



Colorado Public Employees' Retirement Association

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October 6, 2008

**Testimony of**

Gregory W. Smith, General Counsel  
Colorado Public Employees' Retirement Association

**Before the  
United States House of Representatives  
Committee on Oversight and Government Reform  
Causes and Effects of the Lehman Brothers Bankruptcy**

Chairman Waxman and Members of the Committee on Oversight and Government Reform:

Thank you for the opportunity to address the Committee regarding the failure of Lehman Brothers. As an entity responsible for the retirement security of over 420,000 public servants we believe it is important at the outset to recognize that the impact of the failure of Lehman extends far beyond the fat cats on Wall Street. In light of the melt down of our capital markets in recent weeks we can safely conclude that the crisis has arrived on every main street in America. Every man or woman with a 401(k), an IRA or a retirement plan of any kind is feeling the effects of the collapse and is facing life changing adjustments to his or her financial planning.

We at the Colorado Public Employees' Retirement Association (CoPERA) are entrusted as fiduciaries with investing retirement assets of every state employee, Judge, State Trooper, K through 12 teacher (except those in Denver), and many employees of local units of government. Each and every month we are responsible for putting to work more than \$125 million of contributions from our membership in a diversified portfolio. In the past year CoPERA has paid benefits of over \$2.5 billion to over 80,000 retired public servants helping to fuel the economy of communities throughout Colorado. Our asset base as of our most recent audited financial statements was \$43 billion.

In order to meet the needs of our membership we, like our peers that exist in virtually every state in the nation, are entirely dependent on the strength, efficiency, and transparency of our capital markets. What has become apparent in recent weeks is that the strength of our markets is ultimately entirely dependent upon the confidence of investors. Confidence that the environment in which they are considering investing is an environment that promotes investor rights and policies which further the interests of investors. Confidence that violations are the subject of enforcement actions and perpetrators are held accountable. Confidence that the financial statements presented to investors by management are compliant with accounting standards that are designed to reflect all the information relevant to financial analysis. Confidence that a rigorous audit process has verified management's representations and the adequacy of internal controls in the company to prevent fraud. In each of these critical areas of investor confidence we have experienced significant deterioration in recent years and remain at significant risk for further erosion.

We do not presume to know or be able to articulate what it will take to restore investor confidence in the markets so as to allow the current seizure of the markets to be alleviated. Nor do we profess to know the ultimate outcome of what will undoubtedly be an extensive effort to allocate blame and responsibility for the recent events including Lehman's collapse. We do believe we can provide a perspective on what resources are essential to long-term confidence and what tools are essential for investors going forward.

At the outset there must be a regulatory environment that is realigned with the interests of investors rather than the recent alignment with corporate management. Transformation of the regulatory environment requires sustained funding of the applicable regulatory bodies in a manner that does not breed conflicts or promote policies adverse to investors. Sustained investor confidence requires a regulatory framework that allows investors an opportunity to be heard in a meaningful and timely way through access to the corporate proxy by investors, through say on pay for investors regarding executive compensation, and through an unwavering commitment to pursue corporations and individual executives who disregard the duty owed to the shareholders. We respectfully refer the Committee to a compilation of articles which provide a valuable overview of the SEC's recent funding history and enforcement activities. See Appendix A.

Long term investor confidence would be promoted by restoring the quality of the disclosure and transparency standards historically imposed on companies that want to access the U. S. markets. The standards for accounting must not permit off balance sheet liabilities to go undisclosed, must require that valuations be based on market values of assets and must accurately reflect the operations and current financial condition of the reporting entity. The offloading of bad debt and obfuscation of leverage through the use of off balance sheet entities has devastated investor confidence. The reliability of the numbers reported by management and the perception by investors of transparency in the financial reporting by corporate America has disappeared. The shift from U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) presently under consideration by the SEC is premature and should only occur in the event the International Standards are developed further. The current void of investor confidence would likely not be aided by a shift to unfamiliar standards that alter the nature and extent of disclosures required of companies, the thresholds of materiality and are silent on a broad array of issues addressed by GAAP. The Council of Institutional Investors (CII), a nonprofit association of public, union and corporate pension funds with combined assets that exceed \$3 trillion, has conducted extensive analysis of the convergence of accounting standards issue. We respectfully ask the Committee to consider the attached Appendix B response by CII to a recent Concept Release on the issue by the SEC and a white paper prepared at the request of CII by Professor Donna L. Street, Mahrt Chair in Accounting, University of Dayton.

The recent suggestions that mark to market or fair value accounting should be abandoned would merely provide a short term disguise for the problem and ultimately undermine market strength. The demise of fair market valuation of assets would render the balance sheets and financial reporting of affected companies essentially meaningless to any investor attempting to make a rational and informed decision regarding investing in the company. We respectfully refer for the Committees consideration a white paper titled "Fair Value Accounting: Understanding The Issues Raised by the Credit Crunch", prepared for CII by Stephen G. Ryan, Professor of Accounting and Peat Marwick Faculty Fellow, Stern School of Business, New York University. See Appendix C.

Finally, the most fundamental tool used in the investment process is the independently verified financial statements of a company. The accuracy and thoroughness of the financial disclosures are the critical foundation for sound financial analysis. As fiduciaries, our reliance upon audited financial statements has long been recognized as reasonable and appropriate. This reliability has been based on the fact that a qualified and independent auditor has reviewed the internal operations of the company, assessed its internal controls, as well as the systems within the organization, and conducted random statistically appropriate samplings to verify the accuracy of the accounts presented by management. Based on the examination, the auditor or audit firm has certified the accuracy of the disclosures and attested to the appropriateness of the internal controls and operations. Further, if the auditor's certification proves inaccurate or defective, they have traditionally been accountable through both regulatory sanctions and civil liability.

The importance of our ability to rely upon audited financials in our investment decision making cannot be overstated. However, the very features which have allowed us to rely upon the auditors' verification and certification have been under vigorous attack by the auditors themselves for several years. The result has been Congressional limits on accountability and judicial decisions severely limiting investor recourse against audit firms. Recently an active effort has been under way to attain even greater protections by audit firms. The audit function is a critical element in the reliability of managements' representations and thus the investors' perception of transparency. The practice standards for public company auditors and their accountability for breach of those standards must be strengthened and clearly established.

Viewed in their totality, these developments are a call to action for Congress to restore the U.S. market framework in a manner that attracts investment capital and promotes investor confidence. A return to genuine transparency within a regulatory environment where investors set priorities and have a voice that is heard and acted upon.

Thank you for the opportunity to convey our perspective during these critical times.

Respectfully submitted by  
Gregory W. Smith, General Counsel  
Colorado Public Employees' Retirement Association

## **APPENDIX A**

## **The U.S. Securities and Exchange Commission's inability to avert the collapse of [Bear Stearns Cos.](#) may be traced to funding levels at the agency that haven't kept pace with the complexity of Wall Street's biggest companies.**

**May 7 (Bloomberg)**

By: Jesse Westbrook

To contact the reporter on this story: [Jesse Westbrook](#) in Washington at [jwestbrook1@bloomberg.net](mailto:jwestbrook1@bloomberg.net). *Last Updated: May 7, 2008 19:06 EDT*

SEC spending, which rose in response to frauds at Enron Corp. and WorldCom Inc., decreased by 1.3 percent to \$875.5 million in fiscal 2007 from fiscal 2005, according to agency [budget requests](#). The regulator also lost 386 full-time employees in the two-year period, a 10 percent drop, while headcounts at investment banks such as [Bear Stearns](#), [Merrill Lynch & Co.](#) and [Lehman Brothers Holdings Inc.](#) increased at least 10 percent.

Revenue at the five largest U.S. securities firms climbed 74 percent from 2001 to 2006, and more than 30 percent of their earnings may have been derived from structured credit, which includes bonds backed by mortgages, according to estimates by [Charles Peabody](#), an analyst at Portales Partners LLC in New York.

"I've been concerned for some time that flat budgets would create gaps in the SEC's oversight and enforcement efforts," said [Harvey Goldschmid](#), a former SEC commissioner who left the agency in 2005 and is now a professor at Columbia Law School in New York. "That may have been responsible for the failure to identify some of the problems at Bear Stearns."

The SEC's supervision of securities firms and the adequacy of its resources for monitoring them drew scrutiny today from the U.S. Senate at two hearings.

### Fed Lending

Congress is examining the SEC's role in the wake of the Federal Reserve's rescue of New York-based Bear Stearns in March, after customers and lenders abandoned the fifth-biggest U.S. securities firm over concern that it faced a cash shortage. The crisis prompted the Fed to begin lending to investment banks for the first time since the Great Depression.

The Bush administration requested \$913 million for the SEC for the 12 months starting Oct. 1, an increase of less than 1 percent from fiscal 2008. SEC Chairman [Christopher Cox](#), testifying before a Senate subcommittee today, said the budget will allow the agency to regulate "aggressively."

[Erik Sirri](#), who heads the SEC division of trading and markets, told lawmakers today that the agency wants to "step up" its capital and liquidity requirements for investment banks.

The SEC also plans to increase the number of agency staff members who monitor risk at securities firms to 40 from 25, Sirri said in testimony before the Senate subcommittee on securities, insurance and investment.

### One-Year Target

As the investment banking industry's main regulator, the SEC tries to ensure firms have enough funds to meet expected obligations for at least a year during periods of market stress.

That test failed to account for the "unprecedented" situation at Bear Stearns, which couldn't secure loans even when it offered "high-quality collateral," Cox said in April 3 testimony before the Senate Banking Committee. The SEC is reevaluating its approach, he said.

Cox said the SEC's oversight of Bear Stearns succeeded in accomplishing its intended purpose, which is ensuring that the firm's brokerage clients didn't lose any money.

Ten Democratic senators, including Senate Banking Committee Chairman [Christopher Dodd](#) and Rhode Island's [Jack Reed](#), said the SEC should receive \$963 million in fiscal 2009, \$50 million more than Bush has requested.

#### 'Robust Funding'

"The SEC needs robust funding to replace gaping holes in the regulation of our capital markets," the lawmakers said in a letter dated today to Senator [Richard Durbin](#), the Illinois Democrat who heads the appropriations subcommittee that oversees SEC funding.

The agency would "welcome congressional consideration of dedicated funding for the SEC's oversight of investment banks," SEC spokesman [John Nester](#) said.

SEC staffing levels peaked in 2005 at 3,851 full-time employees, including 1,232 in its enforcement division, which investigates fraud. The agency had 3,465 full-time employees in the fiscal year ended last September and staffing in the enforcement unit dropped to 1,111.

"Staffing levels haven't kept pace with the urgent work needing to be done," [Arthur Levitt](#), a former chairman of the SEC, said today in a Bloomberg Television interview. "We need more people in enforcement and more people at the commission. Those budget cuts have got to be restored." Levitt is a board member of Bloomberg LP, the parent of Bloomberg News.

#### Unspent Funds

Under Cox, who became chairman in August 2005, the SEC has left money on the table. The 2007 budget included \$14 million in "available balances from prior years," according to the SEC's 2009 funding request. The \$906 million Congress granted the SEC in 2008 includes \$63.3 million unspent from earlier years.

"This is akin to the fire department laying off people as the house burns down," said [Lynn Turner](#), a former SEC chief accountant.

Nester said more than 90 percent of the money carried over to the 2008 budget from earlier years can't be used for staff salaries. Most of the \$63.3 million represents funding intended for contract work such as technology upgrades, he said.

Cox said in April 16 testimony before the House Appropriations Subcommittee on Financial Services and General Government that the SEC is in "very good shape" to recruit and retain employees. He said the staff turnover rate is 25 percent lower than in the 1990s.

Congress, in approving the 2002 Sarbanes-Oxley Act, almost doubled the SEC budget after its resources were deemed inadequate to prevent accounting scandals at Enron and WorldCom. The law enabled the SEC to employ more accountants, enforcement lawyers and examiners.

# SEC Enforcement Cases Decline 9% Staff Reduced Because of Budget Crunch

By [Carrie Johnson](#)

Washington Post Staff Writer

Friday, November 3, 2006; Page D03

The number of new enforcement cases brought by the Securities and Exchange Commission fell by 9 percent last year as the agency grappled with staffing cuts brought on by a recent budget crunch, according to figures released yesterday.

SEC Chairman Christopher Cox said in a statement that the agency's work in the fiscal year ended Sept. 30 had produced "solid results for investors," including settlements of \$800 million with insurance firm [American International Group Inc.](#) and \$400 million with District mortgage giant [Fannie Mae](#).

The agency's reduced tally of 574 enforcement actions included 91 cases against shell companies that failed to file regular financial reports. That issue has become an SEC priority of late, but pursuing those cases takes less time and fewer resources than most other actions. Former agency lawyers said such cases amount to going after low-hanging fruit.

Cox attributed the decline to temporarily reduced staff levels. The SEC as a whole lost 155 employees last year -- including 43 in the enforcement unit -- compared with fiscal 2005. A total of 3,696 people worked at the agency in 2006, with 1,189 in the enforcement division. The agency is reviewing its staffing levels and plans to restore some of the unfilled positions, officials said.

In recent years, the SEC has faced criticism for failing to uncover widespread accounting fraud at such companies as Enron Corp. and WorldCom Inc. as well as trading abuses at mutual funds. Those scandals prompted Congress to pour hundreds of millions of dollars into the agency's coffers.

But more recent financial difficulties, including construction overruns on its new headquarters near Union Station, led to a budget shortfall last year and a hiring freeze that only recently has been lifted, officials said.

