Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee
of the
Committee on Financial Services
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Full Text of Testimony

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB.

My testimony includes a brief overview of (1) the FASB, including the importance of the Board's independence, (2) the process the FASB follows in developing accounting standards, (3) the Board's project to improve the accounting for combinations between mutual enterprises, and (4) some comments and observations about H.R. 1042, the "Net Worth Amendment For Credit Unions Act."

The FASB

The FASB is an independent private-sector organization.[1] We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises, including credit unions, other mutual enterprises, and not-for-profit organizations. Those standards are essential to the efficient functioning and operation of the capital markets and the United States ("US") economy because creditors, investors, and other consumers of financial reports rely heavily on sound, honest, and unbiased financial information to make rational credit, investment, and other resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002,[2] is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like creditors and investors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor.

Financial accounting and reporting is meant to tell it like it is, not to allow distortions or skew information to favor particular industries, particular types of transactions, or particular political, social, or economic goals other than sound and honest reporting. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting

[1] See Attachment 1 for information about the Financial Accounting Standards Board.
[2] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

standard is harmful to creditors, investors, the capital markets, and the US economy.

The Securities and Exchange Commission ("SEC"), together with the private-sector Financial Accounting Foundation ("FAF"),[3] maintains active oversight of the FASB's activities.

The FASB's Public Due Process in Developing Accounting Standards

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including credit unions.

Our Rules of Procedure require an extensive and thorough public due process.[4] That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, and exposure of all proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. The Board makes final decisions only after carefully considering and analyzing the input of all interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB's Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.[5] In recent years, the FASB and the FAF have undertaken a significant number of

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[3] See Attachment 1 for information about the Financial Accounting Foundation.

[4] See Attachment 1 for information about the FASB's due process.

[5] The SEC also recently reviewed the FASB's due process and concluded that "the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . ." Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, page 5 of 8 (April 2003).

actions to improve the Board's due process procedures. Some of those actions build on and enhance the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses, including mutual enterprises. Those particular actions include the following:

- Establishing a Small Business Advisory Committee ("SBAC") in order to increase involvement by the small business community in developing accounting standards. The SBAC, whose members represent diverse perspectives and experiences, comprises lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community. The SBAC currently has two members representing preparers from mutual enterprises, including a senior vice president and chief financial officer of a credit union.

- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

Other recent initiatives include:

- Making our public Board meeting announcements available to interested parties more broadly through a free email subscription service.

- Making our public Board meetings available to interested parties for monitoring via web cast on our website free of charge and via the telephone at a reduced cost.

- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website free of charge.

The FASB's Current Project to Improve the Accounting for Combinations between Mutual Enterprises

<u>Background</u>

In August 1996, in response to requests from a broad range of users, auditors, and preparers of financial statements, the Board added to its agenda a multi-part project to reconsider the existing accounting guidance for business combinations and goodwill and other intangible assets. The existing guidance permitted the business combinations of all enterprises, including credit unions and other mutual enterprises, to be accounted for using one of two methods, the pooling-of-interests method ("pooling") or the purchase method.[6] Use of pooling was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial results. Consequently:

- Analysts and other users of financial statements indicated that it was difficult to compare the financial results of enterprises because different methods of accounting for business combinations were used.

- Users of financial statements also indicated a need for better information about intangible assets because those assets were an increasingly important economic resource for many enterprises and an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes all intangible assets acquired in a business combination (either separately or as goodwill), only those intangible assets previously recorded by the acquired entity are recognized when pooling is used.

- Company managements indicated that the differences between pooling and purchase methods of accounting for business combinations affected competition in markets for mergers and acquisitions.

The Board conducted over four years of research, deliberations, and other public due process in addressing issues relating to the accounting for business combinations and goodwill and intangible assets. That due process included the following:

- The formation of and active consultation with a business combinations task force comprising individuals from a number of organizations representing a wide range of the Board's constituents.

- The issuance of a Special Report for public comment.[7] The 54 comment letters received in response to that Special Report generally expressed agreement with the Board's initial decisions about the project's scope, direction, and conduct.

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[6] The existing guidance on accounting for business combinations and goodwill and intangible assets had been largely provided by Accounting Principles Board ("APB") Opinions No. 16, *Business Combinations* (August 1970), and No. 17, *Intangible Assets* (August 1970).

[7] FASB Special Report, *Issues Associated with the FASB Project on Business Combinations* (June 1997).

