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Remarks by

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Take Me Out to the Ball Game

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I am pleased to share this session with my former partner, John Shanahan, and with Denny Beresford, Chairman of the FASB.

My remarks represent my views and mine alone, and I do not speak for the Commission or other members of the staff.

At the outset, let me commend the FASB for working long, hard hours to issue Statement 114 on loan impairment and Statement 115 on debt and equity securities earlier this year. I think that investors are and will be the beneficiaries of that work, and I applaud the FASB.

I have been working in the auditing and accounting standard-setting business for a long time. In 1963, when I was at Peat Marwick, I started working with that firm's representatives on the AICPA's Committee on Auditing Procedures and the Accounting Principles Board. Starting in 1966 through 1970, I was one of the technical advisers to a member of the Accounting Principles Board. From 1973 to mid-76, I was one of the original members of the FASB. And, off and on, from 1979 through 1991, I was a member of and chairman of the Accounting Standards Executive Committee of the AICPA. So, I think that I know something about this business.

In the accounting standard-setting business, one has to deal with things emotional and things psychological as much as with things technical. Standard-setting in accounting is as much about managing change as it is understanding technical financial accounting and reporting. Accounting standard-setting is the process of making changes to recognize shifts in business practices and economic situations and sometimes to reflect changes in accounting thought. Some people, especially preparers of financial statements, might welcome less change. I have heard a few of them say that the FASB should take a long holiday. But, that is not the way the world is.

In this world of standard-setting, things take time, sometimes lots of time, and change tends to come in small chunks. In terms of singles instead of home runs. Sometimes bunt singles. Sticking with the baseball vernacular, I think that FASB Statements 114 and 115 were line-drive singles, not bouncers through the infield. In Statement 114, while retaining the indefinite standard of "probable" for identifying impairment in Statement 5, the Board recognized the importance of the time value of money. That required the elimination of part of old Statement 15, which had allowed, indeed required, that the time value of money be ignored in accounting for troubled debt restructurings. FASB Statement 115, although still based on management intent as to debt securities, requires marketable securities to be recognized at market instead of cost, making the financial statements more relevant. Based on Statements 114 and 115 and other recent Board actions, I think that the FASB has been doing quite well. The

standard on pension benefits (Statement 87), aside from its complicated deferrals that level the hills and valleys of changes in asset and liability valuations, is a double; research studies have shown that investors demonstrably are taking the pension disclosures and impounding them into stock prices. The standard on postretirement health care benefits (Statement 106), aside from its complicated deferrals and its permissible drawn-out transition provision, is a bases-clearing double. Research also shows that investors are using information produced by that standard. Indeed, not since line-of-business/segment reporting was introduced in the 1970s has an accounting standard so dramatically and forcefully communicated so much information to so many people as has Statement 106 on postretirement benefits. Had the standard on cash flow information (Statement 95) required direct reporting of operating cash flows, it would have been a home run; as is, it is a stand-up triple. Investors are more than cheering spectators when the FASB scores; investors are the very real winners in a very real game affecting their fortunes.

Those successes by the FASB, along with others such as FASB Statement 14 on segment and geographical reporting, Statement 52 on foreign currency translation, and Statement 94 on consolidation, demonstrate the wisdom of having an independent, full-time, well-funded Financial Accounting Standards Board. Demonstrate the wisdom of the Board's having a Mission Statement and Concepts Statements that drive toward financial information that is relevant, reliable, complete, neutral, free from bias, and even-handed--that will produce financial information that is useful for making economic and business decisions. That will produce financial information that is transparent and credible.

A further strength of the FASB system is shown by the fact that the FASB is willing to, and does, re-examine prior standards, as was done with foreign currency translation where Statement 52 replaced Statement 8, as was done with income taxes where Statement 109 replaced Statement 96, and as the Board now is doing with its re-examination of reporting disaggregated information, which in effect is another look at segment reporting. This demonstrates the wisdom of having a standard-setting apparatus that is the finest of its kind--one that works.

