

Corporate Accounting Congress and FASB Ignore Business Realities

by T. J. Rodgers

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Recent accounting scandals have cast a shadow over the credibility of corporate finances. As a consequence, companies are greatly increasing their efforts to ensure that financial reports are presented in an accurate and transparent manner to gain investor confidence.

Meanwhile, Congress has rushed to pass misguided legislation on financial reporting. New rules may also be issued by the Financial Accounting Standards Board, which sets the nation's "generally accepted accounting principles" (GAAP). For example, FASB is considering damaging changes to the treatment of stock options. Congress is also considering stock option legislation, with its eye set more on populist politics than on sound financial accounting.

New mandates threaten to move accounting further away from commonsense business reali-

ties. In recent years, flawed FASB rulings have led to the growth of alternative pro forma financial reporting in Silicon Valley. In fact, 74 percent of semiconductor companies now also report with pro forma financial statements because GAAP rules no longer provide an accurate measure of company performance for investors.

GAAP rules for mergers and acquisitions have caused particularly large misrepresentations of corporate finances. Further serious problems will be created for Silicon Valley companies if expensing of stock options is mandated. FASB and Congress must be more sensitive to the damage their rule making can cause to financial statement accuracy. If they are not, it will hurt the efficiency of the country's business and financial decisionmaking and weaken the powerful engine of free-market capitalism that propels the U.S. economy.

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Introduction

The Enron debacle and subsequent financial scandals have cast a shadow over the credibility of corporate America. As a consequence, companies are focusing more than ever on providing accurate and transparent information to investors. One would think that, in this new environment, my company, Cypress Semiconductor, would report exclusively with “generally accepted accounting principles,” or GAAP, as determined by the Financial Accounting Standards Board. But Cypress Semiconductor does not publish just GAAP financial statements. We also publish statements based on a pro forma standard, which more accurately reflect the real financial situation of our company. Indeed, a December 2001 PricewaterhouseCoopers survey found that 74 percent of semiconductor companies use pro forma accounting in addition to GAAP (the survey was completed by Raman Chitkara and Tye Thorson at PwC).

In the wake of recent corporate accounting scandals, FASB and Congress are considering adopting further damaging corporate finance rules. This report, which focuses on some of the current problems with FASB rules, discusses the tendency of rule-making bodies to adopt wrong-headed ideas by putting bad accounting theories ahead of business realities. In particular, the serious problems created by the FASB rules for mergers and acquisitions (M&As) are described. Also, the threat to Silicon Valley companies if FASB or Congress mandates the expensing of stock options is discussed. The paper provides other examples of how central planning of corporate finance went awry, such as Japan’s misguided attempt to control its credit markets.

Background: The CEO’s Job Is to Raise Shareholder Value

My job as CEO of Cypress Semiconductor can be boiled down to increasing shareholder value by raising Cypress’s earnings per share over the long term. That is done by creating and

producing profitable and high-quality products, which generate strong revenue growth. I believe in making profits the right way—by hiring good people to create innovative technologies and quality products at competitive costs. Short-term, profit-enhancing maneuvers, such as cutting research expenses to tidy up an income statement, are antithetical to raising earnings per share in the long term and should always be avoided.

When Cypress was founded, there were many naysayers. Jerry Sanders, then president of Advanced Micro Devices, which I had left to form Cypress, declared that there was no room for new start-ups because the semiconductor industry was consolidating toward a “Big Three,” like the car industry. Our first big customer, Digital Equipment Corporation, would not even talk to us during our first year because we were a start-up. But then AMD had to shut down one of its computer assembly lines because it lost the manufacturing recipe for a product that we also happened to make, a static random access memory, or SRAM. Cypress did not lose its SRAM recipe. As a result, we recorded our first significant revenue in 1984.

Just as Cypress took off, Japan began battering the American semiconductor industry. Semiconductor industry leaders whined, claiming unfair practices by the Japanese. But the reality, as I testified many times before Congress, was that the Japanese simply produced better products than we did at that time. Typical Japanese product quality in 1982 was about 50 defective parts per million shipped, while American quality was in the range of 1,000 or more defective parts per million. Just as American consumers embraced Toyota over General Motors in the 1970s, American engineers embraced Nippon Electric Corporation, Toshiba, and Hitachi chips over American chips in the 1980s. The president of NEC said at the time that he did not think smaller firms, such as Cypress, would make it in the new competitive environment.

Nonetheless, our industry fought its way through the Japanese quality wars. Despite four academic degrees, I had never been

taught the concepts of quality control. My tenure at two American semiconductor companies did not add much quality-control education either. When the Japanese quality attack threatened, our company hired experts and put together crash courses in quality education. Our quality level is now 25 defective parts per million, which is in line with other U.S. semiconductor firms. Last year Cypress surpassed NEC in revenues from our primary memory business, SRAMs. Indeed, we have surpassed all Japanese semiconductor companies in SRAMs and became number two in the world behind Korea's Samsung.

