Testimony of

Robert H. Herz, Chairman

Financial Accounting Standards Board

before the

**U.S. House of Representatives Financial Services Subcommittee
On Capital Markets, Insurance, and Government Sponsored Entities**

Accounting & Auditing Standards: Pending Proposals & Emerging Issues

May 21, 2010

Introduction

Chairman Kanjorksi, Ranking Minority 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 and its parent organization, the Financial Accounting Foundation ("FAF"), with an emphasis on both the FASB's role within the U.S. financial system and how we remain accountable to our constituents in performing that role. My testimony then reports on what the FASB has done over the past year, as well as on our planned activities during the coming year. Finally, it includes some information on matters on which I have been asked to comment.

The FASB and the FAF

The FASB is an independent private-sector organization, which operates under the oversight of the FAF, a not-for-profit organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Since 1973, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both businesses (public and private) and not-for-profit organizations. Those standards are recognized as authoritative generally accepted accounting principles ("GAAP") by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for public companies and by the American Institute of Certified Public Accountants ("AICPA") for other nongovernmental entities. GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make resource allocation decisions.

An independent standard-setting process is the best means of ensuring high-quality accounting standards, since it relies on the collective judgment of experts, informed by the input of all interested parties through a thorough, open, deliberative process. Although the FASB's mission is to set standards through an independent process, the FASB does not operate in a vacuum. The FASB is accountable in two important ways: (1) by engaging in robust due process in setting standards, including wide consultation with stakeholders, and (2) by being subject to oversight conducted in the public interest.

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and objective. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure, set by the Board within the parameters of the FAF's bylaws, 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. We meet regularly on both a formal and an informal basis with our counterparts at various levels at the SEC and the Public Company Accounting Oversight Board ("PCAOB"), and SEC and PCAOB staff members serve as observers on our advisory groups and often participate in our working groups. We also have observer status on the PCAOB's principal advisory group. Because bank regulators have a keen interest in GAAP financial statements as a starting point in the assessment of the safety and soundness of financial institutions, we meet with them on a quarterly basis and otherwise as appropriate. We also understand Congress's great interest and regularly brief Members and their staffs on developments. Indeed, a number of FAF trustees and FASB members will be meeting with Members of Congress next week.

The Board makes final decisions on standards 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. The Board is also focused on making technical, rather than policy or legal, judgments. In making those technical 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.

Due process procedures are intended to ensure that all stakeholders have an adequate opportunity and time to make their views known before changes in accounting standards are made. Wide consultation helps the Board to assess whether the benefits to users of contemplated changes outweigh the costs of the changes to preparers and others. Wide consultation also promotes excellence, neutrality, the identification of unintended consequences, and, ultimately, broad acceptance of the legitimacy of the standards that are adopted.

Accountability also derives from oversight of the Board, at two levels. First, the Board is monitored by the independent Board of Trustees of the FAF with regard to its standard-setting process for public companies, private companies, and not-for-profit organizations. Second, the Board is also subject to oversight by the SEC with respect to standard setting for public companies.

In addition to the important and ongoing role of the FAF trustees in appointing FASB members, evaluating the FASB chair, and otherwise ensuring that the FASB has adequate and appropriate human and financial resources to accomplish its mission, the FAF recently initiated a couple of new processes aimed at strengthening its oversight of the FASB. First, it has established a post-implementation review process for assessing whether the FASB followed its rigorous due process procedures in issuing key standards and whether those standards are having the intended effect. Second, the FAF has undertaken its own regular outreach efforts to hear directly from stakeholders, beginning with a "listening tour" last summer.

As I indicated earlier, the FASB and the FAF are also overseen by the SEC, which has the authority and responsibility under the U.S. federal securities laws to set accounting standards for public companies, but has historically looked to private-sector standard-setting bodies to set and improve standards and has deferred to their judgment. In 2003, the SEC studied the FASB and the FAF and determined that they met the criteria prescribed by Section 108 of the Sarbanes-Oxley Act of 2002 so that the FASB's standards may be recognized as "generally accepted" for purposes of the U.S. federal securities laws.[1] The SEC monitors the FASB and the FAF on an ongoing basis to ensure they continue to meet the statutory criteria and other SEC expectations.

Additional information about the FASB and the FAF can be found in the 2009 Annual Report of the FAF, attached to this testimony.

FASB Activities

Addressing Financial-Crisis-Related Issues

Over the past year, the FASB has issued a number of standards addressing reporting issues emanating from or highlighted by the Financial Crisis.[2] Most notably, these have included certain standards for two important financial reporting areas: (1) fair value and impairments and (2) securitizations and other involvements with special-purpose entities (SPEs):

1. <u>Fair Value and Impairments</u>

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[1] See SEC Release No. 33-8221, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 23, 2003).
[2] A complete list of all standards issued by the FASB since January 1, 2009, is attached to this testimony.

- FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (April 2009)

- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (April 2009)

- FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 2009).

2. Securitizations and Other Involvements with SPEs:

- Statement 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (June 2009)

- Statement 167, *Amendments to FASB Interpretation No. 46(R)* (June 2009).

In issuing the FSPs on fair value and impairments, the FASB provided important timely guidance in the midst of the Financial Crisis, while still engaging in extensive due process, following the Subcommittee's hearing at which I appeared in March 2009:

- FSP FAS 157-4 provided important clarifying guidance on the intent of Statement 157,[3] reminding preparers and auditors to use judgment and all appropriate valuation techniques and inputs in measuring the fair value of assets in inactive markets, rather than simply defaulting to stale market data in such circumstances. The FSP also included helpful indicators for when a market may be considered inactive and/or an asset sale forced rather than orderly.

- FSP FAS 107-1 and APB 28-1 helped foster more timely information to help "red flag" potential losses in financial instruments carried at amortized cost (such as loans held for investment and debt securities held to maturity) by requiring public companies to disclose fair value information for such instruments in the notes to their financial statements on a quarterly, rather than an annual, basis.

[3] Statement 157, *Fair Value Measurements* (September 2006).

- FSP FAS 115-2 and 124-2 amended the other-than-temporary impairment guidance for debt securities held outside an entity's trading portfolio, most importantly to allow the non-credit-related portion of such impairment (for example, declines in fair value stemming from market illiquidity) to be reported in other comprehensive income instead of earnings.

In issuing Statements 166 and 167, the FASB provided necessary improvements to the accounting and reporting of securitizations and other involvements with SPEs, effective in January 2010. These improvements should result in more assets involved in such transactions staying on the books of sponsoring institutions, by significantly reducing their ability to give off-balance-sheet treatment to securitizations and similar arrangements for which they retain significant risk. These improvements were taken into account by the U.S. banking regulators in their 2009 "stress tests" of the nation's largest financial institutions, and those regulators have been providing guidance on the regulatory effects of the new FASB standards. Statements 166 and 167 were preceded by interim improvements made to the disclosures requirements in this area through an FSP issued in December 2008.[4]

Also addressing deficiencies in financial reporting involving matters highlighted by the Financial Crisis were three pronouncements that the FASB issued in 2008 which became effective in 2009. Together, these improved the disclosure standards for derivatives, including credit derivatives such as credit default swaps, and the accounting and disclosure standards for financial guarantee insurance contracts:

- Statement 161, *Disclosures about Derivative Instruments and Hedging Activities* (March 2008)

- Statement 163, *Accounting for Financial Guarantee Insurance Contracts* (May 2008)

[4] 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.*

- FSP FAS 133-1 and FIN 45-4, D*isclosures about Credit Derivatives and Certain Guarantees* (September 2008).

In the coming year, the FASB expects to complete two other key projects aimed at improving accounting for financial instruments: Disclosures about Credit Quality and the Allowance for Credit Losses (the "Credit Loss Disclosures" project), and Accounting for Financial Instruments. The Credit Loss Disclosures project, to be completed soon, is aimed at improving the disclosures by financial institutions and other creditors of financing receivables (loans, finance leases, and trade receivables with terms that exceed one year) about the allowance for credit losses and the credit risks inherent in their portfolio of financing receivables.

The Accounting for Financial Instruments project represents a comprehensive reexamination of the standards for financial instruments, including classification and measurement, impairment, and hedge accounting. It is aimed at improving and simplifying the accounting and reporting of such instruments and, to the extent possible, achieving convergence of U.S. GAAP and International Financial Reporting Standards ("IFRS"). (This and other projects covered by our Memorandum of Understanding with the International Accounting Standards Board ["IASB"], aimed at improvement and convergence, are discussed further below.) Later this month we expect to issue an Exposure Draft on financial instruments for public comment, with the goal of finalizing the standard in early 2011, with a subsequent effective date to be determined.

In the Board's deliberations of those two projects, we have given careful consideration to nonpublic entities, including credit unions and many community banks. In the final credit loss disclosures standard, we will provide a one-year deferral of the effective date for all nonpublic entities, so that the standard's requirements will take effect for their 2011 calendar-year-end financial statements. In addition, the expected Exposure Draft on financial instruments will propose a four-year deferral of the effective date for all nonpublic entities with less than $1 billion in assets. This proposed deferral will allow extra time for those nonpublic entities to adopt the new requirements that would likely necessitate the greatest changes in their financial information systems. It is important to note that approximately 90 percent of all U.S. financial institutions, which together represent about 10 percent of the assets in the system, would be eligible for this four-year deferral.

Reducing Complexity in the U.S. Financial Reporting System

In issuing the standards that I just described, as well as other standards it has issued in recent years, the FASB has aimed to make its standards more understandable through a focus on clear objectives and principles (generally set forth in boldface paragraphs), supported by a sufficient level of implementation guidance.

