Testimony of
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Full Text of Testimony

Introduction

Chairman Kanjorksi, Ranking Member Garrett, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). Thank you for inviting me to participate in today's important hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

My testimony this morning includes a brief overview of the FASB, including the importance of our independence and due process to our mission of developing high-quality financial accounting and reporting standards for both public and private enterprises. My testimony also describes the differing roles of accounting standard setters and prudential regulators, discusses the concepts of fair value accounting and measurement, provides some observations on recent calls to suspend the application of fair value accounting, summarizes research on the impact of fair value accounting on financial institutions, explains the purpose and provisions of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157"), and reviews some of the issues surrounding the application of this standard and how the Board has been addressing those issues.

The FASB

The FASB is an independent private-sector organization. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the U.S. economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[1] is a critical aspect of the standard-setting process and fundamental to our mission, because our work is technical in nature and designed to provide preparers with the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the U.S. economy.

The FASB's authority with respect to public enterprises comes from the U.S. Securities and Exchange Commission ("SEC" or "Commission"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 35 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC issued a Policy Statement in 2003 reaffirming this longstanding relationship.[2]

The Policy Statement, consistent with the language and intent of the Act,[3] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the

[1]Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).
[2]Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003).
[3]Sections 108-109; the legislative history of the Act is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

> maximum credibility in the business and investing communities.[4]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"), is responsible for maintaining active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board ("PCAOB"), and ultimately the SEC.

What Process Does the FASB Follow in Developing Accounting Standards?

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

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[4] Page 5 of 8.

The Role of Accounting Standard Setters and the Role of Prudential Regulators

The primary roles of accounting standard setters and prudential regulators are fundamentally different. Accounting standard setters focus on developing accounting standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others to make capital resource allocation decisions. The information needs of those parties often differ from that of regulators, who are largely concerned with safety and soundness and financial stability. Accounting standard setters stress the importance of having the information in general-purpose financial statements be *neutral*, that is, free from bias. The goal is to provide information useful to users of financial statements in their decision making. Such users include present and potential investors, lenders, suppliers, and other trade creditors, customers, employees, governments and their agencies, and the public. Primacy is given to the informational needs of investors (both equity and debt security holders).[5]

The focus of financial reports is on the communication of information to investors and the capital markets to facilitate informed investment decisions, without which markets do not function well. This focus informs the structure and purpose of the financial accounting and standard-setting process and the resultant standards.

A paramount goal of the federal government has been to ensure the stability of the financial system. A principal policy tool used to achieve this goal has been the prudential regulation and supervision of financial institutions, which is designed to remove or lessen

[5]The Advisory Committee on Improvements to Financial Reporting (CIFiR) to the SEC states the following in Recommendation 2.1 of their Final Report (August 2008):

> Investor perspectives are critical to effective standards-setting, as investors are the primary consumers of financial reports. Only when investor perspectives are properly considered by all parties does financial reporting meet the needs of those it is primarily intended to serve. Therefore, investor perspectives should be given pre-eminence[15] by all parties involved in standards-setting.
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> [15]We recognize the need for balance among all parties involved in the standards-setting process. We do not intend to suggest by this recommendation that investor input trumps all others. Instead, in cases where constituent views cannot be reconciled, we believe that the investor perspective should be afforded greater weight.

the threat of systemic instability, as well as, in the case of commercial banks and other deposit-taking institutions, to protect customer deposits.

In the aftermath of the 1980s savings and loans crisis, Congress enacted laws stating that the accounting standards used by bank regulators had to be at least as "stringent" as U.S. generally accepted accounting principles ("GAAP"). Thus, regulatory capital requirements for banks in the United States start with financial information provided in accordance with GAAP. However, the laws also provide the regulators with discretion to adjust GAAP numbers when establishing capital adequacy guidelines governing loan capacity and other regulatory requirements. The regulators also have other tools at their disposal to address the financial positions of financial institutions, including liquidity and collateral requirements and risk concentration rules. So, while financial institution regulators may base computations of regulatory capital on GAAP numbers, their decisions on capital adequacy and responses to capital impairments cannot and should not be driven solely or mechanically by balance sheet results. Their role is different from that of accounting standard setters whose standards are not specifically designed to meet the objectives of prudential regulation. But, while our roles are different, we have longstanding and productive working relationships with financial institution regulators, both at the national and the international levels, wherein we share perspectives, discuss current issues, and look for ways to complement and bridge the reporting needs of investors and regulators.