Law professors and former agency officials who follow the SEC's work said they are closely watching the agency's budget, which held relatively steady at \$888 million last year. They said they are hoping it does not suffer further cuts and would prefer to see it grow modestly to accommodate merit raises for current staff members.

Cox told the Senate Banking Committee last summer that the agency did not need more resources to handle the 130 stock option backdating cases it is investigating, a stance that some analysts have questioned.

"Given the budget cutbacks in the number of people in the SEC's enforcement arm, and the ongoing corporate scandals, all investors should be worried," said Lynn E. Turner, a former chief accountant at the agency who is now director of research at the proxy advisory firm Glass, Lewis & Co. "It will put much of the enforcement burden on the shoulders of investors, just as existed before Enron was exposed, contributing to investors losing tens of billions of dollars."

Duke University law professor James D. Cox, who is no relation to the SEC leader, said: "You get what you pay for. It's been clear in the history of the SEC that as the budget goes, so goes enforcement."

Starving the agency throughout the 1990s meant that SEC officials did not have enough people to review the financial reports of the nation's largest companies every three years, an issue that came to

light only after Enron collapsed into bankruptcy in December 2001 and investors learned that its books had not been examined by regulators.

Joel Seligman, author of a history of the SEC and the president of the University of Rochester, said he is not surprised that the enforcement figures have leveled off given the burst of activity following accounting frauds and mutual fund trading scandals in the past few years.

"I do not have the sense that the SEC is pulling its punches," Seligman said.

SEC Inquiries Stemming From Subprime Crisis Surge (Update1)

## **June 26 (Bloomberg)**

### **The U.S. Securities and Exchange Commission's docket of probes stemming from the subprime- mortgage crisis has grown at least 40 percent since January amid mounting investor losses and the collapse of Bear Stearns Cos., a person familiar with the agency's caseload said.**

By David Scheer

To contact the reporter on this story: [David Scheer](#) in New York at [dscheer@bloomberg.net](mailto:dscheer@bloomberg.net).

*Last Updated: June 26, 2008 12:58 EDT*

The SEC has more than 50 open inquiries relating to the credit-market turmoil, compared with about three dozen in January, the person said, declining to be identified because the cases aren't public. SEC lawyers are examining suspected fraud, market manipulation and breaches of fiduciary duty.

Global credit markets froze last year amid rising defaults on mortgages to the least creditworthy borrowers, triggering almost \$400 billion in losses and writedowns at the world's biggest banks and securities firms. Still, the surging caseload may not lead to a wave of civil and criminal charges, as many inquiries are in early stages and hinge on accounting questions.

"The government is doing what it ought to be doing, which is looking," said [David Becker](#), a former SEC general counsel now in private practice at Cleary Gottlieb Steen & Hamilton LLP in Washington. While the losses are severe, "what we don't know is whether there is any fraud that took place."

Bear Stearns

Last week, the SEC teamed up with the U.S. Attorney's Office in Brooklyn to file the first federal charges over Wall Street's handling of the subprime crisis, hauling former Bear Stearns hedge-fund managers [Ralph Cioffi](#) and [Matthew Tannin](#) to court in handcuffs. They face criminal allegations they misled clients about pending losses and redemptions before two funds collapsed under bad bets on mortgage-backed securities. They are free on bond and deny wrongdoing.

SEC spokesman [John Nester](#) declined to comment on the agency's caseload.

Other hedge funds may also face scrutiny. Routine SEC inspections during the subprime crisis have uncovered cases in which investment advisers, including hedge funds, didn't live up to pledges to implement risk controls, a person familiar with the findings said. Lapses include failures to vigilantly track asset values, cap leverage and avoid concentrating bets.

"We've had some very serious matters" surface during routine checks, [Thomas Biolsi](#), an associate director for the SEC's Office of Compliance Inspections and Examinations, told a legal conference on June 4, declining to elaborate afterward. "We've had some hedge-fund investors complain to us."



SEC Chairman [Christopher Cox](#) last year started an agency- wide task force to deal with the subprime crisis. The SEC also has a separate working group focused on hedge-fund misconduct.

### Inside Information

The Washington-based regulator has said it may look at whether firms and employees manipulated or postponed changes in asset valuations to hide losses from investors. It may check to see whether executives used inside information to profit personally before announcing losses. It is also examining whether brokers steered clients into mortgage-backed securities with inappropriate levels of risk.

U.S. lawmakers, including Senator [Jack Reed](#), have questioned whether the SEC has sufficient resources to deal with the credit crisis. The Bush administration requested \$913 million for the agency's 2009 budget, an increase of less than 1 percent. Reed and Senate Banking Committee Chairman [Christopher Dodd](#), both Democrats, have proposed raising the allocation by \$50 million.

``These are very, very fact-intensive investigations," that include ``difficult accounting issues and involve comprehensive document searches," said [Gregory Bruch](#), a former agency attorney who is a partner at Willkie Farr & Gallagher LLP. ``The SEC has severe resource constraints, particularly with something this complex, this difficult."

`Aggressively' Regulate Cox told Congress in April that Bush's budget will let the agency ``aggressively" regulate markets.

``We always find a way to bring the resources necessary to address the problems we're confronted with," the SEC's enforcement chief, [Linda Thomsen](#), said today in an interview. As the agency did after the collapse of Enron Corp. and the discovery of widespread stock-option backdating, ``we marshal our resources to protect investors."

Among the most recent SEC probes to emerge, American International Group Inc. said June 6 it is cooperating with federal inquiries into how it valued mortgage-linked derivatives that wiped out profit for two quarters. New York-based AIG, the world's largest insurer by assets, had downplayed potential losses in December, then said Feb. 11 that auditors found a ``material weakness" in accounting for the holdings.

### Spread Lies

In March, the SEC also opened probes into whether investors including hedge funds spread lies about Bear Stearns and Lehman Brothers Holdings Inc. to profit from declines in the firms' shares, people familiar with the inquiries said at the time. Speculation that Bear Stearns was facing a cash shortage spurred client withdrawals at the 85-year-old firm, forcing its sale to JPMorgan Chase & Co.

The FBI has struggled to keep pace with the growing number of cases. The agency this month told 26 of its 56 field offices to focus on the subprime crisis and stop opening investigations into other financial crimes including price fixing, mass marketing and wire fraud.

FBI officials said last week they are probing 19 companies, including investment banks and hedge funds, for suspected accounting fraud or other white-collar crimes related to mortgage securities. It had 14 such cases in January.

``We recognize that these corporate fraud cases will increase in numbers due to an enhanced level of regulatory and internal-audit reviews by many of these Wall Street firms," FBI Director [Robert Mueller](#) said June 19. ``We will address these cases as they are identified."

## **Bush admin proposes less than 1 pct boost to SEC budget**

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Mon Feb 4, 2008 11:54am EST

WASHINGTON, Feb 4 (Reuters) - The Bush administration on Monday asked Congress to increase the U.S. Securities and Exchange Commission's budget by less than 1 percent to about \$914 million for fiscal 2009.

The slight increase in funding comes as the SEC investigates companies and individuals involved in the subprime mortgage meltdown, a crisis that has roiled markets and forced major U.S. banks to take billions of dollars in write-downs.

The budget for the enforcement division, which has opened about three dozen subprime-related cases, would rise \$3 million to a total of \$318 million if Congress adopts President George W. Bush's budget.

The amount set aside for corporation finance, which establishes and monitors disclosure requirements, would increase \$2 million to a total of \$113 million.

For the current year ending Sept. 30, the agency is expected to spend about \$907 million.

The SEC spending plan is part of a \$3.1 trillion budget proposed by the White House and still needs to be approved by the Democrat-controlled Congress, which could alter much of it.

The SEC had no immediate comment. The House of Representatives Financial Services Committee, which oversees the investor protection agency, had no immediate comment. Calls to the Senate Banking Committee, which also oversees the agency, were not immediately returned. (Reporting by Rachelle Younglai, editing by Maureen Bavdek)

**Testimony Concerning  
Fiscal 2008 Appropriations Request  
by Chairman Christopher Cox**  
*U.S. Securities & Exchange Commission*

**Before the U.S. House of Representatives Subcommittee on Financial Services and General Government, Committee on Appropriations**

**March 27, 2007**

<http://www.sec.gov/news/testimony/2007/ts032707cc.htm>

Chairman Serrano, Ranking Member Regula, and Members of the Subcommittee:

Thank you for the opportunity to testify today about the Securities and Exchange Commission's budget request for fiscal year 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on your new role as head of this subcommittee. I look forward to working with you and all the members of this subcommittee for the benefit of the nation's investors.

As you know, the President's budget requests \$905.3 million for the SEC in 2008. I fully support this request for increased funding over FY 2007, which will allow the SEC to continue the important initiatives underway to protect and assist the average investor.

These initiatives all have in common that they are aimed at benefiting the average retail customer whose savings are dependent on healthy, well-functioning markets. Since I became Chairman, I have worked to reinvigorate the agency's focus on the ordinary investor. This is the SEC's traditional responsibility. Back in

Joseph Kennedy's day, our first SEC Chairman was amazed that "one person in every ten" owned stocks. But today, more than half of all households own securities, and the median income for shareholders is a very middle-class \$65,000. When you then consider all of the teachers, government employees, and workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets.

In fact, when one considers the staggering growth in Americans' participation in the markets, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, investment advisers that manage more than \$32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the \$44 trillion worth of trading conducted each year on America's stock and options exchanges.

These daunting numbers make it clear that, even if the SEC budget were to double or triple, the agency would have to carefully set priorities. That is exactly what we are doing in this proposed budget for FY 2008. We must continue to think strategically about which areas of the market pose the greatest risk, and which areas of potential improvement hold the greatest benefit for investors. And given the fast changing conditions in America's and the world's capital markets, we must remain agile and flexible enough to redirect our resources with little notice.

This risk-based and flexible approach guides the SEC's examination program as we focus the agency's energies on those practices in the marketplace, and those investment advisers and mutual funds, that are most likely to be high-risk. It also provides the basis for the selection of targets for comprehensive examination sweeps on cross-cutting issues that could present a significant threat to investors. And it drives the SEC's enforcement, rulemaking, and disclosure review functions as well. In each case, the objective is to apply the taxpayer's resources in ways that provide the biggest investor protection bang for the buck.

In recent years, the SEC has professionalized the culture of risk assessment that informs so many of our programs throughout the SEC. From relatively modest beginnings as a discrete office within the SEC established by my predecessor, William Donaldson, the risk assessment function is now wholeheartedly embraced in every major functional division and office of the agency.

If I may, Mr. Chairman, I would now like to discuss some of the major areas in which the SEC is currently focusing its energies, in order to provide the maximum benefit to America's retail investors.

### **Fighting Fraud Against Seniors**

As you know, an estimated 75 million Americans will turn 60 over the next 20 years. And they will live longer than any generation before them. As the baby boomers turn 60 -- more than 10,000 of them every day for the next 20 years - they will need to continue to actively manage their investments for higher yield over their longer lifetimes, rather than switching into low-yield, safe investments as their parents did. This will have enormous consequences for our capital markets. Households led by people aged 40 or over already own 91% of America's net worth. The impending retirement of the baby boomers will mean that, very soon, the vast majority of our nation's net worth will be in the hands of our nation's seniors.

Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable group - because that is where the money is. And it is already occurring. Nearly every day, our agency receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters.

That is why the SEC has focused its energies in this area, and why we organized our fellow regulators and law enforcement officials at the first-ever Seniors Summit in July 2006. This year's Seniors Summit, which will integrate even more of our national resources, will take place in just a few months. With our partners, the SEC has developed a strategy to attack the problem from all angles - from aggressive enforcement efforts, to targeted examinations, to investor education.

Fighting fraud against seniors means taking aggressive action. Over the past year, the SEC's Division of Enforcement has brought 26 enforcement actions aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a \$145 million Ponzi scheme that lured elderly victims to investor workshops with the promise of free food -- and then bilked them out of their retirement money by purporting to sell them safe, guaranteed notes.

In another case, we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds. At "free" dinner and retirement planning seminars, seniors were urged to invest their savings in non-existent businesses with promises of alluringly high rates of return.

By bringing cases like these, and dozens more like them, the federal government is putting would-be fraudsters on notice that they will be caught and punished if they prey upon seniors.

SEC examiners are also working closely with state regulators across the country to stop abusive practices before seniors are actually injured. With our state partners, we're sharing regulatory intelligence about abusive sales tactics targeting seniors, and conducting focused examinations of any firms whose practices raise red flags.

For example, in Florida we initiated an examination sweep of firms selling investments to seniors, in cooperation with the State of Florida and the National Association of Securities Dealers. We subsequently expanded the sweep to include other states with large retiree populations - including California, Texas, North Carolina, Alabama, South Carolina, and Arizona. Working together with state securities regulators in those states, the NASD, and the NYSE, our goal is to see to it that the sales people at "free lunch" seminars are properly supervised by their firms, and that the seminars are not used as a vehicle to sell unsuitable investment products to seniors.

Another tool in fighting securities fraud against seniors is education. These efforts are aimed not only at seniors, but also their caregivers - as well as pre-retirement workers, who are encouraged to plan for contingencies in later life. The SEC is expanding our efforts to reach out to community organizations, and to enlist their help in educating Americans about investment fraud and abuse that is aimed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens (<http://www.sec.gov/investor/seniors.shtml>). The site provides links to critical information on investments that are commonly marketed to seniors, and detailed warnings about common scam tactics.

