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

March 12, 2009

Prepared Statement

Prepared Statement

Robert H. Herz

Chairman, Financial Accounting Standards Board

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

I have some brief prepared remarks and would request that these and the full text of my testimony be entered into the public record.

The mission of the FASB is to establish accounting and financial reporting standards for public and private companies and for not-for-profit entities that if faithfully implemented will provide investors and other users of financial statements with relevant, reliable, and transparent information about a company's financial condition, results of operations, and cash flows. The usefulness and credibility of such information depend heavily on it providing an honest and neutral portrayal and not being skewed to favor any particular company, industry, or type of transaction or being modified in times of economic stress or being purposefully biased in favor of any other regulatory, social, or economic objectives other than sound reporting to investors and the capital markets.

Our current reporting model in the U.S. and across much of the world includes both historical cost and fair value measurements. As the current financial and economic crisis has deepened and broadened, there has been considerable focus on the subject of so-called mark-to-market or fair value accounting, not only in the media and among public policy pundits, but also at public roundtables held by the SEC, public roundtables convened by us and the International Accounting Standards Board, various other discussions between standard setters and regulators and with constituents, and in the

SEC's December 30, 2008 report to Congress and other studies. Some financial institutions and their trade groups have criticized the use of fair value in the current environment as overstating the extent of losses and capital erosion and as a factor exacerbating the crisis. They have therefore called for it to be either suspended or modified in various ways. On the other hand, many investors, financial analysts, and other professional users of financial reports and their organizations have applauded its use as essential in promptly revealing the extent of problem assets and deteriorating financial condition of institutions. Accordingly, they have urged us not to suspend or weaken the current requirements, fearing that would enable institutions to improperly avoid or delay the recognition of economic losses and depleted capital. Indeed, some have urged us to extend the use of fair value to all financial assets, noting that investors seem to believe that bank assets are overstated as evidenced by market valuations of many publicly traded banks at well below their reported book values and recent acquisitions of major banks at a fraction of the acquired banks' book values. Thus, in their view, the reporting problem is not too much use of fair value, but too little.

Clearly, there are strongly held views on both sides of this debate. So, rather than use my time to debate the pros and cons of fair value, my statement will provide you with some information about (1) fair value and its use in financial reporting, (2) our recent and planned standard-setting actions relating to this subject, including our responses to reporting issues emanating from the financial crisis and how we are addressing recommendations in the SEC report, and (3) some observations about the role of financial reporting and its relationship to economic and regulatory consequences.

First, what is fair value? We define the fair value of an asset as the price that would be received by the holder of that asset in an orderly transaction. Conceptually, it is what an asset is worth currently in an exchange between informed parties on an arm's length basis, and not its potential value at some future date under different economic or market conditions. Also, contrary to what some have asserted, it is not the price that would be received in a distressed sale or forced liquidation.

As described extensively in the SEC report, the use of fair value by U.S. financial institutions varies considerably from relatively little by many banks to more general use of so-called "mark-to-market" accounting by broker-dealers. "*Mark-to-market*" accounting occurs when items are carried at fair value on a continuous basis with the periodic changes in fair value (that is the "mark-to-market" adjustments) included in determining reported earnings for each period. Such accounting is used for securities in trading portfolios and, subject to certain exceptions for qualifying hedges, for derivatives. It also can be voluntarily elected, subject to certain constraints, under an available fair value option.

Fair value is also 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. Investments classified as held-to-maturity are carried on a cost basis. Fair value is also used to recognize what are termed other-than-temporary impairments of financial assets where there has been a significant and prolonged decline in their value, as can occur in sustained downward markets. In such cases, the value of securities held as either available-for-sale or held-to-maturity is written down through earnings to reflect the other-than-temporary decline in value. Mortgage loans held for sale are reported at the lower of cost and fair value, while loans held for investment, which make up the bulk of financial assets for many banks, are generally carried at amortized cost, with allowances for loan losses that are not based on fair value.

