Opening Statement of Hon. John J. LaFalce
Ranking Member, Committee on Financial Services
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Mr. Chairman, I'm pleased that you're having this hearing. I believe it is very important to harmonize international accounting standards, yet, I am concerned that in the process we do not undercut the generally strong standards we have in the United States. These standards, and the strength of our accounting and auditing professions, play a fundamental role in protecting investors and maintaining the integrity of our capital markets.

I'd also like to take this opportunity to thank Chairman Volcker for his efforts to improve the international accounting standard-setting process. I believe these efforts will make an important contribution to the integrity and transparency of both our markets and those abroad.

Accounting issues have recently begun to catch the attention of the media. It is difficult not to notice daily reports of financial fraud and restatements of financials by major corporations. I am extremely concerned about this. In fact, outraged may be a better word. The SEC, particularly its Chief Accountant, has also been expressing concerns about various accounting issues and practices involving the accounting profession and corporate management, and I hope they will step up their enforcement efforts, and be given the resources necessary to do that.

Today's hearing obligates me to express my conviction that this Committee and the Congress must not take the strength and integrity of our own accounting system for granted. And most importantly, we should make clear that "harmonizing" international accounting is not an excuse to lower U.S. accounting standards. In other words, standardizing accounting practices around the world should not be a "race to the bottom." Investors, shareholders, and increasingly global capital markets, all benefit from access to the highest quality information.

This hearing should be only the beginning of a new Committee focus on domestic accounting issues and how the application of accounting standards is affecting the integrity of our capital markets. It is certainly an area I shall be pursuing aggressively. This is particularly important in view of the tremendous growth in stock ownership through the country. Estimates from the most recent survey data indicate that approximately half the households in the United States now own corporate stock, either directly or indirectly through a mutual fund, retirement account, or defined-contribution pension plan. This represents over a 60 percent increase in the number of individual shareholders over the last decade. This trend, combined with the decreasing availability of defined-benefit pension plans, means that more Americans than ever are relying on the performance of their stock investments for their savings and retirement. Twenty years ago, two-thirds of all pension plan participants were in defined-benefits plans. Today, more than two-thirds are in defined-contribution plans. That change is profound in its implications.

High quality accounting standards and financial reporting are essential for sound investment choices to be made. At the same time that Americans have become more reliant on the performance of their stock investments, the pressures on firms to manipulate their financial results have grown tremendously. Executive compensation is increasingly tied to market valuation of corporate stock, creating ever more pressure to meet earnings estimates to the penny, lest their stock price be pummeled in the markets.

Judging by the numbers of companies that have had to restate their financial statements after they were released, many companies have succumbed to the temptation to manipulate their results. According to the SEC, the number of restatements has more than trebled from the early 1990s, from an average of less than 50 a year to 156 last year. More than half of the companies accused of financial fraud in shareholder class action lawsuits last year have already been forced to restate their earnings. These figures are particularly troubling when one notes that these are restatements of financials that had been signed off on by the firms' auditors.

Regrettably, there is increasing and disturbing evidence that the problem is widespread. An article this month by a senior editor of the Harvard Business Review describes the insidious effects of so-called "earnings management," saying that, "The earnings game is now so commonplace that it can sometimes seem like a collective agreement to believe the unbelievable." While many of the techniques used may be technically legal, they are economically indefensible, and the conduct of many companies may cross the line into fraud on investors and the markets. Further, while I would like to think that the conduct of these companies is an aberration, what may look like an ice cube is much more likely to be the tip of an iceberg, as the Chief Accountant of the SEC noted only last week. I suspect that iceberg may be gigantic.

This Committee needs to focus seriously on the importance of accounting standards and their proper application to our capital markets. High quality financial reporting is essential to protecting investors and maintaining investor confidence. We need to ensure the high quality of financial information from all firms that compete for capital in our markets, whether they are U.S. companies or foreign corporations.

If this country does not maintain the highest level of integrity in the accounting area, it will serve as a poor standard for others. Today's hearing is a start – but only a small start – in that effort.