### **Returning Funds to Wronged Investors**

We at the SEC work diligently to uncover fraud against investors, gather the evidence needed to build a case, and then prosecute cases to bring fraudsters to justice. But our efforts do not end at the courthouse door. Once we succeed in convincing a court to order a penalty, we must ensure that as many of those dollars as possible go back into the hands of wronged investors as quickly as possible.

Since the Sarbanes-Oxley Act created "Fair Funds," through which penalties in SEC cases can be returned directly to injured investors, the SEC has begun to develop a considerable expertise in using this important new authority. At the time I became Chairman in 2005, this authority was only three years old, and the SEC had completed the process of disbursing funds to investors in only a few cases. Since then, we have returned over \$1 billion to injured investors, including significant distributions from cases involving WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers Squibb. In addition, several large disbursements are pending and will be announced shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort within the Commission to train professionals in this area, to develop consistent practices, and to routinize the execution of the Fair Funds function. Too much money is still undisbursed because of the complexities of the process, leaving investors uncompensated.

That is why I have ordered the creation of a new office that will focus the efforts of all of the SEC's offices around the country, and work full-time to return these funds to wronged investors. The creation of this specialized function within the SEC will ensure that investors' money is returned as quickly as possible, while minimizing the costs of the distributions.

The efforts of this new office will be aided by a new information system, called Phoenix. The system will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what had been a major hindrance in our efforts to quickly distribute Fair Funds.

The agency is taking other steps in this area as well. We are collaborating with the Bureau of the Public Debt to invest disgorgement and penalty funds in interest-bearing accounts. And we are working to consolidate

funds from related cases into a single distribution, where appropriate, to potentially save investors hundreds of thousands of dollars.

The SEC is dedicated to doing the very best job possible for investors in handling this responsibility. We know that you in the Congress, who entrusted us with this task, expect and deserve no less.

### **Interactive Data**

Another major initiative I want to bring to your attention holds great potential for investors. By using what I call "interactive data," we can give investors far more information, in far more useful form, than anything they've ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

For years, ordinary investors have been stymied by the time and effort it takes to separately look up each SEC filing for a single company they might own, and then to do that again and again for every additional company in which they're interested. Even once the right forms are located, wading through all of the legal gobbledygook to find the right numbers has been nearly impossible for the average retail investor.

That is because the SEC's online system, known as EDGAR, is really just a vast electronic filing cabinet. It can bring up electronic copies of millions of pieces of paper on your computer screen, but it doesn't allow you to manage all of that information in ways that investors commonly need.

Not surprisingly, financial firms - who can afford it - usually end up getting the bulk of their information about companies not from the SEC filings, but from middlemen all over the world who re-key the information in SEC reports and put it in more useful form. This process is expensive and inefficient, and it also creates errors in the data. Worse, it feeds the notion that the rich and the highly sophisticated have a leg up in today's markets.

Interactive data will let any investor quickly focus on the disclosure they need. With a few clicks of the mouse, investors will be able to find, for example, the mutual funds with the lowest expense ratios, the companies within an industry that have the highest net income, or the overall trend in their favorite companies' earnings. It works by giving each piece of information a unique label, written in the eXtensible Business Reporting Language (XBRL) computer language.

The agency has taken a variety of steps to expand the use of interactive data. First, the Commission created a voluntary program for companies and mutual funds to submit disclosures using XBRL, and offered expedited reviews of disclosures if firms agree to share their experiences with the agency. More than 35 companies, including some of corporate America's biggest names, are already participating in this program.

Second, the SEC is working with outside groups to develop the standardized computer labels for different kinds of numbers that appear in financial statements. The collections of these labels for each industry - the so-called "taxonomies" - will be completed in 2007. With the taxonomies available to every SEC registrant, we will have in place the basic building blocks of the universal language that explains the components of every firm's financial statements.

Third, the agency is modernizing the entire EDGAR system to convert it to one based on interactive data. As part of this effort, the SEC expects to rename the EDGAR system in 2007.

In all, the Commission is investing \$54 million over several years to build the infrastructure to support widespread adoption of interactive data. Companies have told us that the costs of implementing XBRL are minimal, while the benefits are substantial. In addition to providing far more useful information to investors, we believe the use of interactive data will be more efficient for companies' internal processes, for their registration and compliance reporting to the SEC, and for the SEC's own disclosure reviews for regulatory and enforcement purposes.

### **Credit Rating Agencies**

Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. This new role was given to the SEC by Congress last year.

As you know, in 2006 the Congress gave the SEC both the responsibility and the authority to register and inspect the nation's credit rating agencies, including industry giants Standard & Poor's, Moody's, Fitch Ratings,

A.M. Best, as well as several other large, medium, and smaller current and potential industry participants. Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom even immediately before their collapses, the SEC is tasked with devoting significant manpower and resources to this area.

Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to insure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material non-public information, and refrain from unfair or coercive practices. The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules by the statutory deadline, and we will assemble a team of staff to oversee the program and begin conducting inspections over the next several months.

### **Fiscal 2008 Request**

With all of this as background, I'll take just a moment to provide some useful detail about the President's budget request for fiscal year 2008.

As you know, the request is for \$905.3 million. That will permit the agency to maintain its staffing levels from 2007. This level of personnel strength, which as you know is significantly higher than five years ago, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review programs.

This funding level will allow the SEC to continue its commitment to information technology, which has the potential both to reduce regulatory costs and to give investors vastly more useful information than what they receive today. In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination resources, to help us manage a higher level of enforcement activity at existing personnel and funding levels. There is absolutely no question that these technology improvements will make the SEC more productive, and give both investors and taxpayers better value for their money.

Over the last two years, the SEC has made tremendous progress in improving its operations. The fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The agency has poured tremendous energy into this area during my tenure as Chairman. I am pleased to say that these efforts have generated success: under the leadership of a new Executive Director, the SEC received a clean opinion on its audited financial statements for 2006 and, for the first time, there were no material weaknesses in internal controls. This is vitally important, Mr. Chairman, because the SEC must set the example not only for other federal agencies, but for all public companies whose financial statements and disclosures we review. For this reason, the SEC will continue to upgrade its financial system, and to beef up security over its information systems.

The President's budget request also will fund pay raises for SEC staff, in accordance with the SEC's pay parity authority and our collective bargaining agreement. This is a significant fact. Including cost-of-living increases, career-ladder promotions, and merit pay increases, these raises amount to between five and six percent each year. Given that from a budgetary standpoint the increases are essentially automatic, and given further that payroll represents about two-thirds of our budget, the agency's total budget has to increase by over 3.5% just to maintain personnel at a steady state from year to year.

Finally, and most importantly, the level of funding in this budget request will give the SEC the tools we need to address new, emerging risks in the nation's capital markets - including not only such known areas of concern as hedge fund insider trading, the safety and security of 401(k) plans, and the quality of disclosure to protect against fraud in the municipal securities market, but also those threats to market integrity and investor confidence that have yet to emerge.

### **Conclusion**

Thank you for this opportunity to discuss the SEC appropriation for fiscal 2008. I look forward to working with you on the best ways to meet the needs of our nation's investors, and I would be happy to answer any questions you may have.

## **APPENDIX B**

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

November 9, 2007

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

*Re: Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards (File Number S7-20-07)*

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term, patient capital, the Council welcomes the opportunity to provide comments on the United States (“US”) Securities and Exchange Commission’s (“SEC” or “Commission”) Concept Release to obtain information about the extent and nature of the public’s interest in allowing US issuers to prepare financial statements in accordance with International Financial Reporting Standards (“IFRS”) as published by the International Accounting Standards Board (“IASB”) for purposes of complying with the rules and regulations of the Commission.<sup>1</sup>

In response to the issuance of (1) the Concept Release, and (2) the SEC’s related July 11, 2007, Proposed Rule to accept from foreign private issuers their financial statements prepared in accordance with IFRS without reconciliation to US generally accepted accounting principles,<sup>2</sup> the Council has taken a number of steps to assist Council members and other institutional investors in better understanding the issues raised by those due process documents.<sup>3</sup> Those steps have included:

- A plenary session at our 2007 fall membership meeting discussing international convergence of accounting standards. That session featured Robert Herz, Chair, Financial Accounting Standards Board (“FASB”), Thomas Jones, Vice Chair, IASB, and Mark Olson, Chair, Public Company Accounting Oversight Board.
- The establishment of an informal Council working group on accounting and auditing.

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<sup>1</sup> Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards (“IFRS”), Securities Act Release No. 8831, Exchange Act Release No. 56,217, Investment Company Act Release No. 27,924, 72 Fed. Reg. 45,600 (Aug. 14, 2007) (“Concept Release”).

<sup>2</sup> Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With IFRS Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, Exchange Act Release No. 55,998, International Series Release No. 1302, 72 Fed. Reg. 37,962 (Proposed July 11, 2007) (“Proposed Rule”).

<sup>3</sup> Convergence of International Accounting Standards Receives Attention at SEC, on Capitol Hill, Alert 4 (Couns. Institutional Investors, Washington, DC), Oct. 4, 2007 (on file with the Council).



- A white paper prepared on behalf of the Council by Professor Donna L. Street, Mahrt Chair in Accounting, University of Dayton, entitled “International Convergence of Accounting Standards: What Investors Need to Know” (“White Paper”).

The White Paper, which is attached to this letter, includes a discussion of a number of important investor related issues various parties have raised in support of, and in opposition to, the Commission potentially allowing US issuers to prepare financial statements in accordance with IFRS as published by the IASB.<sup>4</sup> The Council respectfully requests that the Commission carefully analyze the issues and related discussion set forth in the White Paper as part of your efforts to “better understand the nature and extent of the public’s interest” in this area.<sup>5</sup>

Of all of the issues referenced in the White Paper, one area of particular concern to the Council is the independence of the IASB.<sup>6</sup> As background, on March 20, 2007, the Council’s general members unanimously approved the following policy regarding the independence of accounting and auditing standard setting:

Audited financial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that . . . preparers use to recognize and measure their economic activities and events . . . . The result should be accurate, transparent, and understandable financial reporting.

The responsibility to issue and develop accounting . . . standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations’ boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission (“SEC”), and other federal agencies and departments should respect and support the independence of the designated accounting and auditing standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.<sup>7</sup>

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<sup>4</sup> Donna L. Street, International Convergence of Accounting Standards: What Investors Need to Know 24-30 (Oct. 2007) (Attachment).

<sup>5</sup> Concept Release, 72 Fed. Reg. at 45,601.

<sup>6</sup> Attachment, at 22-23; 30.

<sup>7</sup> Council Policies, Pension Fund Issues, I. Independence of Accounting and Auditing Standard Setting (Mar. 20, 2007), available at <http://www.cii.org/policies/Policies%20on%20Other%20Governance%20Issues%2003-20-07.pdf>.

Consistent with the Council's conclusion that high quality accounting standards can best be achieved by an independent private sector standard setting organization, we agree with the Commission that the "sustainability, governance and continued operation of the IASB are important factors for development of a set of high quality, globally accepted accounting standards . . . ." <sup>8</sup> Moreover, we believe that there are at least three related issues that are critical to the sustainability, governance and independence of the IASB and that those issues should be resolved as soon as possible and certainly *before* the Commission considers allowing US issuers to prepare financial statements in accordance with IFRS. Those issues are: (1) IASB funding; (2) the European Union ("EU") endorsement process; and (3) Investor representation on the IASB.

### **IASB Funding**

Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 ("SOX") currently require that US public companies pay accounting support fees to the US accounting standard setter—the FASB. <sup>9</sup> Those sections eliminated the need for the Financial Accounting Foundation, the parent entity of the FASB, "to seek contributions from accounting firms and companies whose financial statements must conform to FASB's rules." <sup>10</sup>

Sections 108 and 109 of SOX were the result, in part, of a decision by the US Senate Committee on Banking, Housing, and Urban Affairs ("Banking Committee") that a source of stable funding was necessary to "strengthen the independence of the FASB . . . ." <sup>11</sup> More specifically, the Banking Committee found that

witnesses overwhelmingly agreed that . . . the FASB required guaranteed sources of funding, in order to protect their independence. . . . With respect to the FASB, Michael Sutton, a former SEC Chief Accountant, testified to the Committee that "[t]o restore confidence in our standards setters, we should take immediate steps to secure independent funding for the FASB—funding that does not depend on contributions from constituents that have a stake in the outcome of the process." <sup>12</sup>

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<sup>8</sup> Concept Release, 72 Fed. Reg. at 45,604.

<sup>9</sup> Sarbanes-Oxley Act of 2002, H.R. 3763, 107<sup>th</sup> Cong. §§ 108-109 (2002), *available at* <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>.