Our latest challenge is the communications revolution. The semiconductor industry is quickly moving away from its decades-long focus on the computer industry and toward the data-com industry and its arcane technologies. Again, Cypress faces a challenging learning curve. Because the semiconductor industry makes the bricks and mortar of every electronic system, a new electronic revolution requires us to move quickly to become experts in the new field.

To summarize, my job is to raise shareholder value by increasing our profits through revenue growth. We do that by constantly learning and innovating. Cypress continues to deliver profits to its investors, despite the best efforts of bigger companies, the Japanese quality challenge, and my having to get the equivalent of a new Ph.D. every five years to be able to understand the language of our customers.

That is why it is maddening when mandates that damage our business and distort our financial statements come down from FASB, Congress, and other authorities. Accounting rules and government mandates should not be put in the way of sound business decisions. Unfortunately, that happens all too often today, as with FASB rulings on M&As.

Mergers and Acquisitions: GAAP Rules Got It Wrong

What companies would risk deviating from GAAP accounting standards in the post-

Enron era? You can start with Intel, Advanced Micro Devices, Conexant, Fairchild, LSI Logic, Motorola, STMicroelectronics, Texas Instruments, and Cypress Semiconductor. In fact, a December 2001 PricewaterhouseCoopers survey by Raman Chitkara and Tye Thorson found that 74 percent of semiconductor companies issue pro forma earnings statements in addition to legally required GAAP statements. I will focus on the semiconductor industry, but this "GAAP exodus" has happened in other high-tech industries as well.

The primary event that caused most semiconductor companies to break ranks with GAAP-only accounting was the gradual elimination of the "pooling-of-interests," or "pooling," method of accounting for M&As beginning in 1998. (A final ban on pooling accounting came in 2001 with the issuance of FASB Statement 141.) Companies were forced to use the "purchase accounting" method for M&As, which had the effect of decimating the reported earnings of the acquiring companies with income statement expenses that did not reflect the reality of the acquisitions. After that change, investors and market analysts were forced to subtract the phantom purchase-accounting losses, known as "goodwill charges," before being able to compare current earnings to prior results.

Pooling Accounting: Simple and Accurate but Now Forbidden

Table 1 illustrates the pooling accounting rules for a merger of two hypothetical U.S. companies, ACO and BCO. Suppose they each have a 50 percent share of the U.S. market and their finances are identical. Now suppose that BCO is acquired by ACO in a one-for-one stock swap to form ABCO.

Under pooling accounting, the revenue and profit of ACO and BCO are simply added together to create ABCO. To pay for the acquisition, ACO issues 100 million new shares to the shareholders of BCO, and the combined share count of ABCO becomes 200 million shares. Since both the earnings and the share count double, the earnings per share remain constant. Assuming that shareholders value ABCO as they did ACO and BCO, ABCO's

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Table 1
Pooling Accounting Treatment of Hypothetical Acquisition of BCO by ACO

	ACO	BCO	ABCO
Revenue (millions)	\$1,000	\$1,000	\$2,000
Pretax profit (millions)	\$200	\$200	\$400
Shares outstanding (millions)	100	100	200
Profit per share	\$2.00	\$2.00	\$2.00
Share price	\$40.00	\$40.00	\$40.00
Market capitalization (millions)	\$4,000	\$4,000	\$8,000
Assets (millions)	\$2,000	\$2,000	\$4,000

share price would remain constant at \$40. With twice as much revenue and profit, and twice as many shares outstanding, the market capitalization of ABCO is simply the sum of the market capitalization of the two companies. This accounting treatment is simple, transparent, and straightforward—yet this accounting treatment is not allowed by FASB.

Purchase Accounting: Complex and Misleading

In contrast with pooling accounting, purchase accounting treatment of the same transaction creates a complicated and misleading result. This is a result of the FASB mandate that required creation of a fictitious “goodwill” amortization entry. FASB has now stepped back from requiring goodwill

amortization under Statement 142 issued in 2001, but the example is illustrative of problems that can be caused by bad rule making. (Instead of amortization, FASB now requires that goodwill be reviewed for “impairment,” another complicated financial process.)

Table 2 shows the purchase accounting rules for a merger of the two hypothetical companies. BCO’s goodwill is the difference between the market capitalization of BCO and the value of BCO’s assets. That is, goodwill is the market capitalization that cannot be accounted for by physical assets. The value of BCO’s goodwill jumps up and down with share price and is not reported in BCO’s GAAP financial statements.

