

The Current Pace and Direction of Accounting Standard Setting

A White Paper of the

AMERICAN **BANKERS** ASSOCIATION

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Summary

Various high profile groups have studied the financial crisis and its root causes. In each case, accounting standards, while not being cited as causing the crisis, have been cited for improvement. Fair value accounting (“FV”, also called “mark-to-market accounting” or “MTM”) and reserving for credit losses are accounting standards that are most often cited (particularly relating to pro-cyclicality), along with off-balance sheet vehicles.

Both the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) are addressing these issues (See Appendix B). The rapid paces at which both organizations are working, as well as the directions in which they are heading, are causing some to question whether there is due process in evaluating these important issues. Some bankers also question whether such efforts are driven by a search for simplicity, transparency, and accuracy or by an appetite to expand fair value accounting, no matter the implications.

One banker described the paths being taken by the FASB and IASB as representing “the most significant accounting changes we have ever experienced.” Although we agree that change is urgently needed, the FASB and IASB direction may cause significant disruption. Rule-makers must be very careful in this effort to ensure that any changes: 1) represent solid and meaningful change that is valuable to financial statement users; 2) focus on the business models used by banking and other financial institutions, and 3) can be implemented and maintained at a reasonable cost.

A major concern is that the current directions in which the FASB and IASB are moving appear to be similarly requiring more MTM within the financial statements, more capital for many existing banking activities, and more operational challenges to comply with these rules for banks of all sizes. The cost of accounting compliance puts continued participation in certain market activities at risk for some smaller institutions.

Another concern is the current divergence between the FASB and IASB proposed models and time frames for completion. The IASB plans to finalize a significant part¹ of its financial instruments accounting standard in 2009, and the FASB’s completion date will be subsequent to that date. In such case, U.S. GAAP will have only one of two choices: (1) to follow the IASB model – which will not provide U.S. companies with appropriate “due process” for providing input, or (2) a lack of international convergence – which should be avoided. Also related to this is that both groups appear to be solving the accounting puzzle on a piecemeal basis, which may result in pre-determining the outcome for subsequent parts of the puzzle that do not fit.

We recognize that the FASB and IASB are under some pressure to finalize their rules quickly; however, we do not believe this should be at the expense of undermining the foundations of financial reporting. It is extremely important that these new standards be developed jointly by the

¹ The first part will include classification, measurement, and impairment, though methods of impairment accounting are not included in the exposure draft that has been issued. Hedge accounting is also part of the financial instruments project; however it will be considered subsequent to these changes.

FASB and IASB, with proper due process and open consultation with a wide range of constituents that ensures a holistic review.

Discussion

The financial crisis, which started in 2007, has led a number of groups to provide recommendations that they believe would decrease the risks of a future crisis. The G-20, the Financial Stability Forum, Group of Thirty, and the United States Treasury Department each have provided commentary on the necessity for changes in accounting standards.²

In its 2008 annual report, the FASB agreed that "...the financial crisis has revealed a number of significant deficiencies and points of stress in current accounting standards..." In response to some of the studies and concerns expressed during the crisis regarding accounting for financial instruments, both the IASB and FASB agreed to re-examine certain financial instrument accounting rules. These projects were given high priority, partially due to the reports noted above, and were put on a fast track – significantly faster than any major project previously completed.

In this regard, IASB and FASB have addressed, or are addressing, these critical issues in the manner as shown on the following table.

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Financial Instruments: To simplify how loans and securities are measured (MTM, or amortized cost) and whether changes in MTM affect earnings.			
Depending on the financial instrument and circumstance of the purchase, there are currently several different ways to account for a loan or security is accounted.	Exposure draft due in first half of 2010. Final statement timing to be determined.	Exposure draft has been issued. Final decision expected in 2009 and effective in 2012.	Both proposals may result in a greater use of changes in MTM recorded through earnings.
The rule-makers' current view is to reduce the number of accounting options to two: MTM and amortized cost.	May require more securities to have changes in MTM recorded through earnings.	Certain commonly held securities will now have changes in MTM recorded through earnings.	FASB increases the use of MTM to determine "Tangible Common Equity." IASB may increase the use of MTM for determining income.

