements for independence of auditors are clear that in day-to-day operations of the business, external auditors may not function as management or as an employee of its audit client. Arthur Andersen appears to have disregarded this principle by counseling the company on issues ranging from FAS 133 implementation to accounting affects of new products. The many organizational changes in the accounting department heads, especially at the controller position, led to the accounting staff heavily relying on Arthur Andersen.

In this regard, evidence supports the conclusion that Arthur Andersen was participating in day-to-day decisions and often acting as an employee or in a management capacity. They also performed extensive consulting work that may have led them to use extreme and sometimes unsupportable assumptions to support specific transactions. Couple this with an environment where management often negotiated accounting decisions and in some cases went as far as suggesting a change in auditors if desired results were not achieved, and the result is an environment which can compromise the auditor's independence.

There are also indicators that the Board was comfortable relying completely on the external auditor for accounting expertise. This contradicts current accounting literature, which holds management accountable for the accuracy of their financial statements.

Accounting Controls

Senior management and the Board did not establish and maintain a strong internal control system. Therefore, they could not provide reasonable assurance that transactions were recorded as necessary to permit preparation of financial statements in accordance with GAAP. As a direct result of management and the Board not addressing these weaknesses in a timely fashion, Freddie Mac went ten months without audited financial statements for 2002, was forced to reaudit and restate both 2000 and 2001 financial statements, and will not be able to provide investors with current quarterly information during 2004.

As noted previously, staffing levels and expertise in the financial accounting area have been insufficient since at least 1998. It has also been demonstrated that the enterprise operated from 1991 to 2003 with non-existent or outdated accounting policies and manuals. Add to this insufficient controls over the financial reporting process such as system and data integrity issues in debt and derivatives accounting, account reconciliation issues, an ineffective process to react promptly to new transactions, and a labor intensive close-out process and you have an environment that will not only allow errors but will most likely result in material misstatements in the financial reporting process. Discussed below are some of the weaknesses in controls that existed during the restatement period.

Derivatives

In an internal audit report dated December 1996, the General Auditor reported that controls over the derivatives execution, administration, and accounting processes require improvement and that further deterioration in controls could prevent objectives relating to the effectiveness and efficiency of operations and the reliability of financial reporting from being achieved.

Management through their internal self-assessment process also identified these same weaknesses. Weaknesses within the derivative area continued to be identified, but not addressed by management, internal audit, or the external auditor during the next seven years. The latest internal audit report stated that inadequate documentation of hedge effectiveness and other required information could disqualify the use of favorable FAS 133 accounting treatment. The report also stated that procedures for derivatives accounting processes, including documentation, effectiveness testing, quality control, analysis, and management review, need improvement to ensure compliance with hedge accounting standards. Significant functional limitations in the derivatives accounting systems create an elevated risk of material operational error. It should be noted that inadequate documentation and controls surrounding the accounting for derivatives were identified as one of the six major restatement issues and constitute the largest dollar impact of the restatement.

Reconciliations

General ledger account reconciliations are a key internal control necessary/used to provide reasonable assurance that the corporation's financial statements fairly present its financial position and results of operations. Not reconciling general ledger accounts dramatically increases the risk that financial reports will not be accurate. The issue regarding reconciliation was brought to management's attention as early as 1995. At that time Internal Audit reported that corporate accounting was not effectively monitoring account reconciliations performed by the decentralized account unit.

Internal Audit again identified reconciliation weaknesses in their 1998 audit. And in 1998 and 1999 Arthur Andersen addressed the issues regarding reconciliation and data integrity in its management letters. In fact, in 1998 Arthur Andersen said that guidance should be provided for the timely and consistent reconciliation of data to the general ledger and other approved sources of data. Reconciliation issues were still outstanding in 2002.

Internal Audit Function

Many of the weaknesses discussed to date were identified by Internal Audit but remained outstanding for a number of years. In evaluating the role of the Internal Audit Department the investigation revealed that Internal Audit did not fully comply with industry standards or best practices in the areas of competency and communication with the Board and Management.

Best practices do not require internal auditors to conduct financial audits, but the Internal Audit Department of Freddie Mac should have policies and procedures in place to address its obligation to evaluate risk exposure relative to the reliability and integrity of the financial information of the Enterprise. Given the volume and wide range of accounting errors made by Freddie Mac, the conclusion of the Internal Audit Department that financial accounting and reporting controls were marginal was a substantial overstatement of their quality.

Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended. A review of relevant internal audit reports noted several instances where major control weaknesses identified as early as 1998 remain unresolved five years later. In many of these instances, internal audit identified major control weakness and set agreed upon actions as well as target completion dates. However, the completion dates of the corrective actions were repeatedly extended. As a result, each of the issues remained outstanding.

By not following up quickly enough or failing to report the failure of management to remedy major control weakness during the period of the restatement, the internal audit function increased the exposure of Freddie Mac to risk.

The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting, the Internal Audit Department, and questionable independence of the external auditor meant that there were weak points at each major control juncture at Freddie Mac.