- The issuance of a Position Paper for public comment developed by an organization known as the "Group of 4 plus 1" (G4+1).[8] The G4+1 consisted of the Australian Accounting Standards Board ("AASB"), the New Zealand Financial Reporting Standards Board ("FRSB"), the United Kingdom Accounting Standards Board ("UK ASB"), the Accounting Standards Board of the Canadian Institute of Chartered Accountants ("AcSB"), the FASB, and an observer, the International Accounting Standards Committee ("IASC"). The Position Paper concluded that only the purchase method should be used for business combinations of all enterprises. The FASB received 148 comment letters, the AcSB received 40 letters, the UK ASB received 35 letters, the IASC received 35 letters, the AASB received 5 letters, and the FRSB received 4 letters. The letters were carefully considered by the Board in connection with its public due process.

- The issuance of a proposed standard for public comment. The Board received 210 comment letters in response to the proposal.[9]

- Four days of public hearings, 2 days in San Francisco and 2 days in New York City, at which 43 individuals or organizations presented their views on the proposed standard.

- Field visits with 14 enterprises during which the Board and FASB staff members explored suggested changes to the proposed standard.

- The issuance of a revised proposed standard for public comment that proposed changes to the earlier proposal with regard to the accounting for goodwill and the initial recognition of intangible assets other than goodwill.[10] The Board received 211 comments on the revised proposed standard.

After completing its deliberations and other public due process, the Board decided to separate the guidance for business combinations from that of goodwill and other intangible assets and issue the guidance in two final standards—Statement of Financial Accounting Standards No. 141, *Business Combinations* (June 2001) ("Statement 141"), and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (June 2001) ("Statement 142").

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[8] FASB Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence* (December 1998).
[9] FASB Exposure Draft, *Business Combinations and Intangible Assets* (September 1999).
[10] FASB Revised Exposure Draft, *Business Combinations and Intangible Assets—Accounting for Goodwill* (February 2001).

Statement 142 improved the existing accounting for goodwill and other intangible assets in the following significant respects:

- By providing for an economic-based view of goodwill (as compared with the existing transaction-based view) and basing the accounting for goodwill on the reporting units of the combined enterprise into which an acquired enterprise is integrated.
- By not presuming (as was the existing practice) that intangible assets are wasting assets. Instead, goodwill and intangible assets that have indefinite useful lives are tested at least annually for impairment. Intangible assets that have finite useful lives continue to be amortized over their useful lives, but without the constraint of the arbitrary 40-year ceiling (as was the existing practice).
- By providing specific guidance for testing goodwill impairment.
- By providing for specific guidance for impairment testing of those intangible assets that are not amortized and removing those intangible assets from the scope of other impairment guidance.
- By providing for disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required.

Likewise, Statement 141 improved the existing accounting for business combinations in the following significant respects:

- By providing that all business combinations be accounted for by a single method—the purchase method, thus eliminating the use of pooling.
- By providing that all intangible assets that meet specified criteria be recognized as assets apart from goodwill.
- By providing for additional disclosures about business combinations.

The requirements of Statements 142 and 141 generally became effective for business combinations and acquired goodwill and intangible assets after June 30, 2001. The Board, however, decided to defer the effective date of the requirements of those Statements for combinations between credit unions and other mutual enterprises. The Board concluded:

> For combinations between two or more mutual enterprises, . . . [Statement 141] shall not be effective until interpretative guidance related to the application

> of the purchase method to those transactions is issued.[11]
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> [Statement 142] shall not be applied to previously recognized goodwill and intangible assets acquired in a combination between two or more mutual enterprises, . . . until interpretative guidance related to the application of the purchase method to those transactions is issued. . . . [12]

Before extending the requirements of Statements 141 and 142 to mutual enterprises, including credit unions, the Board decided to undertake a separate project to develop interpretative guidance related to the application of the purchase method to combinations between mutual enterprises.[13] In the past those enterprises had applied the existing guidance, which was developed primarily for investor-owned enterprises.

The Board decided that the project should use a "differences-based" approach that presumes that the provisions of Statements 141 and 142 apply to combinations between credit unions and other mutual enterprises, unless conditions of the combination are found to be so different as to warrant a different accounting treatment. The Board noted that differences between combinations of mutual enterprises and combinations of investor-owned enterprises include the lack of equity investors (in the traditional sense) and the greater frequency of combinations without an exchange of cash or other readily identifiable and measurable consideration.

Since October 2001 the Board has held eight public meetings, including a public roundtable and liaison meeting, to discuss issues relating to the project on combinations between mutual enterprises. The Board and staff also have discussed issues related to the project at private liaison meetings and at public conferences with many preparers, auditors, and users of the financial statements of mutual enterprises, including credit unions. The Board also conducted field visits with three types of mutual enterprises, including a credit union, to discuss in detail the application of the Board's tentative decisions to those enterprises. Concurrently, the AcSB conducted research and public meetings on the same issues and reached the same fundamental conclusions as the Board.