² Appendix A contains excerpts from reports issued by key organizations and their references to accounting standards.

Other Comprehensive Income (“OCI” for MTM changes not recognized through earnings) prominently displayed on income statement, below net income.

Increased MTM usage promotes pro-cyclicality.

Heightened profile of OCI below the income statement will increase emphasis of MTM.

Financial Instruments: Impairment (Reserving for losses)

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Current accounting requires loss reserves only for those events that have already been “incurred”. Recommendations have been made to provide for “forward looking” or “expected” losses.	Exposure draft due in late 2009. Final statement timing to be determined. Implementation expected after 2009.	Request for Information has been issued. Exposure draft expected in October. Final statement expected prior to year-end 2009, for implementation in 2009.	Estimating expected losses is in line with recommendations by the study groups. The question is whether cash flow estimates will be operational.
	Greater use of expected losses is being discussed and estimating cash flows as of financial statement date.	Greater use of expected losses as the basis for reserves. Preference is for continuous cash flow estimates.	Expected cash flow estimates are much more cumbersome compared to the current incurred loss estimates or expected loss estimates. Current processes for most loans do not estimate specific timing on losses.

Financial Instruments: Hedge accounting for derivatives

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Simplify how hedge accounting may be used in order to better match MTM swings from derivatives used for hedging purposes with the instruments being hedged.	Exposure draft expected in early 2010. Objective is to simplify when hedge accounting can be used and how it is recorded.	Same as FASB. Same as FASB.	Project is expected to result in less onerous rules when hedge accounting is used. However, it may result in fewer situations where hedge accounting may be used.

Off-Balance Sheet Items: Securitizations, sales accounting and consolidations of variable interest entities

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Loans that were securitized and often sold to third parties in securitized form are expected to be recorded back on bank balance sheets.	Final Statements 166/167 issued (6/09) for 2010 effective date.	Exposure draft outstanding. Final Statement expected in 2010 for 2011 effective date.	Increase in loans on the balance sheet may increase required regulatory capital. This is expected to stifle attempts to restore the securitization market, since banks will require significantly more capital to engage in these activities.
While these amounts were disclosed in notes to the financial statements and losses reserved for credit guarantees, investors previously felt confused on the exposure a company assumed.			

Off-balance Sheet Items: "Operating Lease" assets and liabilities

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Contracts that are not in substance a purchase of property will now have an asset and liability recorded on the balance sheet.	Preliminary Views Document issued. Final Statement is expected in late 2010 for 2012 effective date.	Same as FASB.	Increase in assets may increase required regulatory capital. This also may increase local property taxes, depending on how jurisdictions treat capitalized leases.
Currently, such leasing commitments are disclosed in the notes of the financial statements and not recorded as assets or liabilities.			Current rule-makers' views are to increase rent expenses over the earlier years of the contract, which would also decrease capital of financial institutions.

Rule-makers Appear to be Furthering Mark to Market (MTM)

In recent years, some board and staff members of the IASB and FASB have voiced their preference and goal that all financial instruments be subject to MTM.³ MTM, however, has been the subject of significant criticism over many years⁴ and especially during this financial crisis. One criticism of MTM is its procyclical nature: loan and security market losses caused by credit concerns unnecessarily erode capital,⁵ causing further lending to be restrained, stifling economic growth and increasing unemployment, ultimately resulting in borrower defaults, which triggers the cycle again.

While it has been generally accepted that MTM promotes procyclicality, and both the Group of Thirty and the Financial Stability Forum recommended policies that guard against procyclicality, both the IASB and FASB have indicated directions that will further *promote* the use of MTM (See table above). These include:

- The company's business model appears to no longer be the primary factor in how a financial instrument is measured, resulting in the likelihood that more financial instruments will be subject to MTM.⁶
- Specific commonly-held instruments, such as impaired loans acquired through a merger and non-senior classes of a private label collateralized debt obligation, are targeted for MTM accounting, with fair value changes recorded through earnings.
- In considering how to value impairment of assets that are accounted for at amortized cost, the views of both boards appear to exclusively focus on requiring companies to estimate the amount and specific timing of all cash flows. This is somewhat similar to MTM, depending upon what discount rate is required in calculating the present value of expected cash flows.⁷
- Under both the IASB's and the FASB's approaches, MTM would be required for more assets than currently required. The FASB would require fair value for all financial instruments, and the IASB would not go that far; the FASB would require more MTM changes to reported in equity than would the IASB.