Conclusion

Weaknesses in the Corporate Accounting area with respect to staffing, skill set, and resources led to weak or non existent accounting policies, an over reliance on the external auditors, weak accounting controls and an over reliance on manual systems. Couple this with a weak internal audit department that did not accept responsibility for the reliability and integrity of financial information, did not maintain effective controls over the review and follow-up of audit findings and you have an environment with weak points at each major control juncture.

This weak control environment provided the opportunity for management to promote an attitude that GAAP was something to be transacted around. In this regard, the attention of management on meeting analyst's expectations at the expense of proper accounting policies and strong accounting controls lead to aggressive accounting and concurrently resulted in the restatement and reaudit. Management and the Board continually ignored their responsibility for adopting sound accounting policies, establishing and maintaining a strong internal control system to assure that financial statements were prepared in accordance with GAAP. The Board appeared to be operating under the misconception that as long as the external accounting firm signed off on a policy or transaction that management's responsibility was fulfilled.

Management and the Board must accept full responsibility for the Company's financial statements. The auditor's responsibility is to express an opinion on the financial statements. It is management's responsibility to adopt sound accounting policies and to establish and maintain an internal control environment that among other things will ensure the effectiveness of the accounting and financial reporting processes. Freddie Mac's Senior Management and Board did not live up to these responsibilities during this timeframe.

Recommendations

The examination report recommended that OFHEO and Freddie Mac take a broad range of actions. I agree with the recommendations and we are moving to implement them. As a general matter, the report concluded that OFHEO must ensure that Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility, and that penalizes failure to meet appropriate standards of conduct.

The report also detailed a number of specific actions. To improve the effectiveness of the Board of Directors, Freddie Mac should separate the functions of the Chief Executive Officer and the Chairman of the Board, impose strict term limits on Directors, and require that the Board meet more frequently.

To address Freddie Mac's general neglect of operations risks and compliance issues, the report recommends that Freddie Mac establish a formal compliance provision and a position of Chief Risk Officer, reporting directly to the CEO, with explicit responsibility for operations risk, as well as credit and market risk. In addition, Freddie Mac's Internal Audit Department needs to be strengthened so that it can play a more effective role.

To address accounting weaknesses, Freddie Mac will review all accounting and financial reporting changes and communicate this to OFHEO. The enterprise must also act to improve its internal audit and accounting functions. The report also recommends that OFHEO consider requiring a periodic change of external audit firms. Freddie Mac needs to establish and maintain superior accounting controls and prevent undue reliance on its external auditor. It must also document the legitimate business purpose of every significant business transaction.

To address inappropriate managerial incentives, the report recommended that Freddie Mac refocus its compensation program more on long-term goals, not on short-term earnings.

Until remediation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. The report recommends that OFHEO consider addressing this concern by requiring Freddie Mac to hold significant regulatory capital surpluses, at least until it can produce timely and GAAP – consistent financial reports.

Finally, the report recommends that OFHEO take three additional steps to reduce the possibility of future Enterprise difficulties. First, OFHEO should implement regulations that provide for mandatory disclosure, similar to that required of SEC-registered companies, if Congress does not repeal the exemptions of the Enterprises from securities law. Second, OFHEO should expand its capacity to detect and investigate misconduct by including more substantive tests of the internal control frameworks at the Enterprises, including procedures to identify pressures to commit fraud and opportunities to carry it out. Third, OFHEO should conduct a special examination of the accounting practices of Fannie Mae.

OFHEO ACTIONS

Mr. Chairman, I am pleased to inform the subcommittee that the majority of these actions have been put in place. Of the 14 recommendations relating directly to Freddie Mac, a consent order has applied 11 of these recommendations, while I am moving now within OFHEO on the remaining three.

The consent order entered into on December 9th with Freddie Mac expands on the recommendations of the report and Freddie Mac has initiated a compliance program with the consent order that OFHEO is not only monitoring but working with the management to see that it moves along promptly.

Key provisions for accounting matters and related matters are as follows:
The Board of Directors is reviewing the company's bylaws, code of conduct and employee training to assure that changes are made that will support an environment to avoid problems that were discovered in the course of the investigation. The Board will review and recommend changes to its committee structure to meet its oversight obligations including operations risk and internal controls that were issues in the accounting area. The Board and senior management must be briefed not less than annually on their legal and regulatory responsibilities; this includes no less than annually a meeting with OFHEO personnel.

Freddie Mac is developing, with OFHEO oversight, a program to revise its management culture to give equal weight to compliance and operational stability along side other corporate goals; this includes executive compensation that contributed to the accounting failures.

The Enterprise will have a consultant review its accounting and financial reporting changes and communicate to OFHEO on this and improvements to internal controls. The Enterprise must act to improve its internal audit function and internal accounting.
As to specific unique transactions that did not have a business purpose, the Enterprise will assure that a valid business purpose exists for transactions and that they are documented under GAAP.

Finally, the Board must report quarterly on progress in meeting the requirements of the consent order and our staff and Freddie's management, I can assure you, are meeting on a much more frequent basis than that.

Overall, I believe that Freddie Mac has been subject to a rigorous corrective plan by OFHEO and one that establishes accounting as a central point of concern. Freddie has engaged with OFHEO actively and has been operating in a manner that is satisfactory to OFHEO in working through these remedial steps.

That concludes my prepared remarks. I am pleased to answer any questions that you and Members of the Committee may have.

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