With the acquisition of BCO, the \$2 billion of BCO’s goodwill is frozen in time—perhaps

Table 2
Purchase Accounting Treatment of Hypothetical Acquisition of BCO by ACO

	ACO	BCO	ABCO
Revenue (millions)	\$1,000	\$1,000	\$2,000
Goodwill amortization (millions)	—	—	(\$400)
Pretax profit (millions)	\$200	\$200	\$0
Shares outstanding (millions)	100	100	200
Profit per share	\$2.00	\$2.00	\$0.00
Share price	\$40.00	\$40.00	\$40.00
Market capitalization (millions)	\$4,000	\$4,000	\$8,000
Hard assets (millions)	\$2,000	\$2,000	\$4,000
Goodwill “assets” (millions)	—	—	\$2,000

Note: — indicates that no goodwill appeared on GAAP statements before merger.

at an unrealistic peak or trough—then forced onto the balance sheet of ABCO as an asset, despite the asset being a fiction and having no cash backing whatsoever. This goodwill “asset” is required to be amortized over a period of years, as if it were a piece of equipment. Assuming that the \$2 billion of BCO’s goodwill is amortized over a typical period of five years, ABCO’s earnings would be decimated with a “goodwill amortization” expense of \$400 million per year.

Therefore, purchase accounting that required a fictitious goodwill entry to be created would wipe out ABCO’s profits. ABCO would be a \$4 billion company that had no earnings. By contrast, under more accurate pooling accounting, ABCO is a \$4 billion company with \$400 million in earnings. Thus, pooling accounting better reflects reality since neither of the companies, ACO or BCO, actually became less profitable because of the paper shuffling involved in the acquisition.

Investors and Markets Reject GAAP Purchase Accounting

As discussed, purchase accounting with goodwill amortization requires that companies place a fictional asset on their books. In the example, the amortization of that asset over an arbitrary period zeros out ABCO’s earnings. FASB accounting theorists provide convoluted explanations of why a company making \$400 million per year of real profit would not report a \$400 million profit on GAAP financial statements. When common sense fails, the FASB high priests fall back on the religion of “accounting principles.” Yet those supposedly unassailable principles change every time the M&A rules are altered.

This departure from reporting reality, as exemplified by the creation of ABCO, is a key reason why companies and investors have moved to pro forma accounting. For example, all the dozen or so market analysts who review Cypress’s earnings exclude goodwill from their estimates. Analysts are not interested in GAAP financial statement fictions—they want to know our real earnings. Similarly, the investing public rewards us for

meeting our pro forma earnings estimates, not our GAAP estimates. A November 26, 2001, *BusinessWeek* cover story noted that “the numbers reached by applying generally accepted accounting principles (GAAP) are woefully inadequate when it comes to giving investors a good sense of a company’s prospects. Many institutional investors, most Wall Street analysts, and even many accountants say GAAP is irrelevant.” In summary, GAAP-based financial statements misrepresent the finances of Cypress and other companies, necessitating additional reporting of pro forma results.

Fallout from Bad GAAP Rules on M&As

In the past, M&As were less prevalent and usually confined to maturing industries undergoing consolidation. Today, M&As are a way of life in many industries. For example, Silicon Valley powerhouse Cisco Systems sets records for growth by using acquisition as a tool. Cisco has acquired dozens of companies, primarily to get access to talent and technology. That strategy allows Cisco to purchase whole research and development (R&D) teams with known successful projects, rather than build an R&D organization one hire at a time and risk project failure.

In this environment, technology companies must either make strategic acquisitions or fall behind competitors. Cypress made only 1 acquisition during its first decade of operation, but it has made 13 acquisitions in the past three years. The fuel driving our recent surge of acquisitions is the downturn of 2001. The downturn resulted in many good companies having trouble getting further rounds of venture financing. For Cypress, these companies represent a great opportunity to assimilate talent and technology. For the market as a whole, acquisitions allow good technology and talent to find new funding sources.

Here is where the problem with purchase accounting rules stands out. Many young companies we consider acquiring have few hard assets. Under purchase accounting rules with goodwill amortization, we are forced to write off almost the entire acquisition price

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Eighty-two percent of Cypress options granted every year are given to rank-and-file employees.

as an expense. As a consequence, it is quite possible that an acquisitive company may not be able to report a GAAP profit for years after a series of acquisitions, even if it is really making a substantial profit on a more accurate pro forma basis.

Accounting Rules Can Stand in the Way of Good Business Decisions

At an executive meeting in 1998, we discussed acquiring a start-up company with good people and great technology. At the time, the use of pooling accounting was beginning to be restricted. We could not find a way to structure the acquisition without triggering the punitive purchase accounting treatment. We nearly opted not to make the acquisition, which was highly favorable to our shareholders, because of punitive accounting. So sound business decisions may have been torpedoed in the name of "more transparent" financial accounting.