<sup>10</sup> S. Rep. No. 107-205, at 13 (2002).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

With this recent history in mind, we are concerned that the independence of the IASB may be compromised by the current source of its funding.<sup>13</sup> We note that the vast majority of the IASB's current funding is the result of voluntary commitments from less than 200 organizations.<sup>14</sup> Most of those organizations are from the same two constituents—companies and accounting firms—that the Banking Committee was most troubled by.<sup>15</sup>

Our concerns about the potential impact of the IASB's current funding on its independence are real and shared by many other parties.<sup>16</sup> As one example, in a September 19<sup>th</sup> presentation before the Economic and Monetary Affairs Committee of the European Parliament, a research fellow for a European think tank devoted to international economics stated:

Given its light framework of governance and funding, maintaining independence from dominant influences . . . is a first-order priority for the international standard setter . . . .<sup>17</sup>

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<sup>13</sup> As an aside, we note that one commentator has indicated that “[i]t is not clear what would happen to that funding [referring to Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 (“SOX”)] if companies that list in the U.S. could report their financial results using standards set by the IASB instead.” David M. Katz, *IFRS or GAAP: Take Your Pick?*, CFO.com, May 3, 2007, at 1, *available at* <http://www.cfo.com/article.cfm/9133180?f=related>. Similarly, Professor Lawrence A. Cunningham commented that “[i]f IASB began to set the standards [for US-listed companies], affected companies should not be required to contribute to the FASB's budget.” Letter from Lawrence A. Cunningham, George Washington University Law School, to Securities and Exchange Commission (“SEC” or “Commission”) 2 (Aug. 10, 2007), *available at* <http://www.sec.gov/comments/s7-20-07/s72007-1.pdf>. It is surprising that neither the Proposed Rule nor the Concept Release addresses the issue of how the Commission's potential actions permitting greater use of IFRS by U.S.-listed companies will or should impact the funding provisions of Sections 108 and 109 of SOX.

<sup>14</sup> International Accounting Standards Board (“IASB”), *Future Funding 1*, <http://www.iasb.org/About+Us/About+the+Foundation/Future+Funding.htm> (last visited Nov. 7, 2007).

<sup>15</sup> *See id.*

<sup>16</sup> Of note, in 2002 United States Senator Carl Levin (D-Michigan) publicly released an email from David Duncan, the lead auditor of Enron Corp. (“Enron”) at Arthur Andersen. The email described Enron Chief Accountant Rick Causey's inquiries about whether Enron's potential contribution to the IASB would buy access and influence to the standard setting process. Senate Floor Statement of Senator Carl Levin (D-Mich) on the Introduction of Legislation to End the Double Standard for Stock Options [S. 1940] 4-5 (Feb. 13, 2002), *available at* <http://www.senate.gov/~levin/newsroom/release.cfm?id=209088>.

<sup>17</sup> Nicolas Véron, Research Fellow at Bruegel, Presentation to the Economic and Monetary Affairs Committee of the European Parliament 3 (Sept. 19, 2007), *available at* [http://veron.typepad.com/main/files/EuroParl\\_IFRS8\\_Sep07.pdf](http://veron.typepad.com/main/files/EuroParl_IFRS8_Sep07.pdf).

We welcome the recent reports from the Trustees of the International Accounting Standards Committee Foundation (“IASCF”) that they (1) “have achieved multi-year financing commitments of more than £12 million of a £16 million annual target” for the IASB;<sup>18</sup> and (2) that the combination of national funding schemes, broad-based voluntary programs, and other sources “will bring the sources of funding from less than 200 organizations in 2006 to several thousand by 2008.”<sup>19</sup> We, however, note that the entity that has “daily interactions” with the IASB—the FASB—raised the following serious funding concerns in their November 7<sup>th</sup> comment letter to the SEC in response to the Concept Release:

We believe the current funding levels and staffing mechanisms of the IASB are not adequate for the tasks it will face if the improved version of the IFRS becomes the single set of global accounting standards. *Moreover, the current funding sources appear unstable, and they give rise to independence concerns.*<sup>20</sup>

We agree with the FASB and other commentators that a “funding mechanism that provides adequate resources while protecting the independence of the IASB” should be established before “moving U.S. public companies to IFRS . . . .”<sup>21</sup>

### **EU Endorsement Process**

Another issue critical to IASB sustainability, governance and independence is the level of involvement of the EU in the development of IFRS standards, largely as a result of the EU endorsement process. The following is a summary description of that process:

First, the European Financial Reporting Advisory Group (EFRAG) technically assesses each new standard and interpretation approved by the IASB and submits the assessment to the EC. EFRAG is an independent private body whose task is to provide the EC ‘advice on the technical soundness of new standards.’ EFRAG’s members are academics, analysts, auditors, industry representatives, and users. To approve or disapprove an accounting standard, two-thirds of the members of EFRAG’s Technical Expert Group must agree.

In July 2006, the EC created the Standards Advice Review Group (SARG) to review EFRAG’s opinions to ensure their objectivity and proper balance. The EC will appoint up to seven members to SARG. Members will be independent accounting experts and high-level representatives from EU national accounting standards setters. SARG will be expected to deliver its advice within three weeks of EFRAG responses.

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<sup>18</sup> Press Release, International Accounting Standards Committee Foundation, Trustees Announce Strategy to Enhance Governance, Report on Conclusions at Trustees’ Meeting 3 (Nov. 6, 2007), *available at* <http://www.iasb.org/NR/rdonlyres/D3F8A7DA-B979-462E-BF43-32F2581BEE37/0/PRonTrusteesmeet061107final.pdf>.

<sup>19</sup> *Id.*

<sup>20</sup> Letter from Robert E. Denham, Chairman, Financial Accounting Foundation (“FAF”) & Robert H. Herz, Chairman, Financial Accounting Standards Board (“FASB”), to Nancy M. Morris, SEC 8 (Nov. 7, 2007) (emphasis added).

<sup>21</sup> *Id.*; *see also* Parveen P. Gupta et al., The Road to IFRS?, *Strategic Finance* 29, 33 (Sept. 2007), *available at* [http://www.imanet.org/publications\\_sfm\\_bi\\_sep2007.asp](http://www.imanet.org/publications_sfm_bi_sep2007.asp) (“International standards-setting boards would have to develop a funding stream that not only preserves their independence but meets the requirements of Congress and other international legislative bodies”).

The EC then submits a proposed standard to the European Parliament and the Accounting Regulatory Committee (ARC). The ARC is chaired by the EC and composed of representatives of the EU member states. This represents the political aspect of the endorsement process. If a majority of the member states favors a proposed standard, it is approved by the ARC.

After approval by the ARC and the European Parliament, the EC formally decides on the use of new IASB standards and interpretations within the EU. Therefore, the final—and some would say most important—part of the endorsement process requires the EC to adopt new IFRSs and publish them in the *Official Journal of the EU*.<sup>22</sup>

The EU endorsement process has resulted in several incidents that raise serious questions about whether that process impairs the independence of the IASB. For example, in 2004 the process resulted in a carve-out of several paragraphs from International Accounting Standards 39, *Financial Instruments: Recognition and Measurement*.<sup>23</sup>

In March 2005, the EFRAG officially recommended that the EU not endorse International Financial Reporting Interpretations Committee 3, *Emission Rights* (“IFRIC 3”).<sup>24</sup> Following the EFRAG’s recommendation, the European Commission (“EC”) officially requested that the IASB defer the March 1, 2005, effective date for IFRIC 3.<sup>25</sup> In late June 2005, the IASB withdrew IFRIC 3.<sup>26</sup>

In April 2007, the Economic and Monetary Affairs Committee of the European Parliament proposed a Parliamentary resolution calling on the EC to conduct a thorough impact assessment prior to endorsing IFRS 8, *Operating Segments* (“IFRS 8”).<sup>27</sup> In response, the EC has taken action that has to-date delayed the endorsement of that standard.<sup>28</sup>

Given this expansive governmental role, it is not surprising that many parties, including PricewaterhouseCoopers, have observed that the EU endorsement process greatly influences the IASB’s standard setting process.<sup>29</sup> In addition, the FASB has concluded more broadly that “endorsement mechanisms are inconsistent with . . . high-quality international accounting standards, and their continued operation could significantly threaten the benefits of transitioning U.S. companies to IFRS.”<sup>30</sup>

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<sup>22</sup> Robert K. Larson & Donna L. Street, *The Roadmap to Global Accounting Convergence—Europe Introduces ‘Speed Bumps’*, CPA J. 5-6 (2006), available at <http://www.nysscpa.org/cpajournal/2006/1006/essentials/p36.htm>.

<sup>23</sup> *Id.* at 6.

<sup>24</sup> *Id.* at 7.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> European Parliament, Motion for a Resolution 3 (Apr. 18, 2007), available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+MOTION+B6-2007-0157+0+DOC+PDF+V0//EN>.

<sup>28</sup> See European Commission, *Endorsement of IFRS 8 Operating Segment—Analysis of potential Impacts (API) 2* (May 30, 2007), available at [http://ec.europa.eu/internal\\_market/accounting/docs/ifrs8-consultation-final.pdf](http://ec.europa.eu/internal_market/accounting/docs/ifrs8-consultation-final.pdf).

<sup>29</sup> PricewaterhouseCoopers, *ViewPoint—Convergence of IFRS and US GAAP 4* (Apr. 2007), available at [http://www.pwc.com/extweb/pwcpublishations.nsf/docid/fc800243be0e3882852570500000c756/\\$File/viewpoint\\_convergence.pdf](http://www.pwc.com/extweb/pwcpublishations.nsf/docid/fc800243be0e3882852570500000c756/$File/viewpoint_convergence.pdf).

<sup>30</sup> Letter from Denham & Herz, at 9.

Our concern in this area has only been deepened by the November 6th combined statement of European Internal Market Services Commissioner Charlie McCreevy, Financial Services Agency of Japan Commissioner Takafumi Sato, IOSCO Executive Committee Chairperson Jane Diplock, and SEC Chairman Christopher Cox.<sup>31</sup> That statement included the following language:

*International Financial Reporting Standards (IFRS) are becoming more widely used throughout the world. We have a common interest of ensuring continuing user confidence in the institutions responsible for the development of global accounting standards. A natural step in the institutional development of the IASB and the IASC Foundation would be to establish a means of accountability to those governmental authorities charged with protecting investors and regulating capital markets. We will work together to achieve these objectives.*<sup>32</sup>

In commenting on the statement, Floyd Norris of the *New York Times* opined:

They propose to establish a ‘new monitoring body’ that would ‘participate’ with the trustees in choosing board members. ‘The monitoring body would also be responsible for the final approval of Trustee nominees and would have the opportunity to review the Trustees’ procedures for overseeing the standard-setting process and ensuring the I.A.S.B.’s proper funding.’

In other words, this new monitoring body – which evidently would be chosen by politicians – would run the show. It would also work to develop ‘objective procedures’ to assess the costs and benefits of new accounting rules. You can bet that the costs of rules companies do not like would be deemed to be too high.

You can have ‘accountability.’ Or you have have ‘independence.’ But it is an illusion to say you can have both.

The effort to get a genuinely independent accounting rule maker in this country, not dependent on companies for funding, culminated in the passage of the Sarbanes-Oxley law in 2002, which allowed the Financial Accounting Standards Board to essentially impose a tax on public companies.

*The risk is that the F.A.S.B. will eventually be supplanted by an I.A.S.B. whose independence will be preserved in name only.*<sup>33</sup>

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<sup>31</sup> Press Release, Authorities Responsible for Capital Market Regulation Work to Enhance the Governance of the IASC Foundation (Nov. 6, 2007), available at <http://www.sec.gov/news/press/2007/2007-226.htm>.

<sup>32</sup> *Id.* at 1 (emphasis added).

<sup>33</sup> Bye Bye Independence, <http://norris.blogs.nytimes.com/2007/11/06/bye-bye-independence/> 2 (Nov. 6, 2007, 7:25 PM EST) (emphasis added).

## Investor Representation on the IASB

Finally, as indicated above in the Council's policy, we believe that having significant investor representation on the IASB is an important element of the IASB's sustainability, governance and independence. Since financial reports are used primarily for making decisions regarding the allocation of financial capital, investors are the key consumers of the product produced by accounting standard setters.

We note that the 14-member board of the IASB has only one current board member who could be characterized as an investment professional.<sup>34</sup> We believe that, at minimum, four members of the IASB should be drawn from the ranks of pension fund investment advisors, equity security financial analysts, equity security portfolio managers, or other users of financial reports.<sup>35</sup>

The Council agrees with the recent comments of the CFA Institute Centre for Financial Market Integrity that "inadequate investor representation on the IASB . . . handicaps their ability to achieve their objectives for investors."<sup>36</sup> We are hopeful that the IASCF will promptly commit to filling future open board seats with qualified<sup>37</sup> investors or other users of financial reports so that adequate representation of the key customers of financial accounting and reporting can soon be achieved.

\* \* \* \*

We appreciate the opportunity to express our views on this matter. Please feel free to contact me with any questions.

Sincerely,



Jeff Mahoney  
General Counsel

Attachment

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<sup>34</sup> In July 2007, Stephen Cooper, Managing Director and head of valuation and accounting research of UBS Investment Bank in London, was appointed to the IASB as a part-time member. IASB Home Page, <http://www.iasb.org/About+Us/About+IASB/Board+Members.htm>.

<sup>35</sup> We note that in 1992, SEC Chairman Richard C. Breeden encouraged FAF Chairman Shaun O'Malley to consider filling two open seats on the seven member FASB with individuals "from the community of users of financial statements . . . ." Letter from Richard C. Breeden, Chairman, SEC, to Shaun O'Malley, President, FAF (Oct. 22, 1992) (on file with the Council). In 1993, the FAF named Anthony T. Cope, former Director of Fixed Income Credit Research and a Senior Vice President of Wellington Management Company, to the FASB. See News Release, FASB, Anthony T. Cope and James J. Leisenring to Join IASB (Jan. 25, 2001), available at <http://www.fasb.org/news/nr012501.shtml>.