In addition to the issues addressed above that appear to require more capital, requiring an expansion of MTM presents onerous operational challenges to banking institutions. For example, in today's illiquid markets, securities that were acquired as AAA-rated may now be required to have external consultants to perform modeled valuations. These valuations are often performed for fees

³ FASB noted in its accounting standard on hedging activities (SFAS 133): "The Board believes fair values for financial assets and liabilities provide more relevant and understandable information than cost or cost-based measures."

⁴ ABA's first white paper on MTM was written June, 1990.

⁵ New accounting rules approved in April 2009 provide that bank regulatory capital is affected only by the expected credit losses in a debt security. Tangible Common Equity, which includes market losses, was not affected by these rule changes.

⁶ The Basel Accounting Task Force, in a meeting with the International Banking Federation Accounting Working Group (June 2009), expressed concern about abandoning the business model approach.

⁷ In a fair value calculation, a "market" discount rate is applied to the cash flows. Proposed discount rates by the IASB indicate the effective rate of the instrument at the time of purchase. Such rates are normally different from a market rate, but the calculation is significantly different from the current "incurred loss" approach that does not directly regard timing of the cash flows.

exceeding \$3,000 per security. Expansion of such requirements put into question whether the costs are worth the benefits. Additionally, it raises the concern about whether community banks can afford to continue to invest in these markets.⁸

Due Process Appears to be Compromised

The FASB and the IASB are moving on similar projects (joint projects), but with different solutions, at different speeds and with different timing for finalizing their rules. With the difference in pace and the degree of change being discussed, there is the concern that due process is insufficient. This concern about lack of due process can be described in two parts:

- Time period for evaluating the proposals – Certain types of changes to accounting rules require more time for financial statement preparers to evaluate the implications of implementation. For example, current accounting rules regarding MTM were issued in 1994 after many years of discussion and due diligence. Those rules focused solely on debt and equity securities rather than today’s discussion, which centers on all financial instruments – effectively a totally new model for financial institution accounting. Field testing of major changes, commonly performed in the past, and open coordination with banking regulators are both critical and time consuming; however, to date, these important due process procedures do not appear to be a part of the standards-setters’ plans.
- International convergence – The differences in timing between the FASB and IASB are likely to result in a lack of due process or a lack of international convergence, neither of which conforms to the expectations of the study groups above or the investing community. For example, if the IASB finalizes its rule on accounting for loans and debt securities prior to the FASB finalizing its rule, the FASB will likely have only two choices: (a) to adopt the IASB’s rules (which does not provide due process in the U.S.), or (b) to adopt a different rule (which would result in divergence between U.S. GAAP and international rules).

While FASB generally adheres to an eight step process (See Appendix C), the IASB’s intention to issue its final rule by the end of 2009 puts into question whether a thoughtful deliberation is possible by the boards and by users and preparers whose input is critical. Such quick work is indeed possible and the accounting standards being proposed may sound simple. However, the changes that are anticipated are the most significant ever to be presented and appear to represent radical departures from how accountants have historically viewed the theory behind financial instruments accounting.⁹

While FASB is not required to accept any decisions made by IASB, the Securities and Exchange Commission, FASB, and IASB have been working toward convergence for several years. This convergence effort by the two boards (and the allusion to such convergence in the G-20 report)

⁸ The issue of costs for third party verifications is expected to be exacerbated if loans are required to be marked to market.

⁹ Historically, classification and measurement of assets has been determined based first on the business model of the organization (also sometimes referred to as “management intent”). The IASB proposal considers first the complexity of the product and only considers business model afterward in order to determine if the instrument should be accounted for by MTM with changes in MTM recorded through earnings. The default measurement under current FASB proposals is MTM recorded through earnings.

ensures that IASB actions will be given extra credence during the FASB's deliberations. This is why such action by the IASB is of great concern to U.S. companies.