Our investment bankers said that we could solve the dilemma by using "synthetic pooling." That meant making the acquisition using purchase accounting, but with a new strategy. The strategy was not to optimize the purchase accounting treatment—that is, to minimize the impact of goodwill losses on the income statement—but to use purchase accounting at its punitive best, to deliberately create an ugly, large, goodwill hole in reported profits. The purpose was to highlight, not to hide, the inaccuracies of purchase accounting.

The investment bankers claimed that, if we used synthetic pooling, institutional investors, who hold 65 percent of our shares, would ignore the phony goodwill losses and give us credit for our real earnings. We studied several companies that had used synthetic pooling and greatly reduced their profits on paper. Investors had indeed ignored the goodwill charges. The companies maintained normal price/earnings ratios based on their pro forma profits, which eliminated

goodwill. The analysts who followed those companies also used pro forma earnings to provide accurate analysis.

Given our modest size and stature at the time, we were not willing to accompany the pioneers down the synthetic pooling trail. Nonetheless, we acquired the company and have suffered a goodwill expense on our GAAP earnings ever since, despite the fact that the company has been very profitable for us. Many semiconductor companies, and the analysts who follow them, have eliminated goodwill charges from their earnings estimates. Cypress finally joined the crowd and began reporting pro forma earnings when more than half of the semiconductor industry began doing so.

Political Grandstanding on Stock Options

Stock Options and Silicon Valley

Silicon Valley has set very high standards for creating value and treating employees well. At Cypress Semiconductor, our average San Jose employee earns \$107,000 a year in cash and benefits, which is quite typical of the industry. That average includes all our manufacturing workers and excludes our executive staff. Silicon Valley workers do not find it necessary to join unions because they are treated well and most are company shareholders.

Stock options add to worker compensation. Contrary to the political rhetoric about "fat-cat" stock options, 82 percent of Cypress options granted every year are given to rank-and-file employees. The other 18 percent go to our board of directors, our executive staff, and me. We invent the future and spread the wealth we create throughout the community. Why would anyone want to change that?

Yet some politicians and regulators seem intent on meddling with Silicon Valley's winning formula. In the mid-1990s, FASB tried to force the expensing of stock options on financial statements. That is, they proposed requiring companies to report a fictional expense when they granted stock options to

their employees. At the time, FASB came to Silicon Valley for a hearing on the topic, but they made it very clear their minds were made up prior to the meeting. FASB made a big mistake. San Jose, which usually cares more about electrons than elections, got mad and held political rallies. That time, the politicians listened to common sense and short-circuited FASB's proposal.

Unfortunately, the attacks on Silicon Valley and stock options are back, led by Sens. Carl Levin (D-Mich.) and John McCain (R-Ariz.). Senator Levin has openly attacked companies and stock options throughout his career and is currently sponsoring S. 1940 with Senator McCain. The legislation would push up the tax costs of granting options to employees, thus discouraging firms from offering them, particularly to rank-and-file employees. McCain, who garnered media accolades for his campaign finance "reforms," now wants to lead another populist charge. When I met McCain in his office, rather than being interested in a serious discussion about my proposals to eliminate corporate welfare, which he dismissed as "peanuts," he declared that "we are going to take away your big, fat stock options." But attacks on stock options, whether based on populist politics or flawed accounting theories, ignore the realities of running a successful high-tech company.

Stock Option Expensing Is Bad Economics

When a company raises money, it faces a choice between using debt or equity. If it chooses debt, its earnings per share go down because interest on the debt will reduce its earnings. If it chooses equity (raising money by selling stock) its earnings per share go down because of the greater number of outstanding shares, called "dilution." In competitive markets, the coupling between debt and equity financing is very tight. Often, the decision about which funding method to use boils down to a fraction of a percentage point in the cost of money. The bottom line is that companies either pay for raising money in the form of interest expenses on debt or they pay for

raising money by the dilution incurred from issuing shares. *They never pay both ways.*

But stock option legislation would force companies to pay both ways. Using the Enron episode as an excuse, Senators McCain and Levin have reintroduced their failed 1997 anti-stock-option legislation in the current Congress (S. 1940). Also, FASB is pushing hard to require stock option expensing, as it has in the past. That would force companies to incorrectly treat stock options as both an expense and a dilution. In other words, the use of employee stock options not only would reduce profits on an income statement but would further reduce earnings per share because of the increased share count.