<sup>36</sup> Letter from Kurt N. Schacht, Managing Director & Gerald I. White, Chair, Corporate Disclosure Policy Council, CFA Institute Centre for Financial Market Integrity, to Nancy M. Morris, Secretary, SEC 8 (Oct. 2, 2007).

<sup>37</sup> We believe "qualified" IASB investor candidates should, among other required skills, possess outstanding technical accounting expertise.



**COUNCIL OF  
INSTITUTIONAL  
INVESTORS**

**INTERNATIONAL CONVERGENCE  
OF ACCOUNTING STANDARDS:  
WHAT INVESTORS NEED TO KNOW\***

Prepared by  
Professor Donna L. Street  
Mahrt Chair in Accounting  
University of Dayton



# **INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW\***

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**\*This report was prepared by Professor Donna L. Street at the request of the Council of Institutional Investors ("Council"). The views and opinions expressed in this paper are solely those of the author and do not necessarily represent the views or opinions of the Staff, Board of Directors, or General Members of the Council.**

**INTERNATIONAL CONVERGENCE OF ACCOUNTING  
STANDARDS:  
WHAT INVESTORS NEED TO KNOW**

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# **INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW**

## **1. WHAT IS THE INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS?**

While discussion and consideration has been centered around the admirable goal of ‘harmonizing’ accounting standards for decades, the process initially proceeded at a very slow pace and represented a challenging undertaking. More recently, however, the focus has shifted to ‘convergence,’ and in the last decade or so, tremendous progress has been made. Today’s goal is to converge, or minimize the differences between, the two sets of globally recognized accounting standards that co-exist in the world’s capital markets: U.S. GAAP and International Financial Reporting Standards (IFRS).

U.S. GAAP is developed primarily by the Financial Accounting Standards Board (FASB), while IFRS are issued by the London-based International Accounting Standards Board (IASB). The use of IFRS has become increasingly widespread throughout the world with about 100 countries now requiring or allowing the use of these standards. Additional countries are in the process of replacing their national standards with IFRS. For example, from 2005 onward, companies headquartered in the European Union (EU), with securities listed on an EU regulated market, are required to report their consolidated financial statements using ‘EU-endorsed’ IFRS. This requirement affects about 7,000 EU companies. Other countries including Australia and New Zealand (N.Z.), have adopted similar requirements mandating the use of IFRS, while countries including Canada and Israel plan to adopt IFRS as their national standards in the near future. Furthermore, major emerging and transition economies such as Brazil, China, India, and

Russia are adopting or considering IFRS, not U.S. GAAP, in an effort to become integrated in the world's capital markets and to attract the investment needed to finance development.

Recognizing the need to address not only domestic comparability, but also international comparability of financial information, the FASB updated its strategic plan in the 1990s. Working with the then International Accounting Standards Committee (IASC – the predecessor of the IASB) as well as national standard setters from Australia, Canada, N.Z., and the United Kingdom (U.K.), the FASB made notable progress in converging existing standards. For example, the FASB and Canadian Accounting Standards Board issued identical standards on segment reporting and accounting for business combinations, and the FASB and IASC issued similar standards on earnings per share.

Following the formation of the IASB, the IASB and FASB in 2002 issued a Memorandum of Understanding (MOU) formalizing the two accounting standard setting bodies' commitment to converging their standards. Then, in April 2005, the call for a single set of high quality globally accepted accounting standards intensified when the Securities Exchange Commission (SEC) issued its Roadmap for Convergence. The IASB and FASB responded to the Roadmap's challenge to enhance convergence by issuing an updated MOU in February 2006. The new MOU reiterated the Boards' commitment to converging their standards and was accompanied by a revised work program for 2006-2008 aimed at achieving this goal.

## **2. WHAT IS THE SEC CURRENTLY PROPOSING?**

### **What is currently required for a non-domestic SEC registrant?**

Under current SEC rules, foreign companies listed in the U.S. must comply with the information requirements set forth in Form 20-F by the SEC. Accordingly, the financial statements furnished by foreign private issuers disclose essentially equivalent information to statements complying with U.S. GAAP. This information may be presented in two ways. The foreign company may prepare either complete U.S. GAAP statements or statements based on its domestic GAAP or IFRS, but include a reconciliation of reported net income and shareholders' equity to U.S. GAAP.

In their '20-F reconciliation,' companies following the latter option, begin with national GAAP/IFRS net income (shareholders' equity) and then list each material difference with U.S. GAAP and indicate its numerical impact on income (equity). The reconciliation ends with total income (equity) according to U.S. GAAP. A verbal description of each material difference listed in the reconciliation is also provided to concisely explain how the national GAAP/IFRS utilized by the company differs from U.S. GAAP. Furthermore, the SEC requires foreign registrants filing under national GAAP or IFRS to provide certain U.S. GAAP disclosures.

A foreign private issuer must file its annual report, including financial statements reconciled to U.S. GAAP as appropriate, with the SEC six months after its year end. Alternatively, U.S. headquartered companies file with the SEC within 60 to 90 days following their year end.

## **What would the SEC proposal and concept release change?**

The SEC Roadmap for Convergence details the steps that should occur before the elimination of the 20-F net income and shareholders' equity reconciliations for foreign issuers reporting under IFRS. One of the key steps noted is the evidence of sufficient progress in converging IFRS and U.S. GAAP. A SEC<sup>a</sup> proposal and request for comment regarding elimination of the reconciliation for foreign registrants reporting under IFRS 'as issued by the IASB' followed in July 2007. Then, in August 2007, the Commission issued a concept release posing questions aimed at determining whether U.S. headquartered registrants should also be provided with the option to report under IFRS.<sup>b</sup>

### **3. WHY IS CONVERGENCE IMPORTANT TO INVESTORS?**

Among other things, the SEC Roadmap for Convergence highlights the importance of convergence. Converged standards would:

- enhance comparability and enable investors to compare 'apples to apples' as opposed to 'apples to oranges'
- reduce regulatory compliance costs without undermining investor protection or impairing market information and make it significantly less costly for non-domestic companies to access U.S. markets
- promote global financial market competitiveness while improving the information available to investors.

These and other dimensions of convergence are discussed in the following sections.

### **4. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD SUPPORT THE ELIMINATION OF THE RECONCILIATION REQUIREMENT?**

**#1 Eliminating the reconciliation is key to maintaining the premier status of U.S. markets. Doing away with the reconciliation would remove unnecessary costs and remove a barrier for foreign issuers wishing to access U.S. markets.**

About 1,150 of the 13,000 SEC registrants are foreign issuers. Combined with the costs associated with complying with the requirements of other regulations, including

Sarbanes-Oxley, some allege the 20-F reconciliation requirement makes a U.S. listing costly for foreigners and is viewed as onerous by them. Thus, the current U.S. regulatory environment has prompted some foreign companies to exit U.S. markets. Moreover, few new foreign listings are materializing as other sources of capital increasingly provide alternatives to the U.S. markets. With IFRS widely accepted throughout the world, the attitude of some has become: Why bother to reconcile IFRS with U.S. GAAP?

In response to this alleged crisis, a study commissioned by political leaders in New York suggests the city (NYC) may lose its status as the world financial center within ten years unless a major shift in regulation and policy occurs. *Sustaining New York's and the US' Global Financial Service Leadership*<sup>c</sup> is based on analyses of market conditions in the U.S. and abroad and draws from interviews with more than 50 leaders representing the financial services industry, consumer groups, and other stakeholders. The findings indicate that NYC financial markets are becoming stifled by stringent regulations and high litigation risks. Among the high-priority goals set forth in the report as a 'national agenda' is the recognition of IFRS without reconciliation for foreign SEC registrants and the promotion of global convergence of accounting (and auditing) standards.

At a Roadmap Roundtable hosted by the SEC on March 6, 2007, some observers noted that the companies, investors, rating agencies, accounting firms, and others spoke 'in one voice' encouraging the SEC to eliminate the reconciliation to U.S. GAAP provision as soon as possible.<sup>d</sup> Roundtable participants indicated that the main benefit of this elimination would be a significant reduction of costs for some companies. They believe the reconciliation imposes costs in terms of ease, timing, and ability of foreign



private issuers to come to the U.S. markets. During the Roundtable, the CFO of AXA indicated preparing the annual 20-F reconciliation for his company cost approximately \$25 million.

The NYC report reiterates that doing away with the reconciliation without delay would eliminate unnecessary costs and remove a barrier for foreign issuers. This action, it is alleged, would clearly communicate to the global financial services community that the U.S. respects and honors approaches developed outside its borders. Eliminating the reconciliation in conjunction with accelerating convergence of accounting (and auditing) standards would unleash the potential to improve U.S. markets and facilitate access to them by non-domestic companies using IFRS. The NYC report's authors also indicate that following the report's recommendation of eliminating the reconciliation without delay would yield substantial benefits with few discernable offsetting costs.

Furthermore, accelerating the convergence of two sets of high quality accounting standards will make it significantly less costly for non-domestic companies to access U.S. markets, and, in so doing, improve the international competitiveness of the U.S. as a financial center. Finally, the NYC report's authors believe that the ensuing reduction in regulatory compliance costs can be achieved without undermining investor protection or market information.

**#2 IFRS are robust, 'principles-based' standards suitable for the U.S. market and are preferred by some investors over U.S. GAAP.**

According to the NYC report, interviews conducted with business leaders reveal the need to accelerate convergence as well as the need to remove the unintended consequences of the 'rules-based' approach of U.S. GAAP, which can produce financial

reporting that differs from economic reality. Surveyed business executives believe the need to reconcile to the ‘principles-based’ IFRS, which is accepted by almost every other major country other than the U.S., is unnecessary given the quality of IFRS and its widespread adoption.

Some members of the Roadmap Roundtable investors’ panel indicated they were not really using the reconciliation and to some extent preferred IFRS to U.S. GAAP. Some stated that they had essentially already moved to analytic models that do not incorporate the reconciliation. For many industries and peer groups, IFRS is the most common accounting standard, so to understand that industry or sector, analysts must know IFRS. Indeed, institutional investors sometimes ‘reconcile’ U.S. GAAP to IFRS to facilitate comparisons and make investment decisions. According to Dzinkowski, of the 165 foreign companies rated by Moody's, only 13 have analysts within the U.S while the others are covered by foreign analysts, who neither need nor want reconciliation.<sup>e</sup> Many interested parties rely on foreign comparables, information that is not provided by U.S. GAAP.

**#3 Removal of the reconciliation should not result in the loss of any investor or market protections afforded by underwriters, securities counsel, or auditors.**

Some Roadmap Roundtable participants do not expect removal of the reconciliation to impact investors or change the way securities are priced. As noted above, for due diligence, credit rating and other purposes, most capital market players are comfortable relying on IFRS alone when engaging in transactions with foreign private issuers. Thus, Roundtable participants believe that the removal of the reconciliation should not result in the loss of any investor or market protections afforded to them by

underwriters, securities counsel (and other similarly situated parties) or auditors. While the reconciliation may keep foreign issuers out of U.S. markets, some allege it is not facilitating the offering work done by other participants in the capital raising process.

**#4 Reconciliation delays the release of information to U.S. investors.**

A Roadmap Roundtable panel representing the investor community indicated that the timeliness of information is critical. Thus, to the extent that the reconciliation slows the availability of information to U.S. investors, it operates counter to their interests. Presently, foreign private issuers are not required to file Form 20-F with the SEC until six months after their fiscal year end. Filing deadlines for U.S. issuers, alternatively, range from 60 to 90 days. Since reconciling can be a time-consuming endeavor, the requirement to provide the reconciliation is frequently held out as one of the justifications for the extra filing time allowed foreign private issuers. In their quest for timely information, some Roundtable participants indicated that large institutional investors and analysts, and perhaps credit rating agencies, turn to foreign private issuer's home markets.

**#5 With the reconciliation in place, U.S. investors may be missing out on important investment opportunities.**

A critical concern by some at the Roadmap Roundtable was that the reconciliation is keeping foreign private issuers from bringing transactions to the U.S. markets. As a result, U.S. investors are denied possibilities they might otherwise have to invest in foreign capital. Thus, the reconciliation may be detrimental to not only foreign private issuers, who cannot tap the liquidity and depth of the U.S. markets, but also for U.S. investors, as they have fewer options in terms of the investment decisions they might

select. Ultimately, the results of the reconciliation may make the U.S. markets disadvantaged as well.

This arguably holds true not only for institutional investors but also for some retail investors who are highly interested in securities of foreign companies that are not available in the U.S. markets. If these retail investors choose to go overseas to attain more investment opportunities, they do so without the coverage of the U.S. federal securities laws. Thus, the reconciliation may be imposing an indirect cost that appears difficult to justify.

## **5. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD BE CONCERNED ABOUT THE ELIMINATION OF THE RECONCILIATION REQUIREMENT?**

### **#1 Significant differences between IFRS and U.S. GAAP remain. IFRS and U.S. GAAP are not comparable.**

In a recent interview, IASB Chair Tweedie<sup>f</sup> predicts that by ‘2011–12, U.S. and international accounting should be pretty much the same - with 150 countries using IFRS and several others using U.S. GAAP. That adds up to about 170 countries accounting in much the same way.’ However, despite Tweedie’s optimism, research indicates the convergence of U.S. GAAP and IFRS is at an early stage.