In addition to its standard-setting activities, the FASB has taken other significant steps during the past year to reduce complexity in the U.S. financial reporting system.

On July 1, 2009, following an 18-month "verification" trial period by the public, we officially launched the *FASB Accounting Standards Codification*™ (the "Codification") as the source of authoritative nongovernmental U.S. GAAP. This was a milestone event for the FASB and the U.S. financial reporting system, ushering in a new era of modern accounting research to accounting and financial reporting professionals, as well as to analysts and investors. The Codification's launch culminated a multi-year effort to make the U.S. GAAP literature more accessible and user-friendly. Instead of GAAP standards scattered among many pronouncements issued by various standard setters over the years, the Codification provides constituents with one topically organized, easily accessible online research system.

We expect that the new system will significantly reduce the amount of time and effort required to research accounting issues, mitigate the risk of noncompliance with standards through improved usability of the literature, provide accurate information with real-time updates as new standards are released, and assist the FASB with the research efforts and literature amendments required during the standard-setting process.

With the launch of the Codification, the FASB is no longer adding numbered Statements, Interpretations, and FSPs to GAAP but, rather, is issuing Accounting Standards Updates (ASUs) that amend the relevant sections of the Codification.

The Codification's launch was further enhanced by the inclusion of XBRL (eXtensible Business Reporting Language) functionality, making it easier for users of the Codification to access information about the U.S. GAAP financial reporting taxonomy elements that link to the Codification. To ensure continued coordination of GAAP standards and the XBRL taxonomy, the FAF recently assumed responsibility for the ongoing maintenance of the U.S. GAAP financial reporting taxonomy, including updates for changes in U.S. GAAP, reviews of best practices, and technological enhancements.

International Convergence

During the past year, the FASB has also made much progress, intensifying our efforts, on our joint projects with the IASB that are aimed at improving both U.S. GAAP and IFRS and achieving convergence in a number of key areas:

- Consolidations
- Derecognition
- Fair Value Measurement
- Financial Instruments
- Financial Instruments with Characteristics of Equity
- Financial Statement Presentation
- Insurance
- Leases
- Revenue Recognition.

These projects are discussed in the attached March 2010 Quarterly Progress Report.

The FASB's commitment to international convergence of accounting standards is a longstanding one. In 2002, the FASB and the IASB laid the groundwork for convergence projects through an agreement (the "Norwalk Agreement") in which they "acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" and pledged to use their best efforts to achieve such compatibility. In the first few years after signing the Norwalk Agreement, the Boards harmonized their standards in a number of areas, such as employee stock compensation and segment reporting. The current projects became a significant part of both Boards' agendas as the result of a Memorandum of Understanding (MOU) that they entered into in 2006, reflecting the decision by the Boards, with concurrence of the SEC and the European Commission, that their resources should best be focused on developing converged and improved standards in those areas in U.S. GAAP and IFRS that were most in need of improvement. The Boards completed the first such major improvement and convergence project, on Business Combinations, at the end of 2007,[5] and updated the MOU in 2008. The updated MOU targeted 2011 for completion of the various projects.

For many of our constituents, the recent Financial Crisis underscored the need for expeditious progress on these projects, especially those projects that are most relevant to financial institutions (Financial Instruments, Fair Value Measurement, and Consolidations/ Derecognition). At their September 2009 summit in Pittsburgh, the leaders of the G-20 nations called for the Boards to "redouble" their efforts to achieve convergence in these areas by the 2011 target date.[6] In their February 24, 2010 statement,[7] the SEC indicated that along with the execution of an SEC staff work plan, "completion of the convergence projects of the FASB and the IASB according to their current work plan…will position the Commission in 2011 to make a determination regarding incorporating IFRS into the financial reporting system for U.S. issuers."

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[5] FASB Statements 141 (revised 2007), *Business Combinations*, and 160, *Noncontrolling Interests in Consolidated Financial Statements* (both, December 2007), and IFRS 3, *Business Combinations* (January 2008).
[6] *Leaders' Statement: The Pittsburgh Summit*, September 24-25, 2009.
[7] SEC Release Nos. 33-9109 and 34-61578, *Commission Statement in Support of Convergence and Global Accounting Standards.*

Many of these projects are nearing their Exposure Draft stage. Achieving both improvement to U.S. GAAP and convergence with IFRS on the MOU projects, while making necessary improvements to U.S. GAAP on other projects such as those described in the preceding sections of this testimony, remains a significant challenge for the FASB. In some of the MOU projects, the Boards are on track to both make the desired improvements to U.S. GAAP and IFRS and achieve convergence. In other MOU projects, achieving convergence is proving to be quite challenging.