That said, let me now turn to one of the FASB's unfinished projects, namely, the Financial Instruments project, which is of much interest to this audience. That project has been on the Board's agenda a long time, since 1986 in fact. The longer the Board works on that project, the more we learn how significant it is and how large it is. To give you some idea of how large I think it is, I think it is larger than a bread box and larger than my Buick. It's about as large as the Queen Mary. The Board has broken the project down into manageable bites; we have a standard on disclosure about financial instruments with off-balance sheet

risk and concentrations of credit risk (Statement 105), a standard on disclosure about fair value of financial instruments (Statement 107), a standard for recognition and measurement of loan impairment (Statement 114), and a standard on accounting for and disclosure about investments in debt and equity securities (Statement 115). And now the Board is working on what to do about forwards, exchange-traded futures, options, and swaps, or generally speaking, the so-called derivative contracts, of which there now are hundreds.

As things stand now, investors know a lot about what appears on a bank's balance sheet and what went on during the year about cash financial instruments that are recognized on a bank's balance sheet. Taking a bond, for example, the investor can see the bond's cost, its maturity date and amount, and its market value. The coupon interest rate may not be disclosed explicitly but may be inferred. The investor sees the interest income recognized on the bond in the income statement. And if there were sales and purchases of bonds, the investor sees cash receipts coming in and cash payments going out in the cash flow statement. With respect to liabilities like deposits and debentures, investors can see the maturity amount, the fair value, and maturity dates. Coupon rates, if not explicitly disclosed, may be inferred. The income statement shows an amount representing interest expense, and the cash flow statement shows activity in issuances and extinguishments of debentures payable.

Given the disclosures with respect to on-balance-sheet financial instrument items, investors have the necessary ingredients to make judgments about a bank's future earnings and cash flows. The investor can make his or her judgment about the course of interest rates in the future, how quickly the bank can react to changes in interest rates, the prospects of bad debts in the bank's customer base, the bank's cost structure, competition, regulatory changes, and the like, and come up with some fairly good ideas about a bank's future income and cash flow streams.

The information given to investors about derivatives that are used to manage a bank's on-balance-sheet assets and liabilities as an end user is not nearly so robust, however. Even as to futures contracts, where there is daily mark to market for changes in value, there is not always disclosure about those on-balance-sheet cash items related to "hedging" of assets or liabilities. Disclosure about the realized and unrealized gains and losses on non-exchange traded forwards and options and swaps also is often not robust. The explanation of why the contracts are entered often is slight. Disclosure about open contracts and contracts settled or offset with other contracts also is often less than robust. In short, the disclosures need to be improved so that investors may make better and more well-informed decisions.

I recently attended a meeting at the FASB where the participants were discussing accounting for hedging instruments and off-balance sheet derivatives that are used by banks as end users. One banker said that the off-balance sheet instruments are like on-balance-sheet instruments but involve no initial cash outflow, or cost, or no initial cash inflow, or proceeds. That description is, I think, apt. What that suggests to me is that banks should consider giving investors as much information about the off-balance-sheet items used by banks as end users to manage on-balance-sheet assets and liabilities as banks give for the on-balance-sheet items. Notional amounts. Strike prices. Interest rates. Due dates. The amounts of cash that will flow in and out depending on where interest rates go. When cash receipts will come in. When cash payments will go out. Activity in contracts. Unrealized gains and losses or replacement value of contracts. Deferred gains and losses. When, period by period, deferred gains and losses will be recognized in income, and the amounts thereof. The effect of those instruments on net interest income or margin. Why the bank is entering into such contracts. Whether it will enter into such contracts in the future. What the bank is doing to prevent counterparty credit loss. The effects of netting agreements including disclosure about legal enforceability. With that information, investors can make judgments about future income and future net cash flow both for that which is on the balance sheet and that which is not on the balance sheet. Until the FASB decides what the accounting and related disclosures should be for the derivatives used by banks as end users, I think voluntary disclosure of these kind of items will be most helpful to investors.