Proposals to force stock option expensing are inconsistent with current accounting methods for other financial instruments. For example, our company raises money—about \$1 billion over the last 10 years—by selling a widely used security called a convertible debenture. A convertible debenture is a hybrid of equity and debt by which a company sells shares at a price above the current market price. Until a company delivers that higher share price, it treats this security as debt and pays interest. But once the security's "strike price" is reached, the company pays off the debt by issuing shares, as it would in an ordinary stock offering.

Securities and Exchange Commission rules for the financial reporting of convertible debentures require two calculations. In one calculation, the convertible debenture is not counted as debt, but the shares underlying the convertible debenture are counted as shares outstanding, thus diluting earnings per share. In the second calculation, the shares are ignored (there is no dilution), but the interest payments on the debt are taken as a loss. The SEC requires that companies with convertible debentures report the lower of the two results. *Thus, in a case directly comparable to stock options, the SEC requires that the stock options inherent in convertible debentures be treated either as a charge to earnings or as a dilution, but not both.*

If new mandates require companies to expense stock options, that will be another unrealistic charge against earnings, like the goodwill charges discussed above. I predict that

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both companies and analysts will ignore such a ruling on stock options in their pro forma reporting. (Intel has recently announced that it will not expense stock options but will continue to correctly report the effect of options on dilution.) If stock option expensing is mandated, GAAP will be driven another step away from being an accounting method that investors can use to measure companies accurately. It makes no business sense for Congress or FASB to create a new punitive rule for stock options. What they claim they are trying to “fix” is unrelated to improving the high-tech industry or the performance of the economy as a whole.

Business Reality vs. Political and Accounting Theology

Business Reality

Theology relates to ideas taken on faith, which are not required to be supported by reality. There is much theology in accounting, and even more in politics, so those professions are often disconnected from business. By contrast, business has a way of forcing people to deal with reality. Companies must produce what customers want, or they will be out of business. Employees demand regular paychecks. Investors expect firms to achieve earnings estimates. Everybody demands that companies operate ethically and lawfully.

The founding of Hewlett-Packard is regarded as the genesis of Silicon Valley. The postulates of the “HP way” are well-known as a humanistic form of management. Yet even the very first principle of the HP way stresses that the first order of business is to make a profit. Of course, making a profit the HP way involves innovation and treating people right, the hallmarks for which the company is known.

I submit to you that profit is the root of good, not evil. It is profit that enables Silicon Valley companies to pay their employees well, which allows them to support their families and communities. It is the profit-seeking environment that provides Silicon Valley workers

with exciting jobs that inspires them to engage in discovery and invention. Invention creates wealth. That wealth is then reinvested to stimulate further invention in a virtuous cycle. Yet regulators keep throwing wrenches into this incredible engine of prosperity, not for sound policy reasons, but because of the theologies of politicians and accountants.

Japan’s Economic Theology Ultimately Failed

The Japanese economy illustrates how business reality ultimately prevails over economic theology. Japan is a high-tech country, but its economy has been in a decade-long slump. The problem is that the Japanese government does not practice free-market capitalism at home, even though the Japanese claim that they support markets when they sell us their cars and TVs.

The economic theology of Japan is that a ruling group of the right men, from the right schools, with the right companies, with right company groups (called *keiretsu*), should have the unquestioned right to control the assets of the country.

By contrast, in this country the general public owns the assets. Indeed, U.S. shareowner capitalists can be rather brutal about it. Americans save money and invest it in the stock market, either directly or through 401(k) and other pension plans. When a 401(k) underperforms, the worker checks a box on a computer form to fire the 401(k) account manager with no warning and no mercy. That results in an investment firm having to dump some of the stocks that it holds. That could be Cypress stock. I’ve been fired like that. My net worth was cut in half in 30 days in 2001. I accept the public’s brutal decisiveness. Why should the college savings accounts of young people suffer to make me wealthier?

Americans invest in the stock market to get a better return than they could earn at a bank. Do you know where typical Japanese citizens invest their money? They invest in the Japanese post office at a very low interest rate (under 1 percent). Unlike Americans, they do not have the free-mar-

ket flexibility to fire a 401(k) manager. The Japanese government “protects” citizens from the complicated financial markets that Americans deal with—and they pay dearly for it. Meanwhile, the right men from the right companies enjoy financing at interest rates 10 times lower than ours. And the right men can underperform all they want, because no one is able to check a box on a computer form to fire them.

The anti-capitalist flaws in the Japanese economy took more than a decade to run the Japanese semiconductor industry into the stone wall of economic reality. At first, the nearly free money made Japanese companies very competitive. In our industry, 70 percent of the cost of a silicon chip is due to depreciation, the cost of the money we have invested in our factories. With the Japanese cost of money 10 times lower than ours, their chips automatically cost less than half of what ours do. That financial factor, and our industry’s quality problems, took its toll on the U.S. chip industry in the late 1980s, when Japan dominated the world semiconductor market. But the freer American financial markets have prevailed in the long term.