Section 108 of the Sarbanes-Oxley Act and the SEC's 2003 Policy Statement (discussed on page 3 above) require us, in serving as a recognized authoritative standard setter, to "consider, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and the protection of investors." Along these lines, while we are committed to, and are making every effort to, foster convergence between U.S. GAAP and IFRS through the MOU projects, we must ensure that, first and foremost, the resulting standards represent improvements that are in the best interest of U.S. investors and other users of GAAP information.

Activities Related to Private Companies and Not-for-Profit Organizations

While a significant portion of the FASB's attention has been, and continues to be, focused on international convergence of standards and other matters that affect U.S. public companies, privately-held companies and not-for-profit organizations remain very important to the FASB's and the FAF's mission. We extensively outreach to these sectors during our due process and carefully consider their differential needs, with the result often being a deferral of effective dates of new pronouncements and sometimes a reduction in disclosure requirements for those sectors versus public companies. For example, we deferred the effective date of Interpretation 48, *Accounting for Uncertainty in Income Taxes*, for nonpublic entities by two years and we exempted them from some of the quantitative disclosure requirements. And, as noted above, we will be proposing to defer by several years, for many nonpublic entities, some of the significant requirements in our upcoming proposed ASU on Accounting for Financial Instruments.

In our outreach to privately-held companies and not-for-profit organizations, we benefit from the input received from important advisory groups. For private business enterprises, the FASB regularly consults with both its Small Business Advisory Committee (whose members also represent small public companies) and its Private Company Financial Reporting Committee ("PCFRC"), on specific areas in proposed or existing standards where differences for private companies might be appropriate based on user needs or cost-benefit considerations.

Beyond these routine consultations, however, there are a number of forces in play that have challenged the approach that the U.S. has traditionally had, of one set of standards for both public and private companies (with exceptions as appropriate) rather than the type of parallel system of "Big GAAP/Little GAAP" that is present in certain other countries. These include the potential move to IFRS for public companies (and the uncertainty that has created for private companies), the available use of IFRS for Small and Medium-Sized Entities by U.S. private companies, recent developments in other countries that have adopted IFRS for their public companies but not for their private companies, and continuing concerns expressed by some constituents over the relevance and cost/benefit to private companies of certain U.S. GAAP requirements. In response to hearing these concerns from private company constituents during the Trustees' listening tour last summer, as well as receiving input from the PCFRC, in December 2009 the FAF created the "Blue-Ribbon Panel" on Standard-Setting for Private Companies (the "Panel"), sponsored jointly by the AICPA and the National Association of State Boards of Accountancy. The Panel, which includes a cross-section of private company financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors, will examine these matters and issue its report with recommendations to the Trustees in early 2011.

As I indicated earlier, standard-setting for not-for-profit organizations is also important to the FASB's and FAF's mission. In October 2009, the FASB established a Not-for-Profit

Advisory Committee ("NAC"). The FASB has just appointed the initial members of the NAC, which will hold its first meeting in September. The NAC will provide us with input on reporting issues in that sector, including issues that may arise if and when U.S. public companies move to IFRS, because IFRS does not explicitly cover not-for-profit entities.

Other Matters

I have been asked to comment on financial arrangements that companies may employ to manage their financial position near the end of a reporting period—presumably including arrangements such as the so-called Repo 105 and Repo 108 transactions engaged in by Lehman Brothers. I would respectfully refer the Subcommittee members to the attached letter that I sent to Committee Chairman Frank and Ranking Minority Member Bachus in connection with the Committee's April 20, 2010 hearing, "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." As noted in the letter, the FASB does not have any regulatory or enforcement powers, but we do work closely with the SEC whenever there are reports of any significant accounting or reporting issues such as the ones highlighted in that examiner's report. We stand ready to take any additional standard-setting actions that may be warranted as the result of our ongoing discussions with the SEC staff as they evaluate that report and any information they obtain concerning practices of other financial institutions in the area of repurchase agreements and consolidation of SPEs.

Conclusion

The demands on accounting standard setters that have stemmed from the Financial Crisis, together with the goal of continuing to improve U.S. GAAP and of achieving convergence of GAAP and IFRS, have made this past year one of the most challenging in the FASB's 37-year history. The coming year will likely be equally if not more challenging as we work towards completion of the various MOU projects. I and others at the FASB very much look forward to the challenge.

Thank you, Mr. Chairman, for the opportunity to appear here today. I would be pleased to answer any questions.

<u>Attachments:</u>

1. 2009 Annual Report of the Financial Accounting Foundation

2. List of Standards Issued by the FASB since January 1, 2009

3. IASB and FASB Commitment to Memorandum of Understanding: Quarterly Progress Report, 31 March 2010

4. Letter from Robert H. Herz to House Financial Services Committee Chairman Barney Frank and Ranking Minority Member Spencer T. Bacchus III, dated April 19, 2010