What Is Fair Value Measurement and Its Role in Accounting?

The current reporting model in the United States and across much of the world includes both historical cost measurement and fair value measurement. As the current financial and economic crisis has deepened and broadened, there has been considerable focus on the subject of *mark-to-market* or fair value accounting. In discussions on this subject, it has become clear that there are a number of misconceptions about fair value accounting.

As detailed extensively in the recent SEC Mark-to-Market Report to Congress,[6] the use of fair value in financial reporting is not new. In fact, it has been in place for many decades, principally for financial assets. However, fair value is not required for all financial assets. Whether and when fair value is required depends on the types of financial assets that are the subject of the accounting and, to varying degrees, the reporting entity's intent with respect to those assets. Moreover, when fair value is required, it is not always required on an ongoing basis (which is so-called mark-to-market accounting). Some fair value measures within GAAP are one-time and event driven, such as the valuation of assets and liabilities in business combinations; certain types of inventory and long-held assets; and certain retirement obligations initially recognized at fair value. Other fair value measures are recurring, such as the accounting for marketable securities classified as trading securities and derivatives (with certain exceptions for hedges). This is so-called mark-to-market accounting, which also can be voluntarily elected under an available fair value option. Fair value also is used to report securities in available-for-sale portfolios of financial institutions and other entities, but, in such cases, the periodic changes in fair value are included in what is called *other comprehensive income,* which does not affect reported earnings.

Fair value is used to recognize impairments in the value of financial assets. For example, under the standards applicable to impairments, (1) available-for-sale securities and held-to-maturity debt securities have for many years been written down to fair value through earnings if impairment is other than temporary and (2) mortgage loans held for sale are reported at the lower of cost or fair value on an ongoing basis (a continuous impairment notion). Thus, the requirement to write down financial assets in down markets is hardly new and would apply whether one used fair value accounting or other age-old methods such as lower of cost or market. Finally, it is important to note that loans held for investment, which make up the bulk of financial assets for many banks, are carried at amortized cost subject to loan loss allowances that are not based on fair value.

[6]Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, Office of the Chief Accountant, Division of Corporation Finance, United States Securities and Exchange Commission, December 30, 2008 (SEC "Mark-to-Market Report").

Some Observations on Recent Calls to Suspend Application of Fair Value Accounting

In recent months, there have been calls by certain parties to suspend fair value accounting and, specifically, the application of Statement 157. Some commentators have asserted that the fair value standards promote undesirable "procyclical" behavior by requiring write-downs of financial assets that may be exaggerating losses, further driving down asset values, affecting capital ratios, and tightening the availability of credit, thereby causing a further downward spiral in assets prices. While sound and transparent reporting can have economic consequences, including potentially leading to procyclical behavior, it is not the role of accounting standard setters or general-purpose external reporting to try to dampen or counter such effects. Highlighting and exposing the deteriorating financial condition of a financial institution can result in investors deciding to sell their stock in the entity, in lenders refusing to lend to it, to the company trying to shed problem assets, and to regulators and the capital markets recognizing that the institution may be in danger of failing and need additional capital. Indeed, individuals and families may take such procyclical actions when they see falling values of their homes and their 401(k)s and decide to spend less and to sell investments in order to raise cash in troubled times. But I think few would suggest suspending or modifying the reporting to individual investors of the current values of their investment accounts. Thus, to the extent there are valid concerns with procyclicality, these are more effectively and more appropriately addressed through regulatory mechanisms and via fiscal and monetary policy, than by trying to suppress or alter the financial information reported to investors and the capital markets. Moreover, in our view, the standards are not the underlying source of the write-downs. Some of the most vocal critics of the standards have come from institutions that subsequently failed and have had to seek financial assistance from or been rescued by the federal government. As discussed in detail below, there is considerable evidence that underlying economic conditions are the fundamental source of those write-downs.

