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The Honorable Barney Frank
Chairman
Committee on Financial Services
U.S. House of Representatives
Room 2128 Rayburn House Office Building
Washington, DC 20510

CC: Representative T. Baldwin, Senators R. Feingold and H. Kohl (via email)

November 2, 2009

Dear Mr. Chairman:

I write in opposition of recent proposals calling for accounting standard-setting oversight to be placed under the jurisdiction of a new systemic risk regulator. Such actions could change the objectives of financial reporting, harm the capital formation process in this country, and potentially politicize the process of setting accounting standards.

Indeed, concerns about mixing the oversight of accounting for regulatory purposes and that which is best for serving the needs of investors and creditors is well illustrated in the recent debate about fair value accounting. I am on record opposing calls to suspend or roll-back the use of fair value accounting (a.k.a. Mark to Market) and concomitant challenges to independent private sector accounting standard-setting (see the prior bill proposed by Rep. Cohen). In the following discussion, I summarize the basis for this position and why it is important to keep accounting standard setting under the jurisdiction of the SEC, which is responsible for fair, objective, and transparent reporting to those who invest in our public companies. I would be happy to provide expanded consultation with you or your staff on these issues.

The Fair Value Debate

Proposals to roll back fair value accounting or change the oversight of independent standard-setting is a bad idea for two fundamental reasons:

- These proposals will not result in accounting that reflects the economic substance of the transaction taking place and provides a political, rather than an economic answer to an important valuation problem,
- It undermines the important role of an independent private-sector standard-setter (the FASB) at a time when it is essential that we restore faith in our financial reporting system (and it risks undermining the faith of young people in the integrity of our political system.)

Let me provide a bit of background on the fair value issue, which appears to be part of the motivation for changing the oversight of accounting standard-setting. This is not the first time FASB has addressed the accounting for financial instruments, such as those reflected in the investments in mortgage-backed securities, which appear to be at the root of most of the recent fair value proposals. In the early 1990s, in the wake of a prior "credit crisis", the FASB issued rules that required most marketable securities to be reported at fair value on the balance sheet. In response to political pressure at that time, the Board allowed some unrealized gains and losses to bypass the income statement. Although not entirely sound from a conceptual standpoint, these rules worked well – through the accounting and expanded disclosure - in providing investors the information they needed to evaluate investment portfolios.

Since the promulgation of these rules the FASB has been working to improve the accounting and disclosures related to financial instruments. Note that most economists, analysts, investors, creditors, and other users of financial statements believe that in general, financial instruments should be measured at fair value with gains and losses (realized and unrealized) recorded in income. With the exception for the accounting for derivatives, fair value accounting for financial instruments has not been significantly expanded in recent years. However, both the FASB and the SEC have expanded disclosures related to financial instruments in response to demands in the marketplace for more fair value information on these assets and liabilities.

The most recent example of these efforts was the promulgation of Statement No. 157, "Fair Value Measurements". Contrary to the assertions of many (in the media and Congress), this statement ***did not*** introduce any new items for measurement at fair value. Rather, this standard developed a much needed single definition of fair value, when called for in the accounting standards and it developed a disclosure framework that requires expanded disclosures when fair value measures are based on less-reliable estimation techniques. That is, the standard advises that the best fair value measure is based on market prices in active markets between willing buyers and willing sellers (so-called Level 1 measures). Thus, if an active market price is available, "mark-to-market" accounting is used. When an active market price is not available, then the preparer can use estimation techniques (which are well developed and established) to arrive at a fair value measure (Level 2 or Level 3 measures).

Hence, contrary to assertions by those calling for suspension of "mark-to-market" accounting, action by Congress is ***not*** needed because the rules ***allow*** preparers to deviate from mark-to-market accounting when the market prices do not meet the fair value measurement objective. This was likely the case recently in a number of securities markets, such as those for mortgage-backed securities, auction rate securities, and other collateralized securities. That is, if there is not an active market price, the fair values are no longer based on market prices but must be estimated. In these instances, preparers can help users understand the judgments involved in those measures through expanded disclosures. The reporting rules help companies make their investments more transparent to the market.

Why the uproar about the accounting? This is puzzling, because in this case, the accounting is doing exactly what is intended. Note that prior to market meltdown, a number of large banks and financial institutions had been reporting under the new rules with the majority of their fair value estimates based at least in part on market prices. There were no complaints about the accounting then – note that most companies were recording gains in that period. However, when markets seized up, many of these assets moved from Level 1 to Level 3 and expanded disclosure was required. This is the role of accounting – to provide investors with information need to evaluate companies in both good and bad markets.