A few studies have examined the materiality of differences between International Accounting Standards (IAS)/IFRS and U.S. GAAP as reflected in 20-F reconciliation adjustments, but findings from the initial studies should be viewed cautiously as IAS/IFRS numbers have historically not been widely reported in terms of, and thus reconciled to, U.S. GAAP. Street, Nichols, and Gray<sup>g</sup> and Blanco and Osma<sup>h</sup> examined the net income 20-F reconciliations of a small number of companies using IAS to access

U.S. markets prior to 2001. Both studies suggest that IAS and U.S. GAAP were converging. However, more recent research on larger samples suggests a different story.

With the widespread adoption of IFRS by the EU member states, Australia, and others, the significance of 20-F adjustments by larger numbers of 'IFRS-based' SEC registrants is under investigation. Street, Gray, and Linthicum<sup>i</sup> find that adoption of IFRS in 2005 resulted in divergence, as opposed to convergence, with U.S. GAAP for 135 European companies listed in the U.S filing 'IFRS-based' financial statements. During the pre-IFRS period of 2002-2004, European and U.S. GAAP net income measures were generally comparable (not significantly different). However, following the switch to IFRS in 2005, IFRS net income was significantly higher than U.S. GAAP net income. Furthermore, the gap between 2004 IFRS and U.S. GAAP net income significantly exceeded the difference between European GAAP and U.S. GAAP net income. These findings are in line with Gray and Morris<sup>j</sup> who find that the move to IFRS in 2005 resulted in significantly higher net profits under IFRS as compared to Australian GAAP.

A recent survey by Citigroup yields similar results, thereby supporting the conclusion that 'the glut of differences between the two sets of standards causes major swings.'<sup>k</sup> For 73 European SEC registrants, the 2005 and 2006 20-F reconciliations contain 426 reconciling differences with most of the reconciling items attributable to the treatment of tax, pensions, goodwill and intangible assets, and financial instruments. Eighty-two percent of the companies had higher net income under IFRS, with IFRS net income, on average, being 23 percent higher than U.S. GAAP net income (based on the mean). The median IFRS net income was about six percent higher under IFRS.

While the survey covers only two years, Citigroup concludes that the median is dropping, thereby indicating some differences are being removed. Yet, book value for 70 percent of the companies surveyed is lower under IFRS. On average, IFRS returns on equity are much higher. Citigroup stressed that in breakdowns of book value and equity returns, U.K. companies topped the tables of European companies showing the biggest divergences. For example, BSKyB (84.1 percent), GlaxoSmithkline (72.9 percent), Imperial Tobacco (61.5 percent), and National Grid (55.8 percent) had book values significantly lower than the U.S. GAAP equivalent. In terms of the largest differences for return on equity, nine of the top 15 were U.K. based. For example, BSKyB, which headed the list, had a 382 percent increase in return on equity under IFRS.

Citigroup, thus, concludes that the ‘differences could well result in investors and/or analysts arriving at different conclusions about the financial position and performance of business depending on the GAAP used.’ Citigroup further indicates that it appears that ‘if U.S. companies were given the option to use IFRS rather than U.S. GAAP then this would provide a boost to book earnings and returns.’

**#2 The 20-F reconciliation includes valuable information that would be lost after its elimination.**

In *The Roadmap to Convergence: U.S. GAAP at the Crossroads* S&P’s Bukspan and Joas<sup>1</sup> present an alternative view to the Roadmap Roundtable participants’ perspective and state that it is premature to drop the reconciliation before U.S. GAAP and IFRS are fully converged. According to these authors, the 20-F reconciliation guides analysts between different accounting conventions and provides a better appreciation of how accounting differences are evident under varying reporting regimes. In the absence of convergence, the reconciliation serves as a ‘useful tool for aiding comparisons among

global peers, particularly as IFRS is still in its infancy in terms of its application and interpretation.’ Without the reconciliation, analysts and other financial statement users would have to rely more on disclosures, thereby calling into question the robustness of current IFRS requirements.

Bukspan and Joas reference an earlier S&P study that highlights ‘significant variations in the quality and types of IFRS disclosures’ and concludes that many of the disclosures are boilerplate and, thus, lacking in the analytical information needed to gain a full appreciation of the underlying assumptions and risks. This S&P report’s conclusion is consistent with reports issued by SEC staff (see [www.sec.gov/divisions/corpfin/ifrs\\_staffobservations.htm](http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm)) as well as the U.K. Financial Reporting Review Panel (see <http://www.frc.org.uk/images/uploaded/documents/IFRS%20Implementation%2020preliminary.pdf>) based on their regulatory reviews of IFRS accounts. According to Bukspan and Joas, the overall SEC staff report emphasizes the need for robust and consistent disclosures that analysts view as ‘essential in fostering a transparent, principles-based reporting environment.’

Bukspan and Joas also contend that the SEC review of 100 IFRS reports filed for fiscal year 2005 draws attention to other reasons to improve IFRS disclosure requirements before eliminating the reconciliation. They refer to problems associated with ‘scant guidance’ on financial statement presentation; different accounting treatments for merger recapitalizations, reorganizations, acquisitions of minority interests, and insurance contracts; auditors signing-off on home country-based IFRS (as opposed to IFRS as issued by the IASB); and SEC requests for additional disclosures related to

revenue recognition, intangible assets and goodwill, policies for evaluating impairments, leases, and contingent liabilities.

### **#3 IFRS are not being faithfully and consistently applied throughout the world.**

The SEC request for comment and proposal poses the question of whether there is sufficient comparability among companies using IFRS ‘as published by the IASB’ to allow investors and others to use and understand financial statements prepared in accordance with IFRS without a reconciliation. This question is somewhat challenging to address in that, as acknowledged by the Commission, for most of the approximately 200 companies filing fiscal year 2005 20-F’s ‘based on IFRS,’ the auditor did not opine on IFRS ‘as issued by the IASB.’ The studies referred to in the following paragraphs are, accordingly, based on accounts opined on as ‘IFRS-based’ (i.e. IFRS as endorsed by the EU, etc.) as well as IFRS ‘as issued by the IASB.’ No distinction was made in the sample selection by the authors.

Reviews of fiscal year 2005 IFRS statements by academics and regulators indicate that the answer to the SEC question may be ‘no.’ While generally promising, these reviews indicate problems with emerging ‘flavors of IFRS,’ thereby suggesting that a substantial learning curve exists for many 1<sup>st</sup>-time IFRS adopters.

Academic research indicates the degree of compliance with IAS/IFRS by early, ‘voluntary’ adopters was mixed and somewhat selective.<sup>mnop</sup> Street and Bryant find that, for early adopters, the extent of compliance with IAS was greater for companies with U.S. listings than for companies without U.S. listings. Similarly, Street and Gray find greater levels of compliance with IAS-required disclosures for companies with non-regional listings (including most notably U.S. listings), companies referring exclusively



to the use of IAS in their accounting policy notes, and companies audited by, what was at the time, a Big 5+2 accounting firm. These early studies support the SEC position that consideration should only be given to dropping the reconciliation for companies using IFRS ‘as issued by the IASB.’ This position is further endorsed in a comment letter to the SEC prepared by the FASB’s Investors Technical Advisory Committee.

It is important to stress that Glaum and Street<sup>d</sup> identified significant non-compliance by companies listed on Germany’s now defunct Neuer Market not only for IAS accounts but also for U.S. GAAP accounts. Their study, therefore, indicates the key issue is enforcement of standards and not the quality of the accounting standards used. Companies listed on the Neuer Market were required to prepare either IAS or U.S. GAAP accounts. Thus, the use of internationally recognized standards was mandatory as opposed to voluntary, yet compliance, on average, was problematic.

Following the required adoption of IFRS in the EU and elsewhere in 2005, researchers began to examine larger samples of IFRS accounts. Their findings again reveal implementation problems. For example, Glaum, Street, and Vogel<sup>f</sup> conducted an assessment of the 2005 merger and acquisition disclosures of companies comprising the premium segments of 17 major European exchanges (see [www.pwc.de/en/ma-ifrs-survey2005](http://www.pwc.de/en/ma-ifrs-survey2005)). Their analysis uncovers several areas in need of notable improvement. Thus, these authors conclude that the understandability and information content of IFRS merger and acquisition disclosures needs to improve to enhance transparency and comparability. The findings of Glaum, Street, and Vogel are in line with those of regulatory reviews of 2005 IFRS accounts by, among others, the SEC (see [www.sec.gov/divisions/corpfin/ifrs\\_staffobservations.htm](http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm)) and U.K. Financial Reporting

Review Panel (see <http://www.frc.org.uk/images/uploaded/documents/IFRS%20Implementation%20-20preliminary.pdf>).

In a study of 2005 disclosures provided by companies comprising the premier segments of 20 European exchanges, Faßhauer, Glaum, & Street<sup>s</sup> uncover a number of cases where companies omit certain relevant IAS 19 pension disclosures. They also identify a troubling number of boilerplate disclosures and vague, shallow disclosures. Their findings regarding boilerplate and vague disclosures are in line with concerns expressed by the U.K. Financial Reporting Review Panel based on its review of IAS 19 disclosures provided in 2005 accounts by a small sample of U.K. companies (see <http://www.frc.co.uk/images/uploaded/documents/010806%20-%20final%20report.pdf>).

The regulatory reviews of IFRS accounts noted above are uncovering examples of non-compliance in addition to raising questions regarding the quality of the disclosures provided. A notable area of concern is whether various banks complied with IAS 39, in determining loan impairment. SEC discussions on this topic are ongoing (see [http://www.sec.gov/divisions/corpfin/ifrs\\_staffobservations.htm](http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm)), and CESR has posted information regarding several regulatory rulings regarding the issue on its website (see [http://www.cesr-u.org/index.php?page=home\\_details&id=209](http://www.cesr-u.org/index.php?page=home_details&id=209)).

A review of the accounts of 284 companies by the U.K. Financial Reporting Review Panel resulted in 49 companies being obliged to undertake alterations to financial reporting policies. In February 2007, the U.K. Financial Services Authority issued *Financial Risk Outlook 2007*<sup>t</sup> highlighting potential risks stemming from, among other things, the move to IFRS. Inconsistent national application was noted as a major risk to the continued success of IFRS. Specifically, the U.K. report states:

With regard to inconsistency, the true benefit of IFRS can only be realised through enabling a better comparison of similar entities across national boundaries, which, in turn, will provide enhanced transparency for markets and a more efficient global capital market. We also acknowledge that, under a principles-based accounting framework, there may be relevant economic and legal differences between countries such that similar transactions might legitimately be reported in different ways. However, should local custom or national interest operate to threaten the consistent application of IFRS, much of this anticipated benefit could be lost.

There is a great deal of work being undertaken internationally to ensure that IFRS is implemented in a way that is both consistent and responsive to local economic differences. However, judging whether or not this balance is being successfully achieved will only be possible after one or two more years have passed.

#### **#4 Removing the reconciliation should be delayed until foreign issuers, audit firms, and other constituents have more experience with preparing IFRS statements.**

IFRS implementation problems may be linked to, among other things, an inconsistent and fragmented international auditing environment. Bukspan and Joas state that harmonizing international auditing standards and ensuring consistent compliance with these standards are key to developing confidence in any accounting framework. In the same vein, SEC Director of Corporation Finance, White<sup>11</sup> indicates that ‘The auditing point is another very critical one ... that clearly must be considered in any comprehensive conversation about convergence and ending reconciliation.’

Wyatt<sup>12</sup> posits that ‘maybe we are not so close to having a single set of accounting standards around the world. And, maybe we are even further from having an acceptable international financial reporting regime that would add credibility to financial statements that investors rely upon for their investment decisions.’ He calls for ‘patience by all parties to permit the overall environment to become appropriate for a successful transition to the utilization of truly international accounting standards.’ Wyatt’s five

facets to achieving ‘effective’ convergence include effective accounting standards combined with relevant education and understanding, effective regulatory regimes, a suitable political environment, and as stressed in both the NYC report and by Bukspan and Joas, effective auditing standards.

Wyatt explains that while considerable progress has been made by the International Federation of Accountants (IFAC) in developing International Standards of Auditing (ISA), the application of these standards is affected by cultural and environmental forces that vary across countries. Reconciling these differences will not be easy. The existence of a solid set of generally accepted auditing standards will not, therefore, necessarily result in consistent application of those standards globally. It remains an open question as to how regulators in different countries will address variations in audit practice that have led to inconsistent application and implementation of IFRS.

#### **#5 U.S. accountants and auditors are not adequately versed in IFRS.**

Wyatt explains that, regardless of the quality of IFRS, effective implementation cannot be achieved until accounting practitioners, both in public and private practice, in countries all around the world, achieve a degree of understanding of those principles that enable their application in practice. Since we currently do not have a set of accounting standards on which broad agreement has been reached, we do not have the textbooks necessary to convey those standards to students and other interested parties. In the U.S., Wyatt notes that universities do not have courses devised to assist in this educational process. While the development of the necessary educational materials and course

curricula should not require a lengthy time period, the process is highly unlikely to commence until IFRS are further along in their development stage.

Wyatt estimates that the various requirements of the educational process will not get underway globally in any concerted fashion until the IASB determines that it has an effective set of standards and securities regulators around the world deem these standards to be acceptable. At that point, we are probably looking at a three to seven year changeover from current educational processes to the introduction of new curricula. While the large accounting firms and publicly-owned companies may be able to re-educate their employees in a somewhat shorter time period, the process for an international company will require planning and dedication to retraining.