The Japanese economy fell ill as Japan’s economic belief system came into conflict with reality. Here is a hypothetical illustration of how it happened. A *keiretsu* bank lent the hypothetical Japanese semiconductor company JSEM \$1 billion to build its first wafer fabrication plant (Fab 1). That plant was optimized to give up capital productivity in return for better quality and higher human productivity. Why not? The capital was cheap, quality was an effective competitive weapon, and people were expensive. The enhanced financial competitiveness of Fab 1 was used, not to make extra profit, but to reduce prices to drive competitors out of the market. And it worked for a while—Japan took over the number one semiconductor market share position from the United States in 1986.

When it came time to build Fab 2, JSEM had no retained earnings because of its low-price strategy, so it borrowed \$1.5 billion more from the *keiretsu* bank to build a second capital-inefficient plant. JSEM then owed its *keiretsu* bank

\$2.5 billion but continued to seek market share rather than profits.

JSEM then planned Fab 3 at a cost of \$2 billion. But JSEM’s meager profits would not support the interest on \$4.5 billion of debt. Furthermore, since JSEM built its original Fab 1, American semiconductors had caught up in quality. Also, American plants—built with much less capital because of the high price of money in United States—had become more cost competitive than JSEM’s plants.

There were other problems for JSEM. Its *keiretsu* bank had lent too much money to too many companies that defaulted. The *keiretsu* bank ran out of money, and even the national bank of Japan had a liquidity crisis, which endures today. There were no more “free-money” loans to be had. Since 1993 the American semiconductor industry has been back solidly in first place. It had 51 percent market share in 2001, nearly double Japan’s 28 percent. Free markets worked; it just took a while.

In free markets, investors cold-heartedly select only the best investments. CEOs must be productive with investor capital or they will be fired with a check mark on a 401(k) form. Japan is often described as a capitalist country, but it certainly is not. Under Japan’s economic theocracy, ordinary citizens have little control over their savings—the ruling class makes the “right” decisions about how money is spent. This is central planning with capitalist camouflage. Unfortunately, when America engages in government-industry partnerships, corporate subsidies, tariffs, and heavy regulations, it engages in the same destructive practices that have devastated Japan’s economy and put the Soviet Union out of business. Americans who seek to mandate restrictive and erroneous accounting rules are heading down that path.

Should Businesses Build the Economy or Build Relations with Washington?

The people building businesses and creating innovation in Silicon Valley have generally ignored the theologians in Washington. They are instead consumed by increasing their knowledge and pushing back techno-

The Japanese government “protects” citizens from the complicated financial markets that Americans deal with—and they pay dearly for it.

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logical frontiers. A conflict ignites only when companies are threatened by destructive new ideas from Washington; or Sacramento; or Norwalk, Connecticut—the home of FASB.

When attacked by Washington, American companies split into two camps. One group includes most Silicon Valley companies. The other group is made up of politically correct businesses that subscribe to the theology of the day. The latter group believes the government should subsidize R&D and put tariffs on foreign competitors to keep us healthy. They also believe that CEOs need \$30 million jets to be efficient and that top managers need \$20 million severance agreements. Do you see some of the Fortune 100 here?

Consider Bethlehem Steel, the company that just helped convince President Bush to put a punitive 30 percent tariff on imported steel. The sad story of Bethlehem Steel is outlined by Professor Jim Collins in his new book, *Good to Great*. Bethlehem executives spent their energies building a luxury office tower in an X shape to maximize corner offices, golfed on the executive course, and showered according to their pecking order in the hierarchy. Meanwhile, other steel companies went about building newer, more efficient steel mills and responding to the marketplace. Bethlehem's newest set of tariff training wheels will simply prevent the company from learning how to pedal unassisted.

In the reality-theology debates, the sad fact is that, despite their pro-capitalist rhetoric, many American CEOs are not free marketers at all. When a new attack on free markets comes from Washington, they don't see it as an attack on the basic process of wealth creation to be resisted with vigor. Instead, they see it as an opportunity to gain some legislative advantage, and they put their lobbyists to work to hunt for gold.

I am happy to say that the semiconductor industry mostly lines up on the free-market side and eschews government "help." The Semiconductor Industry Association, our trade organization, has a policy of not soliciting government handouts. That policy was initiated in 1996, when the partly govern-

ment-funded research consortium, Sematech, returned to Washington an unused \$200 million government grant given to the consortium after the Japanese onslaught. The industry does not want government handouts, but it also does not want government to push bad accounting and finance rules on it.

