

June 19, 2003
HEARD ON THE STREET

Freddie Restatement May Be Big

**Earnings Could Rise by \$1 Billion to \$3 Billion,
 But Future Net Would Decline by Same Amount**

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Freddie Mac, facing government and investor scrutiny over its accounting, could restate its earnings by between \$1 billion and \$3 billion, according to people familiar with the matter.

The move, mortgage specialists say, would boost Freddie Mac's bottom line for the past two or three years, but reduce net income by the same amount during the next several years.

The McLean, Va., federal government-chartered mortgage company, which recently ousted three of its top executives, in January said it would restate earnings for as many as the past three years after the company's new accountant, PricewaterhouseCoopers, raised questions about past accounting procedures. So far, the company has said the restatement is "material" and likely to boost past earnings and capital, while likely reducing future earnings. But it hasn't provided specific estimates of the restatement's impact.

However, a former executive at the company said the restatement would boost earnings about \$3 billion. Another person familiar with the restatement, meanwhile, said it would be a "big number" that would boost earnings by "more than" \$1 billion. The individuals are in contact with current leadership of the company.

Speculation about the amount of money involved in Freddie Mac's restatement has been one of the hottest topics on Wall Street during recent days. The billions of dollars potentially at the heart of the matter are believed to be tied in part to the company's extensive use of financial contracts known as derivatives. Freddie Mac, one of the nation's heaviest users of these contracts, says it uses them to offset the risk it faces from changing interest rates and the impact on its assets and funding costs. Executives in the mortgage industry say a restatement that runs into the billions of dollars is logical given the size of Freddie Mac's business and the types of financial hedging it does.

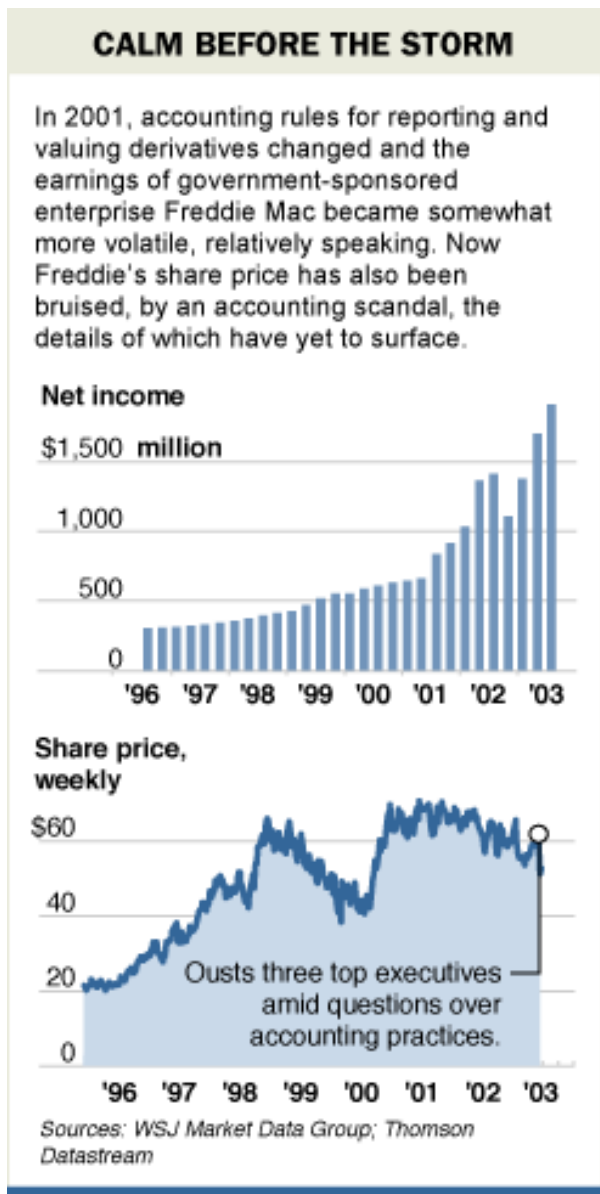
A Freddie Mac spokesman said the company wouldn't comment until it completes its restatement by the end of the third quarter. "As we have consistently stated since January, Freddie Mac expects that the likely cumulative effect of the restatements will be to materially increase the reported levels of [generally accepted accounting principles] earnings for prior periods," company spokesman David Palombi said. "When we have

FREDDIE MAC'S ILLS

Q and A:¹ Finding Answers to Explain Issues Freddie Mac Faces

Plus, **some terms**² that are getting extra attention as investors try to understand the controversy at Freddie Mac.

information we can share with the markets with confidence, we will do that. Any speculation by Freddie Mac prior to that would be inappropriate."