In a bulletin describing the move to IFRS in Canada, the Canadian Accounting Standards Board stresses that such a transition from national GAAP to IFRS requires education, not only for auditors and in the universities, but also for public companies, their investors, lenders, and advisors. The need for a comparable transition period prior to acceptance of IFRS in the U.S. should not be overlooked by the SEC or taken lightly.

**#6 Convergence, particularly the work of the IASB and FASB, will most likely be impeded if the reconciliation is dropped prematurely.**

Street and Linthicum<sup>w</sup> consider whether it is conceivable that eliminating the reconciliation now would stall convergence efforts of the IASB and FASB, especially since the EU's incentive to achieve convergence and comparability with U.S. GAAP, as well as its support for the continued improvement of IFRS, may disappear with the reconciliation. While stressing the importance of convergence, the SEC is adamant that the IASB and FASB should not focus on eliminating differences between accounting standards needing significant improvement. Instead the Boards should cooperate and

develop new requirements in areas where both sets of standards require improvement. SEC Deputy Chief Accountant Erhardt<sup>x</sup> has specified that the Boards should ‘tackle the toughest, most intractable and problematic standard setting issues’ such as financial instruments, performance reporting, revenue recognition, pensions, leases, and consolidation policy. The IASB and FASB accepted this challenge in the 2006 update of their Memorandum of Understanding by revising their joint work program with the goal of making significant progress in the development of new joint standards to address the areas highlighted by Erhardt.

While the efforts of the IASB and FASB to address the SEC’s desire to ‘advance the frontiers of accounting’ are clearly in the best interest of investors, Street and Linthicum point out that one can question whether the Boards’ work program is in favor with the EU. For example, EU Commissioner for the Internal Market and Services McCreevey<sup>y,z</sup> stated that convergence cannot be allowed to destabilize the IFRS platform in Europe and, cautioned that convergence is not an invitation for standard setters to advance the ‘theoretical frontiers’ of accounting. ‘Revolutionary’ new standards will not be acceptable as the ‘IFRS train’ has just ‘left the station.’ While the SEC has not suggested a timetable for addressing the issues noted by Erhardt, the implication is that IFRS and U.S. GAAP must improve. It is feasible that McCreevey’s stable platform may hinder the improvement desired by the SEC as his message to the IASB contradicts the SEC position.

It is important to acknowledge that the IASB responded to concerns expressed by European and other IFRS adoptors that the Board was moving too fast in the development of new standards. To assist ‘adoption of IFRS and reinforce consultation,’

in 2006, the IASB announced that no new standards will be effective until 2009, thereby providing four years of stability in the IFRS platform for companies adopting IFRS in 2005. The IASB stresses that establishment of this approach does not preclude issuance of new standards before that date. IASB Chair Tweedie explains that the policy is directed at assisting those involved with IFRS implementation throughout the world, while concurrently enabling the IASB to make progress on its contribution toward eliminating the need for 20-F reconciliation requirements by 2009. From the perspective of the U.S. investor, a key issue, however, remains. If the reconciliation is dropped, will EU and other non-U.S. registrants adequately implement the new international standards that become effective in 2009? Or, will there again be implementation and compliance issues in line with those identified based on reviews of 2005 accounts?

Another concern pointed out by Larson and Street is the onerous and ever expanding EU endorsement process.<sup>aa</sup> The NYC report states that elimination of the reconciliation without delay would communicate to the global financial services community that the U.S. respects and honors approaches developed outside its borders. However, as discussed by Street and Linthicum, the EU endorsement process suggests a similar view may not be shared in Europe. Even with the reconciliation in place and some U.S. GAAP disclosures required for foreign registrants (including segment reporting requirements), the IASB's decision to adopt U.S. segment reporting requirements in IFRS 8 sparked opposition. In April 2007, the Economic and Monetary Affairs Committee of the European Parliament<sup>bb</sup> proposed a Parliamentary resolution calling on the EC to conduct a thorough assessment of the impact prior to endorsing IFRS 8. Among the concerns expressed was that adoption of IFRS 8 'would import into EU

law an alien standard without having conducted any impact assessment.’ In response, the EC announced that a vote on IFRS 8 would be delayed.

Another example of the EU endorsement process hindering convergence is IAS 39. Despite a SEC warning that ‘watering down’ IAS 39 could hinder convergence,<sup>cc</sup> the EU went forward with a ‘carve out’ of IAS 39. With the EC willing to block convergence efforts by modifying IFRS for use in Europe with the reconciliation in place, how much bolder will the Commission become post-reconciliation?

The EU’s endorsement process to determine whether each IASB standard will be approved for use in the EU will likely continue to produce variations between IFRS ‘endorsed by the EU’ and IFRS ‘as issued by the IASB.’ While the SEC is adamant that the reconciliation will be dropped only for companies using IFRS ‘as issued by the IASB,’ careful consideration should be given to the conflicting objectives of the SEC and EU prior to eliminating the reconciliation. As a major IASB constituent, the impact of EU lobbying on the development of IFRS should not be underestimated.

At the Roadmap Roundtable, investors also connected convergence with reconciliation. They generally support removing the reconciliation, except in the case where its elimination would cause convergence to cease. It is, therefore, worthy for one to consider what would be the incentive for convergence once the reconciliation takes place. Given the existence of differing global views, one should also ponder whether the IFRS of the future will be ‘principles-based.’



## **6. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD SUPPORT PERMITTING U.S. COMPANIES TO USE IFRS?**

### **#1 For U.S. companies in certain industries, IFRS would enhance comparability with competitors.**

Deloitte's Gannon, Sogoloff, and Madla<sup>dd</sup> state that U.S. companies, if permitted, may consider IFRS if their significant competitors report under IFRS (i.e. companies in the banking, insurance, motor vehicle manufacturing, pharmaceutical, and telecommunications industries). According to these authors, comparability in reporting would level the playing field, thereby providing investors an 'apples-to-apples' perspective when comparing results.

### **#2 IFRS presents several opportunities to U.S. companies that operate globally.**

Gannon, Sogoloff, and Madla further explain that IFRS offers U.S. companies, particularly those operating globally, several potential opportunities, including:

- **Standardization of Accounting and Financial Reporting Policies** – A consistent set of accounting policies and financial statements in each country where local reporting is required improves comparability of financial information and tax planning.
- **Centralization of Processes** – By moving toward company-wide IFRS use, a company could reduce reliance on local accounting resources for statutory reporting purposes, develop standardized training programs, and eliminate divergent accounting systems.
- **Improved Controls** – Standardized reporting would allow companies to assign one worldwide owner for statutory reporting, yielding better control over the quality and issuance of financial statements in other locations.
- **Better Cash Management** – Dividends that can be paid from subsidiaries may be based on local financial statements. Allowing use of a consistent standard across countries can help improve cash flow planning.

**#3 Elimination of the reconciliation should be paired with allowing U.S. registrants to use IFRS. Otherwise, some U.S. companies, particularly those in certain industries, may be at a competitive disadvantage.**

According to BDO's Johnson, unless allowed the same option to use IFRS, dropping the reconciliation could put U.S. companies at a competitive disadvantage.<sup>ee</sup> For example, IFRS and U.S. GAAP revenue recognition rules differ for the tech industry. Under IFRS, a company can report revenue growth faster than a U.S. company. This is due to the 'principles-based' nature of IFRS, which provides more flexibility in regard to when companies recognize revenue. This is especially important for emerging tech companies because customers, investors, and analysts view revenue recognition as the easiest way to comprehend such a company's worth. Thus, even though two companies could have the same product and similar financial health, customers may view them differently because of the U.S. GAAP company's delay in revenue recognition. Therefore, given the option, U.S.-based tech companies may consider moving to IFRS to avoid competitive disadvantage.

Following a similar line of thinking, at the Roadmap Roundtable, Phillip Jones, Director of External Reporting and Accounting Policies and Procedures at Dupont, referred to his company's willingness to see the reconciliation end. However, from a competitive point, Jones suggests that U.S. issuers should be afforded the same opportunity to report in IFRS.

The SEC's White<sup>ff</sup> shares that he has heard the same from a number of finance and accounting executives at large, multinational corporations in the U.S. These multinationals are already using IFRS for various reasons, whether at their international subsidiaries or for reporting purposes with various regulators in other jurisdictions. They

hold that reporting under IFRS in their SEC filings could improve disclosure and reporting processes overall in terms of transparency and internal consistency.

**7. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD BE CONCERNED ABOUT PERMITTING U.S. COMPANIES TO USE IFRS?**

**#1 Allowing U.S. companies to use IFRS may be followed by elimination of U.S. GAAP. This contradicts with the general sentiment in the U.S. that we should maintain control of establishing accounting standards utilized by U.S. companies.**

Bukspan and Joas state that the SEC's willingness to explore giving U.S. companies a choice between IFRS and U.S. GAAP may 'be interpreted as a not-so-gentle nudge toward a looming exit for U.S. GAAP, and could bring a sea of change for the future role of U.S. GAAP and of the FASB.' Indeed at the Roadmap Roundtable, former SEC Chief Accountant Nicolaisen shared his belief that eventually U.S. registrants should be required to report under IFRS.<sup>88</sup> At the Annual Conference of the International Organization of Securities Commissions, SEC Commissioner Campos<sup>hh</sup> further explored the possibility of not only allowing, but requiring, U.S. companies to use IFRS. Campos stated that over the long-term, it is difficult to argue that one set of accounting standards is anything other than an ultimate target.

In May 2007, a poll was taken at the Financial Services Executives Forum in NYC, which was attended by several hundred CFOs and other finance professionals. The results reveal that a vast majority are willing to accept an IFRS-based standard or a converged set of standards. However, when asked if they are prepared to give up control of establishing accounting standards, 68 percent responded no and another seven percent was unsure. Bukspan and Joas believe the latter likely reflects the U.S. sentiment in general, given the historical strength of the U.S. capital markets relative to global

markets. Despite the shortcomings of U.S. GAAP, these authors believe that the U.S. market may not be prepared to embrace a completely new set of standards that are in an evolutionary stage, yet to be tested, and to which the market will have to get accustomed.

Based on responses by 142 members of the American Association of Individual Investors to their survey, McEnroe and Sullivan<sup>ii</sup> report that the attitudes of individual investors are in line with studies highlighting potential negative consequences linked to the elimination of the reconciliation. Their study finds that U.S. individual investors are very much in favor of foreign listings on U.S. exchanges. However, individual investors endorse current rules requiring either the use of U.S. GAAP or the reconciliation. A large majority of the individual investors believe the U.S. should maintain control of accounting standards used for U.S. listings. A smaller majority believe there should be a global set of accounting principles for all stock exchanges.

**#2 Requiring U.S. companies to use IFRS will limit the influence of the FASB, SEC, and other U.S. organizations in shaping the accounting standards used by U.S. and other companies accessing the U.S. markets.**

Tarca<sup>jj</sup> describes the impact of adoption of IFRS in Australia, which historically has followed a standard setting model similar to the U.S. Her major points provide a preview of what the future would likely hold for the U.S. if IFRS were adopted.

- The Australian Accounting Standards Board no longer develops standards from inception. The Board cannot independently determine the content of standards, but is constrained to ensure that Australian standards are not inconsistent with IFRS. The Board does not have control over its work program, which is aligned with that of the IASB, so that matters under consideration by the IASB are also considered by the Australian Board.
- Lobbying efforts of the corporate sector must be directed more at the IASB than the Australian Board. Australian companies have less influence in international standard setting than they had in national standard setting.
- The Federal Government is more removed from the standard setting process now that Australian standards are based on IFRS. Given the Government's support for

harmonization with IFRS, it is unlikely to intervene in the standard setting process to allow Australian standards to be incompatible with IFRS.

As noted previously, U.S. investors, in general, apparently are not prepared to give up control of establishing accounting standards as has occurred in Australia.

Tarca's point on lobbying is consistent with Wyatt's view that, upon acceptance of IFRS, lobbying is redirected from the national standard setter to the IASB. According to Wyatt, with lobbying from 'multiple governments with differing priorities and multiple business communities with various interests to protect' pressures on the IASB will eventually exceed those ever faced by any national standard setter and make development of 'principles-based' standards a massive challenge.

**#3 IFRS does not provide a comprehensive set of standards suitable for the U.S. market.**

Bukspan and Joas describe IFRS as a 'work in progress' that does not cover some areas of accounting (see also Street and Linthicum). When an IFRS standard does not address a matter, IAS 8 requires companies to look to the most recent pronouncements of other standard setters. In a review of 2005 IFRS accounts, the SEC staff identified substantial variation in accounting for insurance contracts and in reporting of extractive industry exploration and evaluation activities in the absence of an extensive IFRS standard for these activities. If the reconciliation is eliminated and, more importantly, if U.S. registrants are allowed to use IFRS, the SEC should clarify what rules to follow in the absence of an IFRS. Otherwise, comparability will likely be greatly impeded.

**#4 There is limited experience in preparing IFRS statements in the U.S. market. Thus, important implementation concerns should be addressed prior to allowing U.S. companies to use IFRS.**

Most U.S. accountants and auditors are not trained in IFRS. Thus, as explained by Wyatt, a move to IFRS would necessitate substantial continuing professional education for those in practice as well as extensive changes in the curricula of universities. Furthermore, a move to IFRS at a rapid pace would require, among other things, investments in systems, personnel, new reporting formats, and modification to the internal control system over financial reporting.<sup>kk</sup> Significant costs could result from re-negotiating contracts, lending agreements and debt covenants, and compensation agreements tied to U.S. GAAP. Tax advisors, as well as regulators, would need to comprehend the implications of moving to IFRS. Following the like-sized efforts associated with implementation of Sarbanes-Oxley, such a move would likely not be welcome.