In the words of some investors, "Blaming fair value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick."[7] The fact that fair value measures have been difficult to determine for some illiquid instruments is not a cause of current problems, but rather a symptom of the many problems that have contributed to the global crisis, including lax and fraudulent lending, excess leverage, the creation of complex and risky investments through securitization and derivatives, the global distribution of such investments across rapidly growing unregulated and opaque markets that lack a proper infrastructure for clearing mechanisms and price discovery, faulty ratings, and the absence of appropriate risk management and valuation processes at many financial institutions. Many of the complaints about fair value also seem to arise in the context of its impact on capital adequacy. As previously noted, while the consideration of the impact of fair value accounting on bank regulatory capital is a very important issue, it is beyond the purview of the FASB.

For accounting standard setters, the fundamental question about fair value accounting is whether it provides investors with the relevant information with which to judge current and potential investments. In developing the fair value measurement and reporting standards, the Board has repeatedly been told by investor organizations and other users that fair values of financial assets and liabilities are more relevant for their decision making than historical cost. Over time, historical prices of financial instruments become increasingly less relevant in assessing an entity's current financial position. Many investors have made it clear that, in their view, fair value accounting allows companies to report amounts that are more relevant, timely, and comparable than amounts that would be reported under alternative accounting approaches, even during extreme market conditions.

Companies' ability to manipulate their reported net income may be more limited when amounts are reported at fair value on a regular or ongoing basis, because changes in the values of assets and liabilities are reported in the period they occur, not when they are realized as the result of transactions. During the savings and loan crisis, there was considerable criticism of the practice of *gains trading,* under which institutions would "cherry pick" appreciated securities for sale thereby boosting reported earnings, while in

[7]Dane Mott and Sarah Deans, *Accounting Issues: Q&A on Financial Instrument Accounting During the Credit Crunch*, Global Equity Research, J.P. Morgan (July 28, 2008).

accordance with regulatory accounting requirements not recognizing the unrealized losses on other securities they were holding. Gains and losses resulting from changes in fair value estimates reflect economic and market events that companies and investors may find relevant to their decisions. Thus, fair value accounting has helped investors and capital markets more quickly identify where problems exist and react to those problems. The Center for Audit Quality, the Council of Institutional Investors, and CFA Institute issued the following joint statement on October 1, 2008:

> Suspending fair value accounting during these challenging economic times would deprive investors of critical financial information when it is needed most. Fair value accounting with robust disclosures provides more accurate, timely, and comparable information to investors than amounts that would have been reported under other alternative accounting approaches. Investors have a right to know the current value of an investment, even if the investment is falling short of past or future expectations.[8]

In its recent report to Congress, the SEC reported that investors have repeatedly told the Commission that fair value information is vital in times of stress and that suspending the fair value information would weaken investor confidence and result in further capital market instability.[9]

Ben Bernanke, chairman of the Federal Reserve System Board of Governors, testified in a hearing of the House Financial Services Committee on monetary policy and the state of the economy on February 25, 2009. During that hearing, Chairman Bernanke was asked to discuss the pros and cons of suspending mark-to-market accounting. Chairman Bernanke responded that "…the basic idea of mark to market accounting is very attractive, the idea that wherever there are market values determined in free exchange, that those market values should be used in valuing assets so that investors would have a more accurate sense of what the institution is worth. So that's the principle and it's a good principle in general." Mr. Bernanke noted that difficulties with mark-to-market accounting arise when markets become illiquid or do not function. And, he stated, "So some real challenges there and I think the accounting authorities have a great deal of

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[8]"Joint Statement of the Center for Audit Quality, the Council of Institutional Investors and the CFA Institute Opposing Suspension of Mark-to-Market Accounting," Press Release (October 1, 2008).
[9]SEC Mark-to-Market Report, pages 1, 139–144.

work to do to try to figure out how to deal with some of these assets, which are not traded in liquid markets. But I don't see a suspension of the whole system as being constructive because there is a great deal of information in valuing many of these assets according to market principles."