In Search of Accurate Financial Statements

Forcing Goodwill onto Balance Sheets Is Central Planning

By 2000 it was clear that the mandate regarding purchase accounting for M&As was not working, as judged by the GAAP exodus. The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on June 14 to address the problem. I testified at that hearing, which was classic politics: The purpose seemed to be to show that FASB had been right about the accounting change all along, but at the same time the board sought to change the rules again to reverse the GAAP exodus.

Under the new procedure, goodwill from an acquisition would still be put on the balance sheet, but the requirement to amortize it—the rule that caused fictitious losses—would be eliminated. Ultimately, FASB stepped back from requiring goodwill amortization under Statement 142 issued in 2001. It now requires goodwill to be reviewed for "impairment," a process in which each goodwill entry on a company's balance sheet is reevaluated every year. Unfortunately, our industry has not come back into the GAAP camp because the new rules have not fixed other GAAP problems.

The Senate hearing was a menagerie that amply demonstrated that Washington could not be a neutral arbiter of corporate finance issues. All sorts of "entrepreneurs" who seemed to want something from government testified. Each had an angle on how to make money from the new accounting scheme. An investment banker testified on how his industry would be needed for the new impairment testing procedure. (I started to have visions of

\$1 million invoices for those new outside “services.”) A commercial banker testified that goodwill could be an asset to secure a loan. He was either irrational or saw an opportunity to get 15 percent interest on junk collateral. There was also the testimony of accountants and securities lawyers who saw an opportunity to profit from the new rule.

I used the forum to present a bigger and more powerful investor rights concept. I argued that mandating that goodwill be put on balance sheets is not just an accounting distortion; it is fundamentally wrong because it allows the government to take control of private property. Think about what the abstract term “goodwill” represents. It is the difference between the market capitalization of a company and the value of its hard assets. It is the value that shareholders give to companies for being more than just bricks and mortar.

My company has market capitalization of \$2.5 billion and assets of \$1 billion. Our shareholders have therefore awarded us—for our company’s knowledge, talent, and technologies—a premium of \$1.5 billion. That is a private, free-market transaction between our 77,033 shareholders and us. It is the bonus that they have given us for our performance. We are proud of the goodwill value we have earned from our shareholders. No government agency should try to distort that voluntary market transaction.

Sometimes investors get the value of companies totally wrong. But people must have the right to make bad decisions and lose money as a result. Without that freedom, people will not correct their bad behavior. The dot.com boom spawned three companies that sold pet food over the Internet. They had almost no assets, but their market capitalization, and hence goodwill value, was sky high. Then people discovered that pet food was expensive to ship and simpler to buy at the supermarket. The demise of those and other dot.com companies reminded investors that ownership and control of goodwill also carry the responsibility to disperse goodwill carefully.

At Cypress our shareholders have awarded

us an extra \$1.5 billion over our asset value for doing a good job. Suppose General Electric acquired Cypress and asked me to run Cypress as a GE subsidiary. GE shareholders should value the acquisition for themselves, by setting GE’s share price and hence goodwill value after the acquisition. Should they set GE’s postacquisition share price to reflect only Cypress’s acquired assets? Or should they reflect the whole Cypress acquisition price in GE’s share price? Or should they give GE an even higher share price to reflect the fact that Cypress fills a strategic gap in GE’s technology portfolio? Those decisions belong to GE shareholders.

In other words, GE shareholders should “vote” in the free market to add or subtract goodwill value from GE’s share price. But under either the old or the patched FASB rules, the goodwill value of GE’s hypothetical Cypress acquisition would be confiscated from GE shareholders. The old book-and-amortize rule creates a preposterous result, such that GE’s shareholders are told: “You don’t get to value Cypress’s goodwill. We will seize it and put it on GE’s balance sheet and then depreciate its value to zero.” Under the new book-but-don’t-amortize rule, GE shareholders are told: “You don’t get to value Cypress’s goodwill. We will force GE to hire an investment banker to value it for you on a yearly basis.” This smacks of a centrally controlled economy.

Unfortunately, my Senate testimony on goodwill and investor rights was ignored, and we now have a cottage industry “helping” us manage our goodwill “assets.” I even tried to get the SEC to listen to my goodwill-belongs-to-the-shareholders pitch. Arthur Levitt, then head of the SEC, agreed to hear me. Although Levitt was touted as a champion of shareholders, he told me that his hands were tied since the SEC just followed the rules set by FASB. (Even a Washington outsider like me realized that this claim was not true but was simply a polite dismissal.)

Rule Makers Put Numerous Fictions on Financial Statements

When the new book-but-don’t-amortize rules for goodwill took effect, I hoped that my

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Many of the so-called assets on the balance sheets of major corporations today are accounting fictions.

company could return to GAAP-only accounting. I would like nothing better than to report our quarterly results in a single, standard format. But the new rule has not fixed the problem of distorted earnings reports.