At the September 23, 1993 meeting of the Emerging Issues Task Force, I made an announcement of SEC staff positions on (i) the discount rate used to measure the amount of defined pensions benefits under FASB Statement 87, "Employers' Accounting for Pensions," and other postretirement benefits other than pensions under FASB Statement 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," (ii) the classification of in-substance foreclosed assets, and (iii) the reclassification of securities in anticipation of the adoption of FASB Statement 115.

The SEC staff expects registrants to use discount rates to measure obligations for pension benefits and postretirement benefits other than pensions that reflect the current level of interest rates at each measurement date. Interest rates have declined substantially and are at levels not seen in twenty years. In reviewing various filings, we have found that registrants are not updating the discount rate assumption, and we have required that it be done. We will be looking at future filings to make sure that registrants are updating their assumption about discount rates. In that announcement, we also said that we would expect the

rate to be the rate of high-quality bonds, which are the equivalent of AA rated bonds.

Financial Reporting Release 28, "Accounting for Loan Losses by Registrants Engaged in Lending Activities," requires that in-substance foreclosed assets be classified and accounted for as "other real estate owned." On June 10, 1993 the banking regulators jointly issued a regulatory credit initiative that is not consistent with the guidance provided in FRR 28 because the regulatory initiative permits the classification of ISF assets as loans rather than as real estate owned. Registrants have asked whether the SEC staff would object to the classification of ISF assets as loans in financial statements and other financial information filed with the Commission.

Even though the classification of ISF assets as loans is not consistent with the guidance contained in FRR 28, it is the position of the SEC staff that the main objective of FRR 28 is to require a systematic methodology to be applied to the recognition and measurement of ISF assets, and that this objective should be met even if the classification pursuant to the regulatory credit initiative is adopted by registrants. Therefore, the SEC staff would not object to the reclassification of ISF assets as loans, provided:

1. Registrants do not change their recognition and measurement accounting policies for ISF assets.

2. Registrants file with the Commission, in a current report, financial statements and other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, that reflect the effects of the new classification policy for ISF assets for each period for which such statements and other financial information were provided in the most recent 10-K and subsequent interim reports. This means that the staff would like registrants to present the impact of the new reclassification policy on (i) the financial statements for each of the latest three years, (ii) each quarterly period since the last Form 10-K as well as comparable quarters for the preceding fiscal year, and (iii) all other financial information, including Guide 3 disclosures and Management's Discussion and Analysis, for each period for which such statements and other financial information were provided.

3. There is disclosure of the reclassification and its effects.

The SEC staff will object if, because of the adoption of this new regulatory initiative, ISF assets are not classified consistently. Therefore, registrants should not adopt this initiative on a prospective basis because the financial statements

and other financial information would not be presented in a consistent manner.

FASB Statement 114 is silent on the issue of classification. Paragraph 26 of FASB Statement 114 states that annual financial statements shall not be restated but it does not state whether annual financial statements should be retroactively reclassified to present ISF assets consistently. I would think that investors would be better informed if the financial statements for all periods had the amounts for ISF assets classified and displayed consistently, rather than having a disjointed presentation that may confuse investors.

Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," requires an investment in a security to be classified as held to maturity, available for sale, or trading, based on an enterprise's intent with respect to holding the security. The staff understands that the anticipated adoption of Statement 115 and possible changes in regulatory capital requirements may have caused registrants to change their intent with respect to holding certain securities. As a result, for financial reporting purposes, these registrants may need to change their classification of certain securities to reflect that revised intent.

The SEC staff has been asked whether such a change in classification would call into question the prior accounting for securities. The staff will not challenge a registrant's prior accounting for securities as a result of a one-time change in the classification of securities on, or prior to, the date of adopting Statement 115 if that change is caused by a change in intent because of the anticipated adoption of Statement 115 and possible changes in the regulatory capital requirements. Registrants should not, however, change the measurement principles for securities prior to the adoption of Statement 115.

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