Most of these requirements have been in place for many. Counter to what some have asserted, FAS 157 on fair value measurements (which we issued in 2006 following over three years of extensive input and public due process) does not require any new fair value measurements. Thus, it is not surprising that the SEC report indicates that the extent of use of fair value has remained fairly constant over time. Rather, FAS 157 was issued to establish a consistent definition of fair value. It also provides a coherent framework for determining fair value across varying types of assets and liabilities and differing market conditions and requires significantly expanded and enhanced disclosures relating to the use of fair value in financial statements and its impact on reported earnings and financial condition.

So, fair value is by no means a new concept. Further, the use of fair value in determining write-downs in periods of down markets is hardly new and would apply whether one used mark-to-market accounting or other age-old accounting methods such as lower of cost or market.

What is new are all the now well-chronicled problems that contributed to the global crisis, including notoriously lax and fraudulent lending, excess leverage, the creation of complex and risky investments through securitization and derivatives, the global distribution of such instruments across rapidly growing unregulated and opaque markets lacking 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. As the crisis has deepened and broadened, the values of many financial assets have fallen significantly, credit spreads have widened, and the markets for some complex instruments have become increasingly illiquid and virtually inactive. Those conditions pose significant challenges to the valuation process, often requiring additional data gathering and analysis and the use of sound judgment. But while our standard on fair value measurement did not specifically contemplate the current crisis, it did include guidance on determining fair values for illiquid assets for which there may be little or no transaction activity. And, during the fall of 2008, our staff together with the SEC staff provided additional guidance on valuing financial assets in illiquid markets which we then supplemented with further guidance. Also, in such situations, clear and ample disclosures are critical to helping investors understand where fair value was used, how it was determined, and its impact on reported earnings and financial condition.

Additionally, consistent with the recommendations in the SEC report and with the significant input we received at our recent public roundtables with the IASB and following many other discussions with constituents and with our Valuation Resource Group, we have recently undertaken a series of near-term standard-setting actions aimed at providing further helpful guidance on determining fair values under current conditions that will again emphasize the need for exercising appropriate judgment, further enhancing disclosures, and dealing with certain inconsistencies in the current requirements on impairments of financial assets. These actions are described in the full text of my testimony. Also consistent with the recommendations in the SEC report and other input we received, we and the IASB are undertaking a joint project to more comprehensively improve, simplify, and reach convergence of our standards on accounting for financial instruments. These efforts are benefiting from the ongoing discussions of our senior-level Financial Crisis Advisory Group. I would also note that over the course of the past year we have responded to various other reporting issues emanating from the global financial crisis, including issuing new standards to improve transparency for securitizations, the use of special- purpose entities, financial guarantee insurance, and credit default swaps and other derivatives.

I would be remiss if I did not briefly comment on the role of financial reporting and economic and regulatory consequences, including assertions by some that the use of mark-to-market accounting and fair value has caused banks to fail and has exacerbated the financial crisis. We agree with the SEC's conclusion that fair value did not cause banks to fail. Rather, its use can help to more promptly reveal underlying problems at financial institutions. We also agree with the SEC that suspending or eliminating the existing fair value requirements would not be advisable, would diminish the quality and transparency of reporting, and could adversely affect investors' confidence in the markets. The role of accounting and reporting standards is to help provide investors and the capital markets with sound, unbiased financial information on the activities, results, and financial condition of reporting enterprises. 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 ours, and our standards are not specifically designed to meet their objectives. We are charged with providing investors with the best available information about the financial condition of reporting entities. Financial institution regulators can and do systematically make adjustments to reported GAAP figures in computing regulatory capital and in determining the proper response to capital impairments. The preservation of these separate roles is essential to both transparent capital markets and effective prudential financial regulation.

But, while our roles are somewhat different, we do have longstanding and productive 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 with those of the regulators.

Of course, good accounting and reporting can have economic consequences, including potentially leading to what some term as *procyclical* behavior. Highlighting and exposing the deteriorating financial condition of a financial institution can result in investors deciding to sell their stock in the entity and 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 the falling value of their homes and of 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 that 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 procylicality, I believe these concerns are more effectively and 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.

Finally, as noted above, in these very challenging times we continue to provide application guidance and to actively work with the SEC, the IASB, banking regulators, investors, and other constituents on broader improvements to accounting standards in what is clearly a changing world.

Let me end on that note.

Thank you again, Mr. Chairman. I look forward to discussing these important matters further with the Subcommittee during the question period.