The problem is that there are ways other than using goodwill to account for the value of a company beyond its tangible assets. Other accounting fictions such as “in-process technology,” “existing technology,” “license value,” and “noncompete contracts” can be put on the books as phony assets, instead of goodwill. Each theoretical “asset” has its own different, convoluted accounting rules. Acquiring companies tend to divide up their goodwill problem into multiple categories to optimize their specific finances. The stock market, not accounting mandates, should be valuing these items.

The new FASB rule fixed only the goodwill part of the problem. Phony expenses resulting from other junk on the balance sheet still decimate otherwise healthy earnings statements. All this should make investors start to wonder how real their GAAP reports can be when less than half of many firms’ reported assets are cash or real property.

Consequently, the semiconductor industry and the analysts who follow it did not accept the book-but-don’t-amortize olive branch extended by FASB because it did not fix other earnings statement distortions. Furthermore, the GAAP vs. pro forma accounting issue cannot be put to rest until we have resolved whether or not GAAP will require the expensing of stock options. If new bad stock option rules are mandated, many high-technology companies will never make a profit—at least according to GAAP.

Top Accountant Supports Reality-Based Financial Statements

Recently, I wrote an editorial for the *Wall Street Journal* attacking the proposed McCain-Levin stock option legislation. In response, I received an e-mail from Walter Schuetze, a former chief accountant of the SEC. He supported my position, but not as a fervent defender of stock options. Rather, he is a fervent defender of the integrity of balance sheets.

The financial reporting problems I have discussed all involve distorting balance sheets with assets that do not have any hard backing. What do you do with “goodwill” or “noncompete contracts” if you are awarded such assets in a bankruptcy?

Schuetze, a logical and plain-spoken Texan, told me what ought to be reported as assets on a balance sheet:

I think that we should define assets by reference to real things, not abstractions. I think that we should define assets as follows: Cash, claims to cash, for example, accounts and notes receivable, and things that can be sold for cash, for example, a truck.

I think a balance sheet meeting his criterion would be easier for shareholders to understand. However, FASB does not. Indeed, many of the so-called assets on the balance sheets of major corporations today are accounting fictions, rather than cash or saleable assets. As a result, it is difficult to glean solid information from many financial reports, thanks to FASB and the SEC. Schuetze concluded: “I think FASB and the SEC have done a terrible job on reporting. The financial reports today are almost unreadable.”

Conclusion

Many corporate accounting issues are complex and require thoughtful solutions by the marketplace and the accounting profession. But we must first demand that the rule makers take the Hippocratic oath and “do no harm.” FASB and Congress should swear that oath, particularly with regard to stock options. Stock options helped build Silicon Valley. Thus, tampering with them is foolhardy. Besides, stock options are already properly accounted for in earnings-per-share reporting, as part of the “per share” calculation.

Mistakes in judgment by companies, investors, and whole industries will be corrected by the free market. Corrections may take time, as in the case of the dot.com bub-

ble, but economic reality eventually penalizes bad ideas and badly run companies. Good employees and customers will leave if a firm's top management spends its time partying on the corporate jet while letting company performance tank. It is true that some arrogant CEOs in poorly managed companies overpay themselves, sometimes breathtakingly so. But it is misguided to try to "correct" narrow abuses by new mandates that will hurt the majority of companies in Silicon Valley.

Besides, many free-market corrections are already taking place. *USA Today* reported on June 10 that we are in a period of record CEO sackings, two per day in America's public corporations. The replacement CEOs surely know that they must run a tight ship or face the same fate as their predecessors. Meanwhile, auditors are becoming more diligent to avoid becoming the next Arthur Andersen.

Ultimately, shareholders are the best check on poorly performing corporate managers. Today, shareholders are poring through the fine print in financial reports as never before. Shareholders of public companies have the right, through yearly

proxy votes, to fire boards of directors, remove CEOs from boards of directors, and remove non-independent directors from boards. In due course, shareholders will exercise their rights and corporations will improve their performance.

Corporate accounting needs reform, but not in the direction that FASB and Congress are moving. Instead, GAAP needs to be reformed to remove the balance sheet fictions that I discussed. The goal should be to bring transparency and accuracy back to financial statements. If such changes are made, many of the semiconductor industry's objections to GAAP accounting will go away, and high-tech firms with pro forma financial statements will return to the GAAP fold.

If GAAP accounting is not reformed, then an alternate solution will be to establish a new "seal of approval" for financial statements—perhaps a pro forma accounting standards board, or PASB. That would inject some healthy competition into the current monopoly of regulation under the federal government and FASB and allow markets and investors to gravitate toward the best standards.

GAAP needs to be reformed to remove the balance sheet fictions and bring transparency and accuracy back to financial statements.