As the SEC concluded in its report to Congress, suspending or eliminating the current fair value accounting requirements would diminish the quality and transparency of reporting and could adversely affect investors' confidence in the markets. In turn, this loss of confidence could also cause downward pressure on the financial markets and the economy and additional financial instability.

Impact of Fair Value Accounting on Financial Institutions

The SEC, Merrill Lynch, and the FASB staff have performed research on the impact of fair value accounting on financial institutions. Each group studied the linkage between fair value accounting and recent bank failures and concluded that fair value accounting did not appear to play a meaningful role in bank failures. The SEC Mark-to-Market Report describes the SEC's study on this issue. Dividing the failed banks by asset size, the SEC analyzed 22 banks' use of fair value measurement over a 3-year period, evaluating the impact of fair value measurement on capital adequacy relative to loan losses and other factors affecting the capital position of the banks. The SEC found that for most of the failed banks, fair value accounting was applied in limited circumstances and did not have a significant impact on the banks' capital. The SEC concluded that fair value accounting did not appear to play a meaningful role in bank failures in 2008 and that the failures were more likely due to probable credit losses, concerns about asset quality, and, in some cases, eroding lender and investor confidence. Furthermore, the Commission reported that for banks that recognized sizable fair value losses, the reporting of these losses did not appear to be the cause of the failure. The SEC also noted that market concerns about these banks, as evidenced by their share price, appeared to indicate that the marketplace factored in losses for those banks that had not been recognized in GAAP reported income.[10]

[10]SEC Mark-to-Market Report, pages 4, 97.

The SEC also examined the impact of fair value accounting on financial institutions' balance sheets. They found that the majority of a bank's assets are not reported at fair value. Their analysis illustrated that 31 percent of total bank assets were reported at fair value as of first quarter 2008 and that 30 percent of those assets reported at fair value constituted investment securities classified as available-for-sale with changes in fair value recognized in other comprehensive income (a component of equity). It is our understanding that unrealized gains and losses on available-for-sale securities are added back for Tier 1 regulatory capital purposes. The SEC determined that 22 percent of total assets were reported at fair value with changes in value affecting income, primarily comprising trading securities and derivatives.

For broker-dealers, the SEC determined that 50 percent of total assets were measured at fair value and that changes in the value of almost all of those assets were reported in the income statement. The SEC found that broker-dealers reported large trading and derivative instruments portfolios, which were measured at fair value. Specifically, those assets constituted 43 percent of broker-dealer total assets.[11]

Merrill Lynch's research report states that recent bank failures and earnings weakness had far more to do with poorly performing loans than with mark-to-market accounting. The loans that had caused these problems were not accounted for at fair value but on an accrual basis of accounting. Under this accrual method, loss reserves are gradually added, producing a charge to earnings, as delinquencies are observed and actual losses are incurred. Reviewing 2008 data, Merrill Lynch found that rapidly rising credit loss provisions had a much greater impact on a bank's financial condition than the impact of mark-to-market losses.[12]

The FASB staff also analyzed institutions that were closed by the Federal Deposit Insurance Corporation between January 25, 2008, and October 31, 2008. The FASB staff's findings are consistent with the SEC's conclusions that fair value accounting was applied in very limited circumstances at those institutions. In addition, the FASB staff

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[11]SEC Mark-to-Market Report, pages 47, 50.