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[11] Statement 141, paragraph 60. Footnote 24 to paragraph 60 states that "the Board intends to consider issues related to the application of the purchase method to combinations between two or more mutual enterprises in a separate project."
[12] Statement 142, paragraph 48(c) (footnote reference omitted).
[13] See Attachment 2 for a summary of the project on Combinations Between Mutual Enterprises.

Tentative Decisions

As a result of the Board's public deliberations in connection with this project to improve the accounting for combinations between mutual enterprises, the Board has reached the following tentative decisions.

First, the Board affirmed that combinations between mutual enterprises for which Statement 141 provided a delayed effective date should be accounted for as acquisitions of businesses under the purchase method. In reaching that decision, the Board observed, as it did in the development of Statement 141, that because virtually all business combinations are acquisitions of an enterprise by an acquiring enterprise, the purchase method of accounting is the method that most fairly represents the underlying economics of the transaction or event at the time the acquiring enterprise obtains control of the acquired enterprise.

The Board rejected the argument made by some mutual enterprises, including some credit unions, that eliminating the application of pooling would impede consolidation within certain industries and, perhaps, misrepresent the financial soundness and regulatory capital of certain mutual enterprises. The Board noted that mutual enterprises are similar to other enterprises in most important economic respects. Consistent with the FASB's commitment to developing neutral standards, the Board concluded that business combinations between credit unions and other mutual enterprises should be accounted for similar to combinations between other enterprises—by using the purchase method of accounting.

Second, the Board decided that certain additional interpretative guidance for applying the purchase method to credit unions and other mutual enterprises should be provided. That additional guidance includes (a) some specific measurement guidance to assist mutual enterprises in estimating the fair value of mutual enterprises acquired and (b) clarifying that in those circumstances in which a combination between mutual enterprises involves an exchange of the equity or member interests of one mutual enterprise for the equity interests of the other mutual enterprise, the fair value of the acquired mutual enterprise should be included as part of the capital or equity in the acquiring mutual enterprise's financial statements. With respect to the latter guidance, some representatives of mutual enterprises suggested that when a combination between mutual enterprises involves an exchange of equity, the fair value of the acquired mutual enterprise should be included as part of the "retained earnings" of the acquirer similar to the existing practice under pooling. The Board has tentatively rejected that view.

The Board concluded that business combinations between two mutual enterprises in which the acquirer issues member interests for the entire member interests of the acquiree are economically similar to those between two investor-owned enterprises and, thus, the accounting for those transactions should be similar.

Moreover, the interests of members are similar to investor equity interests—generally both have liquidation rights and the right to vote on major transactions, such as business combinations.

Cost-Benefit Considerations

The cost-benefit of the Board's tentative decision to eliminate pooling for all business enterprises, including credit unions and other mutual enterprises, was considered in Statement 141. The basis for conclusions of Statement 141 explains:

> The Board addressed cost-benefit considerations in developing the 1999 Exposure Draft [which included and was proposed to apply to all business combinations, including combinations between mutual enterprises] and concluded that a single method of accounting is preferable in light of those considerations because having more than one method would lead to higher costs associated with applying, auditing, enforcing, and analyzing the information produced by them. Cost-benefit considerations were thoroughly analyzed at that time and are discussed in paragraphs B225–B234. The Board concluded that those that favor retaining the pooling method on the basis of cost-benefit considerations did not provide any additional information that the Board did not consider previously.[14]

As indicated above, roundtable discussions were held specifically with mutual enterprises to gather information about mutual enterprises; combinations of mutual enterprises; concerns with alternative approaches to the purchase method; and difficulties, costs, and benefits of applying different methods.

Also as indicated above, field visits were conducted with three mutual enterprises, including a credit union. One of the objectives of those field visits was to assess and understand the incremental costs that constituents expect to incur, in qualitative terms, in applying the requirement to measure the fair value of the mutual enterprise acquired, particularly when control of that mutual enterprise is achieved through an exchange of member interests. The major concerns expressed in the field visits were among those that the FASB had previously considered.

[14] Statement 141, paragraph B68.

The Board's tentative decisions will be exposed for comment as part of a proposed standard that will solicit additional input on all aspects of the proposal, including the costs and benefits of the proposed accounting for business combinations between mutual enterprises. Consistent with the FASB's Rules of Procedure, the Board will carefully evaluate the input received as part of its public redeliberations relating to the project.