According to past company news releases, Freddie Mac earned \$5.76 billion in 2002 and \$4.15 billion in 2001.

It isn't clear if Wall Street analysts would reduce their earnings estimates for the company even if the restatement has the effect of reducing future earnings as much as \$3 billion. The reason: Analysts and investors may end up viewing the adjustments as some kind of one-time occurrence, focusing instead on underlying economics some analysts don't see as being jeopardized.

Indeed, some analysts say they believe the company's earnings might suffer little or not at all if the housing market continues to boom, offsetting any earnings taken away by the restatement. Also, earnings could be affected positively by other changes in accounting that may be under consideration.

Analysts said the company's accounting problems don't appear to result from the kind of cooked-up earnings that troubled Enron Corp., among other onetime stock-market darlings that have crashed to amid accounting irregularities. That is because one of the accounting issues tied to the use of financial derivatives appears to be a question of when the company should have booked legitimate gains that it gets from certain of the transactions used to hedge interest-rate risk. Freddie Mac shares fell 16% June 9, when the executive departures were announced, though they have gained 3.5% since.

Either way, investors appear to be growing increasingly impatient with the timing of the company's restatement and what they perceive to be a lack of clear information flowing from the company. Paul Miller, an analyst at investment-banking firm Friedman, Billings, Ramsey Group Inc. in Arlington, Va., said a figure of \$3 billion has been circulating widely in financial circles in recent days, but he said he hasn't been able to determine if the number is correct. "The issue is that Freddie has not given us clear visibility," he said, instead limiting comments to the expectation the change would be "material." "They have stuck by that like I've never seen any company stick by" its statements, he said.

Political leaders also are concerned. Rep. Cliff Stearns, a Florida Republican, said his House Commerce subcommittee will hold a hearing as soon as next week on Freddie Mac and its derivatives accounting. Rep. Edward Markey, a Massachusetts Democrat, said "if Freddie Mac ends up restating its earnings for the last three years due to problems with its accounting for derivatives, this logically will affect reported earnings in future years."

One of the people familiar with the discussions about the restatement said he has heard a figure of \$3 billion within the past couple of months from three sources, including a current company officer as well as a board member. They typically have used the figure in a hypothetical context. "They've all said, 'Let's say it's \$3 billion,'" the person said. But the implication has been that that is roughly the amount the company must shift from current and future years into the past, this person said.

The greatest impact of such a change likely would be felt in the company's earnings during the next three to four years, the person added. Given Freddie Mac's recent and projected earnings, that would equate to just below 20% a year, or a "substantial" hit, the person said.

The other person familiar with the discussions who said he has been in contact with people at the company who were knowledgeable about recent developments -- said the restatement "is going to be a substantial number." The person also said there is some concern at Freddie Mac that the stronger-than-stated past earnings would "raise the bar" for management, in terms of earnings growth.

The derivatives used by Freddie Mac can generate considerable gains. In the past, when Arthur Andersen LLP was the company's auditor, the company chose to spread those gains across a number of years. That had the benefit of smoothing out the company's earnings, preventing them from gyrating wildly from quarter to quarter.

After PricewaterhouseCoopers succeeded Andersen in early 2002, the auditors concluded at least one hedging derivative frequently used by Freddie Mac didn't qualify as a hedge for accounting purposes, according to the company and other people familiar with the situation. The reasoning was largely technical -- the derivative was "synthetic" and therefore involved several separate transactions.

The result: The derivative didn't qualify for the type of accounting that would allow the gains to be spread out over time. That meant the gains and losses had to be booked right away.

Just how much that kind of transaction contributed to the company's accounting problems remains unclear. In January, the company said it had identified at least two issues that called for a restatement. But during a conference call following the recent management shake-up, new Chief Executive Greg Parseghian said the company had uncovered additional issues.

Fannie Mae, the other giant government-chartered mortgage company, also employs an array of hedges designed to achieve the same goal of protecting the company against swings in interest rates. However, the company said it doesn't employ the same type of hedge used by Freddie Mac because it doesn't qualify for the accounting treatment that allows the gains or losses to be spread out over time.

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