[12]Guy Moszkowski, Edward Najarian, M. Patrick Davitt, and Christopher Black, *Does TARP Point to Suspension of Mark-to-Market*? Banks-Multinational/Universal, Merrill Lynch (October 24, 2008).

analyzed investor pricing of commercial banks by looking at their market values. The staff found that, as of November 3, 2008, more than 50 percent of publicly traded banks were trading below tangible book value. Based on November 3, 2008, stock prices, 52 percent of all U.S.-listed commercial banks (358 banks) were trading at less than tangible book value; 236 of those banks were trading at less than 80 percent of tangible book value. Investors' pricing of banks suggests that they viewed bank net assets as overstated, not understated, as would be the case if fair value adjustments were causing excessive write-downs of bank assets. Similarly, a Bloomberg News analysis of two major commercial bank mergers in 2008 involving the acquisition of National City by PNC Financial and the acquisition of Wachovia by Wells Fargo shows that the consideration paid was significantly less (in both cases about 70 percent less) than most recently reported book value before acquisition, suggesting that fair value markdowns recorded by the acquired institutions may not have captured all of the information relevant to a willing buyer.[13]

FASB Statement No. 157, *Fair Value Measurements*

Much of the current criticism of fair value accounting has been directed toward Statement 157, issued in 2006. Here, too, we believe there are a number of misconceptions.

Contrary to the assertions of some, Statement 157 did not introduce mark-to-market or fair value accounting and did not expand the range of items that are required to or permitted to be measured at fair value. Rather, Statement 157 improves the consistency and comparability of fair value measures within GAAP by more clearly defining fair value, establishing a framework for measuring fair value, and expanding disclosures about fair value measurements. **It does not change which assets and liabilities companies report at fair value.** Before Statement 157, numerous accounting standards provided guidance about fair value measures. However, that guidance evolved piecemeal over time and was dispersed throughout several pronouncements.

[13]Jonathan Weil, "Wachovia Shows Why No Bank's Books Are Trusted," Bloomberg.com (October 30, 2008).

Differences among that guidance created inconsistencies and added complexity to GAAP.

Before the issuance of Statement 157, there were varying definitions of fair value, including fair value exit and entry price (purchase price). Statement 157 defines fair value as an exit price. **For an asset, the fair value estimate is determined by reference to the price that would be received in an orderly transaction for the asset at the measurement date (an exchange price notion), not, as some have asserted, the price that would be received in a fire sale or forced liquidation transaction for the asset at the measurement date**. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market before the measurement date. In contrast, a fire sale or forced liquidation transaction is one that involves market participants that are compelled to transact (under duress) and allows for little (or no) exposure to the market before the measurement date. Statement 157 clarifies that the fair value estimate is intended to convey to investors the value of an asset or liability at the measurement date (a current value), not the potential value of the asset or liability at some future date under different economic or market conditions.

Statement 157 also establishes a fair value hierarchy that prioritizes the inputs that should be used to develop the fair value estimate. The fair value hierarchy prioritizes quoted prices in active markets for identical assets or liabilities (Level 1). In the absence of quoted prices in active markets for identical assets or liabilities, the fair value hierarchy allows for the use of valuation techniques (for example, pricing models) that incorporate a combination of other inputs. Those other inputs consist of observable inputs that are reasonably available in the circumstances, including quoted prices in markets for comparable assets or liabilities (Level 2), and unobservable inputs, including the reporting entity's own analysis of the underlying economic data that market participants would factor into the pricing of the asset or liability (Level 3).

The fair value hierarchy prioritizes observable inputs over unobservable inputs. By distinguishing between inputs that are observable in the marketplace and, therefore, more objective and those that are unobservable and, therefore, more subjective, the hierarchy is designed to indicate the relative reliability of the fair value measures. When there is little or no market activity for comparable assets or liabilities at the measurement date (illiquid markets) or when information about transactions involving comparable assets or liabilities is not publicly disclosed, the fair value estimate might rely principally on unobservable inputs (Level 3 estimates). Like many other estimates used in financial reporting, Level 3 estimates can be difficult and require the use of significant judgments. However, as previously noted, many investors have stated that those estimates provide more relevant and useful information than alternatives that ignore current economic and market conditions.