Interaction of the Board's Tentative Decisions and the Federal Credit Union Act

During the development of the Board's tentative decisions described above, some representatives of credit unions raised specific concerns about the potentially adverse economic consequences of the tentative decisions for those enterprises. More specifically, some noted that the Federal Credit Union Act ("Act") defines net worth as the "retained earnings balance of the credit union, as determined under generally accepted accounting principles." Because the regulatory definition of net worth is narrower than "equity" as defined under generally accepted accounting principles ("GAAP"), those representatives expressed the concern that the tentative decision to exclude the equity of an acquired credit union from retained earnings of the combined enterprise would misrepresent a financially sound combined enterprise as if it were not financially sound. Some also suggested that credit unions be permitted to (a) continue to apply pooling for their combinations or (b) report the equity of an acquired credit union as an addition to retained earnings of the combined enterprise. The Board has tentatively rejected those arguments.

The Board believes that the tentative decisions will generally not affect the ability of credit unions to restructure and combine with other credit unions. For example, the Board has been informed by experts in the credit union industry that the number of combinations between credit unions in which the regulatory net worth calculation could be significantly impacted is relatively small in any given year.

More importantly, the Board noted that its decisions apply to general-purpose financial statements of all enterprises and that regulatory filings of credit unions and other enterprises and the needs of their regulators are separate matters beyond the purpose of those financial statements. The Board's conceptual framework states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but, rather, provide information about those combinations that is fair and evenhanded.

The Board has tentatively concluded that, consistent with the Board's mission, its public policy goal is to issue accounting standards that result in neutral and representationally faithful financial information. The elimination of pooling for all enterprises and the requirement that all enterprises, including credit unions, report the resulting increase in equity as a result of a business combination as a direct addition to equity are consistent with that goal.

Status and Plans

The Board has substantially completed its public deliberations relating to its project on combinations between mutual enterprises. The Board's tentative decisions on this project are expected to be combined with the tentative decisions that the Board has developed in connection with a related project to improve the existing guidance for applying the purchase method of accounting into a single proposed standard for public comment.[15] Later this month, the Board, at public meetings, will address the length of the comment period and the proposed effective date.

The Board currently expects to issue the proposed standard for public comment by the end of June. Following the comment period, the Board will, at public meetings over a period of months, carefully consider all of the comment letters and other input received from all parties.

As with virtually all FASB projects, the redeliberations will likely result in a number of suggested changes to clarify and improve the proposed standard. Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board. As with all of the FASB's activities, the FAF and the SEC staff will monitor and oversee the Board's due process on this important project.

Some Comments and Observations about H.R. 1042

As indicated above, the mission of the FASB is to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises, including credit unions and other mutual enterprises. Those standards are essential to the efficient functioning of the economy because creditors, investors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

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[15] See Attachment 3 for a summary of the project on Business Combinations: Purchase Method Procedures (including Combinations Between Mutual Enterprises) and Certain Issues Related to the Accounting for and Reporting of Noncontrolling (Minority) Interests. The FASB and the International Accounting Standards Board are working cooperatively to develop common proposed standards in connection with this project.

Consistent with the FASB's mission and expertise the Board does not take positions on proposed legislation or other public policy initiatives, except in those limited circumstances when those initiatives would impair the mission and the independence of the FASB.

Per review of the provisions of H.R. 1042, the FASB observes that the proposed legislation appears to seek to revise the definition of net worth under the Act for purposes of assessing the regulatory capital adequacy of credit unions pursuant to the Act. As such, the proposed legislation does not appear to establish or change general-purpose standards of financial accounting and reporting. Therefore, the proposed legislation has no impact on the standard-setting activities of the FASB or GAAP.

Conclusion

In conclusion, the Board's project to improve the accounting for combinations between mutual enterprises has resulted in a package of tentative decisions that will soon be exposed for public comment. The Board is committed to carefully considering the input received in response to the proposed standard. That input will be considered in an open, thorough, and objective manner.

Our ultimate goal is to develop an accounting standard that will faithfully report the underlying economic effects of combinations between public and private enterprises, including credit unions, in a cost-effective manner and, thus, improve the transparency and integrity of financial reporting in the United States and abroad.

We observe that the provisions of H.R. 1042 appear to revise the definition of net worth as defined under the Act. The proposed revision of that definition appears to resolve a potential regulatory issue that some in the credit union industry believe, if not resolved, would have adverse consequences for merged credit unions.

We also observe that the provisions of H.R. 1042 do not appear to establish or change general-purpose standards of financial accounting and reporting. We, therefore, very much appreciate, Mr. Chairman, your leadership in addressing this important matter in such a thoughtful and appropriate manner.

Thank you again, Mr. Chairman. I would welcome the opportunity to respond to any questions.