As noted in our letter to the FASB and IASB (dated August 4, 2009), a costs versus benefits analysis is critical. The sheer volume of change being discussed will be expensive, and the boards must make every effort to ensure that banking institution shareholders will receive benefits relative to the costs of providing new or different information.

Due Process Must Be Coordinated with Regulators

Coordination with regulators on any change relating to these topics is necessary for orderly market transition in understanding the new financial information. This is indicated through the Group of Thirty's recommendation regarding off-balance sheet vehicles "that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets."

With that in mind, ABA had requested that the banking agencies provide regulatory guidance at the time of the release of new FASB rules on securitizations and consolidations (FASB Statements of Financial Accounting Standards No. 166 and 167). These new rules, which are expected to significantly increase regulatory capital requirements for entities that securitize assets, puts into question whether such coordination was performed. While some are still digesting the rules and continue to question the logic used in the rules, as of this date, banks have not been notified as to how to react to these new requirements from a regulatory capital perspective. The restoration of securitized credit markets may be delayed further because of these new rules and the lack of information about the regulatory impact.

While one could say that this is a regulatory capital issue and not an accounting issue, the FASB issuance also was not coordinated with the IASB, which has a similar project currently underway. Delaying the issuance of these statements until a truly unified, international standard could be developed had been recommended by a number of respondents during the standard setting process. Vast disclosures had been newly required only six months prior to the issuance of these final accounting standards. Thus, transparency of the risk of such securitization structures, the main concern addressed by the newly-issued statements, had been provided.

Why the Rush to Issue these Rules?

Some have noted that demands from the SEC, which may have received pressure from members of Congress, has resulted in FASB's quick issuance of its securitization and consolidation rules – even though it may result in a lack of convergence with international standards and may throw a monkey wrench into recovery.

Similarly, some have indicated that the G-20 recommendation has resulted in pressure on the IASB to finalize its rules on loan and debt security accounting before year-end 2009 – even though it may result in a lack of convergence with U.S. GAAP. However, bankers question whether the massive changes being contemplated by the IASB and FASB were truly contemplated by those requesting quick action. Given the possible consequences upon all financial services industries, bankers believe a more deliberate discussion among these groups, financial statement users, regulators and preparers be conducted to identify what degree of change is needed. For instance, confusion over the mere

terms “transparency” and “fair value” can have unintentional adverse repercussions and result in missing a more reasonable repair of current standards.

Additionally, as noted in our letter to the FASB and IASB (dated August 4, 2009), the following points should also be considered when making substantial changes to the accounting model:

- Serious consideration must be given to field testing proposals prior to implementation, and sufficient transition time must be provided.
- Regulatory accounting rules should be consistent with GAAP.
- Accounting changes must meet a “costs vs. benefits” test.

Conclusion

It is time to pause to determine whether the accounting rule-making process is working the way that these major groups have intended. Due process, the emphasis being placed on MTM (when MTM seems to be a source of procyclicality and has proven to be difficult to estimate), and overall coordination and convergence should be reconsidered. The goal should be improving the current accounting rules that are in need of repair within a time frame that provides for due process and permits international convergence in a prudent manner.

Appendix A: Accounting Recommendations from Key Organizations

The G-20¹⁰

Declaration on Strengthening the Financial System, London Summit 2 April 2009

We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons, while reaffirming the framework of fair value accounting. We also welcome the FSF (Financial Stability Forum) recommendations on procyclicality that address accounting issues. We have agreed that accounting standard setters should take action by the end of 2009 to:

- reduce the complexity of accounting standards for financial instruments;
- strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information:
- improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty;
- achieve clarity and consistency in the application of valuation standards internationally, working with supervisors;
- make significant progress towards a single set of high quality global accounting standards; and,
- within the framework of the independent accounting standard setting process, improve involvement of stakeholders, including prudential regulators and emerging markets, through the IASB's constitutional review.