To provide investors with enhanced information about a company's fair value estimates, Statement 157 requires new disclosures about the company's use of fair value measurements and their effects on the financial statements. Before Statement 157, a few of the accounting pronouncements that require fair value measurement also required disclosures about those measurements. Statement 157 significantly expands those disclosures. In general, under Statement 157, the new disclosures are based on the fair value hierarchy. Statement 157 requires a company to disclose (1) its fair value measures at each reporting date, (2) where in the fair value hierarchy the measurements were determined, and (3) a roll forward schedule of assets and liabilities carried at fair value using Level 3 inputs, and the amount of unrealized gains and losses not yet realized that are included in earnings. In addition, Statement 157 requires a company to annually disclose its valuation techniques and discuss any changes in those valuation techniques.

Statement 157 is a principles-based standard that requires the application of sound judgment in determining fair value estimates. Judgment is not new in accounting; however, the increased attention on fair value estimates and principles-based standards has increased focus on the use of judgment. In its final report to the SEC, CIFiR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments, including the factors that it considers when making this evaluation. That recommendation also included a suggestion that the PCAOB should adopt a similar approach with respect to auditing judgments.[14]

FASB Implementation Activities Relating to Fair Value Measurements

A number of issues have been raised about fair value or mark-to-market accounting, including assertions by some that the use of fair value measurements in the current environment understates the "true" or "fundamental" value of financial assets, thereby overstating the extent of "true" losses. The Board acknowledges that there are significant challenges to estimating fair value, particularly in illiquid markets, requiring the gathering and analysis of relevant data and the exercise of sound judgment. Those challenges do not mean fair values should not be estimated and reported, supplemented by robust disclosures. The FASB is responding, as appropriate, to these issues and concerns. As part of its normal due process, the FASB monitors the implementation of new accounting standards in a number of ways, including ongoing discussions and consultations with the SEC, regulators, companies, auditors, and a variety of users. The FASB has been actively working with the SEC and the federal banking regulators to monitor the implementation of Statement 157 to determine if additional clarification or guidance is needed to improve the application of the standard. The FASB has also established the Valuation Resource Group ("VRG") to provide the Board with information about implementation issues on fair value measurements in financial reporting and the variety of viewpoints associated with those implementation issues. The VRG is composed of a cross-section of industry representatives, including financial statement preparers, auditors, users, and valuation experts. Representatives of the SEC, the PCAOB, the American Institute of Certified Public Accountants, and the International Accounting Standards Board ("IASB") also observe VRG meetings.

In addition, the FASB reviews publications and articles issued by users and others that discuss the fair value requirements and their use in financial reports. Companies and auditors submit questions to the staff via the FASB's technical inquiry process. The FASB Board and staff members meet at least quarterly with representatives from the

[14] CIFiR Final Report, Recommendation 3.5, page 13.

PCAOB and the SEC to discuss matters of mutual interest. Similar meetings also are held periodically with federal banking regulators.

Since the issuance of Statement 157, the Board and FASB staff have taken significant actions, addressing application issues relating to Statement 157 and other GAAP affected by the global financial crisis. First, after extensive consultations with participants in the capital markets on the application of fair value measurements in the current market environments, the SEC staff and the FASB staff jointly issued a news release in September 2008 to address a number of practice issues where there was a need for immediate additional guidance. That news release provided additional interpretative guidance to address fair value measurement questions that have been cited as most urgent in the current environment, including the valuation of Level 3 assets and valuations generally in distressed markets.[15]

Second, on October 10, 2008, the FASB issued additional guidance in the form of a FASB Staff Position ("FSP") to clarify the application of Statement 157 when markets are not active.[16] The guidance in the FSP is consistent with and amplifies the guidance in the September press release. The FSP clarifies the application of Statement 157 in three main areas:

1. When markets are dislocated, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. In other words, the determination of whether a particular price is forced or not should be made at the transaction level, not the market level. Proper consideration should be given as to how recent the transaction occurred and the volume of the transaction relative to the market for the item.
2. In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Regardless of the valuation technique used, an entity must include appropriate

[15]See Attachment 3.
[16]See Attachment 4.

risk adjustments that market participants would make for credit and liquidity risks.