Furthermore, the SEC, based on a comprehensive analysis of the application of fair value accounting, in a study released in late 2008 concluded that mark-to-market/fair value accounting was not an important factor in the economic events that unfolded in 2007-2008. In fact, many have concluded that the outcomes could have been much worse with less transparent reporting during this period. Finally, banking regulators need not rely, and have not always relied, on GAAP accounting measures, such as fair value. Note that these regulators (rightfully so) are more focused on solvency, safety and soundness, in order to protect depositors and the broader credit markets. Investors and creditors, which are the users the FASB serves, need information that is future oriented -- fair value. And they need it in a timely fashion, not at the held-to-maturity date.

Independent Standard-Setting to Serve Investors

With respect to concerns about independent private sector standard setting, it is important to understand that transparent financial reporting about fair values is not the problem. We may not like what the financial statements say, but we are always better off when the statements are representationally faithful to the underlying economic substance of transactions. While the FASB has dealt with this issue by adhering to a conceptual framework based on relevance and reliability of information reported in financial statements, proposals to roll-back, “carve out”, or suspend certain accounting provisions do not. Rather, it is a sell-out to a few companies that want to keep a privilege for themselves. In fact, these proposals are deceitful because it allows some companies to hide or otherwise obscure the consequences of prior investment decisions. We need truth in financial reporting – applied to all companies, without exceptions for companies that have invested more in lobbyists, in order to get an exception.

The FASB’s efforts to improve the accounting for financial instruments (similar to the prior politically charged decision to require stock option expensing in 2005) strengthens investor confidence in the financial statements of all companies, thus lowering their cost of capital. The efficient allocation of capital to the most economically valuable business activities depends on consistent accounting rules. For this reason, all companies must adhere to these accounting provisions so that losses on some investments are not hidden from investors. The fact that for several quarters affected institutions have been unable to sell these securities is a strong indication that some losses need to be reported. Only by owning up to these losses will these companies regain investor confidence -- in these companies and the market overall. Indeed, as more information is coming to the market on these securities recently, the market has opened up.

Moreover, reporting that favors some companies is biased – it may be in the interests of managers of some companies but does not serve financial reporting or our markets well. Biased reporting raises concerns about the credibility of these companies' reports, as well as the credibility of financial reporting in general. Consider companies that did not invest in these various collateralize instruments? Why should they be made to look worse because they made different (less risky) investment decisions? Not too long ago we learned from the accounting frauds at Enron, WorldCom, Xerox, MicroStrategy, Lucent, as well as from the fallout of the recent credit market events, that credibility of financial reporting is fundamental to the efficient operation of our capital markets. And even good companies get tainted by biased reporting of a few bad apples.

An additional source of bias in financial reporting arises when political interests attempt to circumvent the due process in the setting of accounting standards in the private sector. All relevant issues related to fair value accounting have been studied and given full consideration by the FASB and the SEC (and international standard-setters) both recently and in the prior round of deliberations in the early 1990s. Congress needs to stay out of accounting standard-setting and trust the SEC and the FASB to serve the interests of our markets. Recall that this independence was affirmed by actions in response to the Sarbanes-Oxley Act of 2002.

The missions of bank regulators and accounting standard setters, although often complementary, are different in their purpose. The mission of bank regulators is to ensure the safety and soundness of financial institutions and the banking system. As such, one of their primary responsibilities is to set regulatory capital requirements. In doing so, regulators must take many factors into consideration, including the needs of the economy and the particular circumstances of financial institutions.

Grouping these two functions under the auspices of a single systemic regulator threatens to weaken both missions.

Accounting standard setters have a single mandate: To ensure that investors and the capital markets at large are equipped with the information they need to evaluate U.S. companies. The information contained in financial reports plays an essential role in the effective allocation of capital within the United States; it allows investors to understand the risks facing public and private companies and make informed investment decisions about their value. Unfortunately, as discussed above, the lack of transparency within certain financial institutions was a major cause of the financial crisis. For that reason, accounting standard setting should remain under the jurisdiction of the SEC, which is responsible for fair, objective, and transparent reporting to those who invest in our public companies.

I urge you to reject any efforts to place accounting standard setting under a systemic risk regulator and continue to support independent accounting standard setting in the United States.

Thank you for your consideration of my views. I interact with great young students everyday. I hope that I will be able to convey to them that Congress is indeed working to improve financial reporting and it is doing so by supporting unbiased reporting that has been fully studied by an independent group with the technical competence to make the decisions. Let the FASB do its job.

Sincerely,

Terry D. Warfield Digitally signed by Terry D. Warfield
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