The Group of Thirty (G30)¹¹

Financial Reform: A Framework for Financial Stability, 15 January 2009

“The primary aim of prudential regulation should be to maintain the health of the system and contain systemic risk by... Avoiding accounting, regulatory, or other practices that may inadvertently reinforce recurrent tendencies toward excessive exuberance or risk aversion.... Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.”

¹⁰ The G-20 is a group of finance ministers and central bank governors from 20 economies: 19 of the world's largest national economies, plus the European Union (EU).

¹¹ Established in 1978, the G30 is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. The current chairman of the G30 is Paul Volcker, former chairman of the Federal Reserve.

G30: Financial Reform: A Framework for Financial Stability, 15 January 2009 (continued)

(From recommendations on “Fair Value Accounting”)

- a. “Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less-liquid instruments and distressed markets.
- b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.
- c. Accounting principles should also be made more flexible in regard to the prudential need or regulated institutions to maintain adequate credit-loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.
- d. As emphasized in the third report of the CRMPG (Counterparty Risk Management Policy Group), under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the evaluation and price verification process.”

(From recommendations on Restoring Confidence in Securitized Credit Markets)

“Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.”

The Financial Stability Board (formerly “The Financial Stability Forum” or “FSF”) ¹²

London Summit: Leaders’ Statement 2 April 2009

“We agree...to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards”

United States Department of the Treasury

Financial Regulatory Reform: A New Foundation -- Rebuilding Financial Supervision and Regulation, 17 June 2009

“The accounting standard setters (the FASB, the IASB, and the SEC) should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.”

¹² The Financial Stability Board was founded in 1999 to promote international financial stability. Membership includes about a dozen nations who participate through their central banks, financial ministries and departments, and securities regulators, including the United States, Japan, Germany, the United Kingdom, France, Italy, Canada, Australia, the Netherlands and some other industrialized economies. It also includes several international economic organizations. At the G20 summit on 15 November 2008 it was agreed that the membership of the FSF will be expanded to include emerging economies, such as China.

Appendix B: Accounting Standard Setters

United States Accounting Standard-setting: FASB

The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting. Those standards govern the preparation of financial statements. They are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants.

There are five Board members of the FASB, of which a simple majority is required to approve new or revised standards.

International Accounting Standard-setting: IASB

The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard-setter based in London, UK. The IASB is responsible for developing International Financial Reporting Standards (IFRS) and promoting the use and application of these standards. As part of this, the IASB negotiates with standard-setters in each country so that each country will adopt IFRS. Virtually all European countries have adopted IFRS. Countries such as the United States, Japan, China, and India have agreed to "converge" accounting standards with IFRS in the future, though, at present, none of these countries permits IFRS to be used.

There are thirteen members of the IASB (of which four are from the U.S.) and nine are required to approve any new or revised standards.

Convergence

In 2002, FASB and the IASB agreed upon efforts to converge accounting standards, thus creating one standard that each company would uphold, no matter the country of residence. While the SEC has set timetable targets over the next three years, comments from FASB member indicate that total convergence is unlikely for several years. However, decisions made by one body certainly influence those of the other body.

Appendix C: FASB Due Process – Steps Required by the Rules of Procedure

The FASB has established the following procedures for developing accounting standards. These procedures are used for major agenda projects. Not all of the steps may be necessary for application and implementation projects. Many other steps are followed during the course of the project that are not specifically required by the Board's Rules of Procedures.

1. The Board receives requests/recommendations for possible projects and reconsideration of existing standards from various sources.
2. The staff summarizes the information it receives and discusses its findings at a public Board meeting as part of the agenda-decision-making process.
3. The Board votes on whether to add the project to its agenda. A simple majority vote is needed.
4. The Board deliberates the various issues identified and analyzed by the staff at a series of public Board meetings.
5. The Board issues the Exposure Draft. (In some projects, the staff may prepare and issue an Invitation to Comment or Preliminary Views prior to the Board issuing an Exposure Draft.)
6. The Board holds a public roundtable meeting on the Exposure Draft, if necessary.
7. The staff analyzes comment letters, public roundtable discussion, and any other information and the Board re-deliberates the proposed provisions at public meetings.
8. The Board issues a Statement or Interpretation by simple majority vote.