3. Broker (or pricing services) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset.

Third, in November and December 2008, the FASB, along with the IASB, held three public roundtables, one each in the United States, Asia and Europe, to discuss concerns arising from the global financial crisis. The roundtables were designed to provide members of the Boards with input from a wide range of stakeholders, including users and preparers of financial statements, governments, regulators, and others, to help the Boards identify accounting issues that may require urgent and immediate attention to improve financial reporting and help enhance investor confidence in financial markets. The Boards asked roundtable participants to identify broader financial reporting issues arising from the global financial crisis. Topics discussed at the roundtables included issues relating to the impairment of financial assets, fair value measurement, reclassification of financial instruments, disclosure issues relating to fair value and the impairment of financial instruments, and potential steps that could be taken to provide additional application guidance on issues arising in the current environment.

After considering the extensive input received during the roundtables, as well as after numerous consultations with constituents and U.S. regulatory agencies, on December 15, 2008, the Board decided to undertake four short-term projects to improve and simplify the accounting practices for financial instruments, focusing on improving the impairment models for investments in debt and equity securities and enhancements to the disclosures about certain financial instruments.[17]

- The first project resulted in the issuance of FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*. This FSP is designed to achieve more consistent determination of whether other-than-temporary impairments have occurred to available-for-sale or

[17]See Attachment 5 for the news release on projects added to the FASB's agenda in December 2008.

held-to-maturity debt securities. When a security has been other-than-temporarily impaired, GAAP requires that the security be marked down to its fair value.

- The second project, FSP FAS 107-b and APB 28-a, would amend existing fair value disclosure requirements for financial instruments to require those disclosures on an interim basis.

- In addition to the two FSPs, the FASB is working on two other short-term projects to address issues about measurement and reporting of financial instruments. The first would clarify when embedded credit derivatives are not required to be recorded at fair value. The second would allow companies to reverse a previously recognized impairment charge through earnings for debt securities classified as held-to-maturity or available-for-sale when evidence exists that a recovery has occurred. The second project is being conducted jointly with the IASB.

Fourth, the FASB and the IASB decided to jointly undertake a project to consider broader improvements in the accounting for financial instruments. The Boards also established the Financial Crisis Advisory Group ("FCAG") to assist them in evaluating major issues to be addressed in this project, as well as consider various other reporting issues arising from the global financial crisis. Comprising recognized leaders in the fields of business and government, the FCAG's primary function is to advise the Boards on the standard-setting implications of the global financial crisis and potential changes to the global regulatory environment.[18] The FCAG will consider how improvements in financial reporting could help investor confidence in financial markets. The FCAG also will help identify significant accounting issues that require the Boards' urgent and immediate attention, as well as issues for longer-term consideration. In providing that advice, the FCAG will draw upon work already under way in various jurisdictions on accounting and the credit crisis, as well as information gathered from the FASB-IASB roundtables. To

[18]See Attachment 6 for a list of FCAG members.

date, the FCAG has held three meetings and plans to hold two or more additional meetings prior to issuing its final report in mid-2009.

Fifth, in response to the recommendations contained in the SEC Mark-to-Market Report, as well as input from the FASB's VRG and others, the Board recently added several projects to its agenda intended to improve the application guidance used to determine fair values and disclosure of fair value estimates.[19] The projects on application guidance will address determining when a market for an asset or liability is active or inactive; determining when a transaction is distressed; and applying fair value to interests in alternative investments, such as hedge funds and private equity funds. The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between fair value measurement levels. The Board is devoting substantial staff resources to these projects and plans on completing the projects on application guidance by the end of the second quarter of 2009 and the project on improving disclosures in time for year-end 2009 reporting.

Sixth, over the past year the Board has issued new standards and additional guidance on various other issues relating to the financial crisis, including securitizations, special-purpose entities, financial guarantee insurance, and credit default swaps and other derivatives. The Board is currently completing deliberations on two projects to amend the existing accounting guidance for transfers of financial assets and consolidation of thinly capitalized (special-purpose) entities. The project on transfers of financial assets is intended to (1) address concerns about the use of off-balance-sheet entities, (2) simplify the guidance on accounting for transfers of financial assets, and (3) improve consistency and transparency in accounting for such transfers. The project on consolidation of thinly capitalized entities is intended to address concerns about the application of that guidance as a result of recent market events. Specifically, the Board is considering amendments that may (1) require companies to reconsider their involvements with thinly capitalized entities more frequently and (2) alter how companies determine whether they must

[19]See Attachment 7 for the news release on projects added to the FASB's agenda in February 2009.

consolidate a thinly capitalized entity. In conjunction with those projects, the Board issued an FSP in December 2008 to enhance disclosures about transfers of financial assets and companies' involvements with thinly capitalized entities.[20] Those disclosure requirements became effective at the end of 2008.

Finally, the Board is working with both the Financial Stability Forum and members of the "G20" on issues relating to concerns about the potential procyclical effect of fair value accounting on the capital position and balance sheets of financial institutions and companies.

International Financial Reporting Standards

In addition to the joint efforts with the IASB previously described, the IASB currently has been working on a fair value measurement project to consider fair value measurements broadly, focusing on the definition of fair value and the framework for measuring fair value.

As part of that effort, the IASB exposed Statement 157 for comment by its constituents. The IASB is now in the process of developing a standard that would be substantially convergent with Statement 157 and has also recently made changes to its disclosure requirements to parallel those of Statement 157.

Conclusion

For accounting standard setters, the fundamental question about fair value accounting is whether it provides investors with the relevant information with which to judge current and potential investments. Accounting standard setters focus on developing standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others in their decision making. The information needs of these parties often differ from that of prudential regulators, who are largely concerned with safety and soundness and financial stability.

[20]FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (December 11, 2008).

Many investors, financial analysts, and others have indicated that fair value accounting has been instrumental in providing financial statement users with important information about the current values of a company's financial assets and with better and more timely information about the risks faced by financial institutions in the current environment. Calls for suspending or eliminating the fair value standards are misdirected. The standards are not the underlying cause of the write-downs in financial assets, but rather reflect the underlying problems with those assets. Now, more than ever, transparency is essential in bringing critical information to investors and the capital markets. Fair value accounting helps provide the transparency and comparability that are vital to investor confidence.

That is not to say that fair value is perfect or is the universal panacea. There are many challenging issues, particularly in illiquid markets. Mark-to-market works best in sound, active, liquid markets. Therefore, while it is in our collective interest to try to keep improving disclosures about and techniques for valuing items in illiquid markets, it also would be worthwhile for policymakers and regulators to take steps necessary to create sound markets. Sound markets require a proper infrastructure to facilitate the flow of information, ascertain price discovery, support the necessary clearing mechanisms, and allow for informed and knowledgeable market participants. Effective oversight and regulation are also key ingredients of sound markets, as are the exercise of appropriate due diligence by investors and proper risk management processes by financial institutions.

We understand that determining fair value in illiquid markets can be challenging and requires significant analysis and judgment to accomplish. To the extent legitimate issues are raised about our standards, we pledge to continue to work with our colleagues in the financial reporting and regulatory system to examine and address those issues and to continue to strive to improve accounting standards for the benefit of investors and the capital markets.

Thank you Mr. Chairman. I would be pleased to answer any questions you may have.