As noted by the Canadian Accounting Standards Board, in the short-term, Boards of Directors of public companies would need to ensure that a member of management, or an advisor, is responsible for reporting on a regular basis on the implications of IFRS adoption.<sup>ll</sup> Effort up-front would be necessary to mitigate longer-term costs and impact.

**#5 Enhanced lobbying will limit the IASB's ability to maintain IFRS' status as 'principles-based.' Thus, acceptance of IFRS will not represent the desired move from the 'rules-based' approach of U.S. GAAP.**

Both the NYC report and Bukspan and Joas highlight the need for convergence towards 'principles-based' as opposed to 'rules-based' accounting standards. Wyatt explains that the FASB's departure from the underlying concepts set forth in the Board's Conceptual Framework has in many instances been the result of political interference,

either from disagreement with SEC thinking, or more frequently, effective lobbying by the business community signaling to the FASB that the direction of a FASB proposal would cause harm to the U.S. economy. The result is often issuance of a U.S. standard that departs from the Conceptual Framework and that accordingly is more 'rules-based' than 'principles-based.'

According to Wyatt, no one understanding accounting standard setting can possibly think the IASB will be immune from the political forces that have caused the FASB so much anguish and have lead to the issuance of bad U.S. standards. He states that 'multiple governments with differing priorities and multiple business communities with various interests to protect will generate even greater pressures on the IASB than the FASB has faced.' Thus, according to Wyatt, the 'principles-based' versus 'rules-based' issue represents a red herring. Future international standards will likely look more like FASB standards than 'principles-based' standards. While 'principles-based' standards are an admirable goal, the evolution of standards, be they U.S. GAAP or IFRS, will likely continue to be influenced by forces unrelated to accounting concepts. While 'rules-based' standards will continue to be issued, Wyatt is hopeful that they will be issued on a diminished basis.

In line with Wyatt's thinking, a PwC report<sup>mm</sup> states that, the IASB and FASB 'fail to acknowledge other key forces that influence standard setting in the EU – specifically, the ... endorsement process at the European Commission level. Thus, the belief that IFRS are the route to global 'principles-based' standards may be flawed.

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## **APPENDIX C**

# **FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH**

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July 2008



# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

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for the Council of Institutional Investors\*

July 2008

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\* This white paper was commissioned by the Council of Institutional Investors for the purpose of educating its members, policy makers and the general public about the important and timely topic of fair value accounting and its potential impact on investors. The views and opinions expressed in the paper are those of Professor Ryan and do not necessarily represent the views or opinions of the Council members, board of directors or staff. Official policy positions of the Council are determined only after an extensive due process that includes approval by a vote of the Council board and membership.

# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

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# FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

## Executive Summary

Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of the liabilities. Under fair value accounting, companies report losses when the fair values of their assets decrease or liabilities increase. Those losses reduce companies' reported equity and may also reduce companies' reported net income.

Although fair values have played a role in U.S. generally accepted accounting principles (GAAP) for more than 50 years, accounting standards that require or permit fair value accounting have increased considerably in number and significance in recent years. In September 2006, the Financial Accounting Standards Board (FASB) issued an important and controversial new standard, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), which provides significantly more comprehensive guidance to assist companies in estimating fair values. The practical applicability of this guidance has been tested by the extreme market conditions during the ongoing credit crunch.

In response to the credit crunch, some parties (generally financial institutions) have criticized fair value accounting, including FAS 157's measurement guidance. Those criticisms have included:

- Reported losses are misleading because they are temporary and will reverse as markets return to normal
- Fair values are difficult to estimate and thus are unreliable
- Reported losses have adversely affected market prices yielding further losses and increasing the overall risk of the financial system.

While those criticisms have some validity, they also are misplaced or overstated in important respects.

The more relevant question is whether fair value accounting provides more useful information to investors than alternative accounting approaches. The answer to that question is "yes."

Some of the key reasons why fair value accounting benefits investors include:

- It requires or permits companies to report amounts that are more accurate, timely, and comparable than the amounts that would be reported under existing alternative accounting approaches, even during extreme market conditions
- It requires or permits companies to report amounts that are updated on a regular and ongoing basis
- It limits companies' ability to manipulate their net income because gains and losses on assets and liabilities are reported in the period they occur, not when they are realized as the result of a transaction
- Gains and losses resulting from changes in fair value estimates indicate economic events that companies and investors may find worthy of additional disclosures.

## I. Introduction

During the ongoing credit crunch,<sup>1</sup> the markets for subprime and some other asset and liability positions have been severely illiquid and disorderly in other respects. This has led various (possibly self-interested) parties to raise three main potential criticisms of fair value accounting. First, unrealized losses recognized under fair value accounting may reverse over time. Second, market illiquidity may render fair values difficult to measure and thus unreliable. Third, firms reporting unrealized losses under fair value accounting may yield adverse feedback effects that cause further deterioration of market prices and increase the overall risk of the financial system ("systemic risk"). While similar criticisms have been made periodically for as long as fair values have been used in GAAP (well over 50 years), the recent volume and political salience<sup>2</sup> of these criticisms is ironic given that in September 2006 the FASB issued FAS 157, *Fair Value Measurements*. This standard contains considerably more comprehensive fair value measurement guidance than previously existed. It almost seems that the credit crunch was sent to serve as FAS 157's trial by fire.

This white paper explains these potential criticisms, indicating where they are correct and where they are misplaced or overstated. It also summarizes the divergent views of parties who believe that fair value accounting benefits investors and of those who believe it hurts investors. Believing in full disclosure, the author acknowledges that he is an advocate of fair value accounting, especially for financial institutions, but not a zealot with respect to fair value measurement issues such as those raised by the credit crunch. Like any other accounting system, fair value accounting has its limitations, both conceptual and practical. The relevant questions to ask are: Does fair value accounting provide more useful information to investors than the alternatives (generally some form of amortized cost accounting)? If so, can the FASB improve FAS 157's guidance regarding fair value measurement to better cope with illiquid or otherwise disorderly markets? In the author's view, the answer to each of these questions is "yes."

Section II provides useful background information about fair value accounting, the limited alternative of amortized cost accounting, and the unsatisfying current mixed-attribute accounting model for financial instruments. This section abstracts from the difficult issues raised by the credit crunch, because investors cannot properly understand these issues and their relative importance without first understanding the more basic issues discussed in this section. Section III summarizes FAS 157's fair value measurement guidance, indicating where that guidance does not address the issues raised by the credit crunch with sufficient specificity. Section IV discusses the aforementioned potential criticisms of fair value accounting during the credit crunch and provides the author's views about these criticisms. Sections V and VI summarize the reasons why some parties believe that fair value accounting benefits investors while others believe it hurts investors.

## **II. Background Information Abstracting from the Credit Crunch**

### **A. Fair Value Accounting**

The goal of fair value measurement is for firms to estimate as best as possible the prices at which the positions they currently hold would change hands in orderly transactions based on current information and conditions. To meet this goal, firms must fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements. As discussed in more detail in Section III, when market prices for the same or similar positions are available, FAS 157 generally requires firms to use these prices in estimating fair values. The rationale for this requirement is market prices should reflect all publicly available information about future cash flows, including investors' private information that is revealed through their trading, as well as current risk-adjusted discount rates. When fair values are estimated using unadjusted or adjusted market prices, they are referred to as mark-to-market values. If market prices for the same or similar positions are not available, then firms must estimate fair values using valuation models. FAS 157 generally requires these models to be applied using observable market inputs (such as interest rates and yield curves that are observable at commonly quoted intervals) when they are available and unobservable firm-supplied inputs (such as expected cash flows developed using the firm's own data) otherwise. When fair values are estimated using valuation models, they are referred to as mark-to-model values.



Under fair value accounting, firms report the fair values of the positions they currently hold on their balance sheets. When fair value accounting is applied fully, firms also report the periodic changes in the fair value of the positions they currently hold, referred to as unrealized gains and losses, on their income statements. Unrealized gains and losses result from the arrival of new information about future cash flows and from changes in risk-adjusted discount rates during periods. As discussed in more detail in Section II.C, current GAAP requires fair value accounting to be applied in an incomplete fashion for some positions, with unrealized gains and losses being recorded in accumulated other comprehensive income, a component of owners' equity, not in net income.<sup>3</sup>

The main issue with fair value accounting is whether firms can and do estimate fair values accurately and without discretion. When identical positions trade in liquid markets that provide unadjusted mark-to-market values, fair value generally is the most accurate and least discretionary possible measurement attribute, although even liquid markets get values wrong on occasion. Fair values typically are less accurate and more discretionary when they are either adjusted mark-to-market values or mark-to-model values. In adjusting mark-to-market values, firms may have to make adjustments for market illiquidity or for the dissimilarity of the position being fair valued from the position for which the market price is observed. These adjustments can be large and judgmental in some circumstances. In estimating mark-to-model values, firms typically have choices about which valuation models to use and about which inputs to use in applying the chosen models. All valuation models are limited, and different models capture the value-relevant aspects of positions differently. Firms often must apply valuation models using inputs derived from historical data that predict future cash flows or correspond to risk-adjusted discount rates imperfectly. The periods firms choose to analyze historical data to determine these inputs can have very significant effects on their mark-to-model values.

This issue with fair value accounting is mitigated in practice in two significant ways. First, FAS 157 and the accounting standards governing certain specific positions (e.g., FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which governs retained interests from securitizations) require firms to disclose qualitative information about how they estimate fair values as well as quantitative information about their valuation inputs, the sensitivities of their reported fair values to those inputs, and unrealized gains and losses and other changes in the fair value of their positions. These disclosures allow investors to assess the reliability of reported fair values and to adjust or ignore them as desired. Over time, the FASB can and surely will improve these disclosures and expand them to more positions. Second, most fair value accounting standards require fair values to be re-estimated each quarter, and so past valuation errors can and should be corrected on an ongoing and timely basis.

In principle, fair value accounting should be the best possible measurement attribute for inducing firms' managements to make voluntary disclosures and for making investors aware of the critical questions to ask managements. When firms report unrealized gains and losses, their managements are motivated to explain in the Management Discussion and Analysis sections of financial reports and elsewhere what went right or wrong during the period and the nature of any fair value measurement issues. If a firm's management does not adequately explain their unrealized gains and losses, then investors at least are aware that value-relevant events occurred during the period and can prod management to explain further. Until recently, however, managements have made relatively few voluntary disclosures regarding their fair values. Fortunately, this appears to be changing as a result of the credit crunch and other factors, as illustrated by the Senior Supervisors Group's (2008) survey of recent leading-practice disclosures.

## **B. The Limited Alternative of Amortized Cost Accounting**

The alternative to fair value accounting generally is some form of amortized cost (often referred to over-broadly as "accrual") accounting. In its pure form, amortized cost accounting uses *historical* information about future cash flows and risk-adjusted discount rates from the inception of positions to account for them throughout their lives on firms' balance sheets and income statements. Unlike under fair value accounting, unrealized gains and losses are ignored until they are realized through the disposal, or impairment in value, of positions or the passage of time. When firms dispose of positions, they record the *cumulative* unrealized gains and losses that have developed since the inception or prior impairment of positions on their income statements.

Amortized cost accounting raises three main issues, all of which arise from its use of untimely historical information about future cash flows and risk-adjusted discount rates.

1. Income typically is persistent for as long as firms hold positions, but becomes transitory when positions mature or are disposed of and firms replace them with new positions at current market terms. This can lull investors into believing that income is more persistent than it really is.
2. Positions incepted at different times are accounted for using different historical information and discount rates, yielding inconsistent and untimely accounting for the constituent elements of firms' portfolios. This obscures the net value and risks of firms' portfolios.
3. Firms can manage their income through the selective realization of cumulative unrealized gains and losses on positions, an activity referred to as gains trading.

Issues 2 and 3 are particularly significant for financial institutions. These institutions typically hold portfolios of many positions chosen to have largely but not completely offsetting risks, so that the aggregate risks of the institutions' portfolios are within their risk management guidelines but still allow them to earn above riskless rates of return. Amortized cost accounting effectively treats financial institutions' positions as if they have no unexpected changes in value until institutions realize gains and losses on their positions. Financial institutions can easily engage in gains trading, because their positions are often quite liquid, and because one side of each of their many offsetting positions typically will have a cumulative unrealized gain while the other side will have a cumulative unrealized loss. Financial institutions can selectively dispose of the side of their offsetting positions with cumulative unrealized gains (losses), thereby raising (lowering) their net income. Because these institutions hold many offsetting positions, such gains trading can go on for many periods, possibly in the same direction.

In practice, financial report disclosures mitigate these issues with amortized cost accounting in very limited ways. For example, regarding issues 1 and 2, SEC Industry Guide 3 requires banks to disclose detailed breakdowns of their amortized cost interest revenue and expense by type of interest-earning asset and interest-paying liability. Through careful analysis of these disclosures, investors can attempt to disentangle the persistent and transitory components of amortized cost interest and to undo the inconsistent calculation of interest for different positions. This analysis can be difficult to conduct, however, because it requires investors to estimate from other information sources the average lives of banks' different types of assets and liabilities and thus when these positions likely were incepted and will mature (assuming banks do not dispose of them before maturity). Moreover, these disclosures are not required for non-banks. Regarding issue 3, all firms must disclose their realized and unrealized gains and losses on available-for-sale securities under FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, which clearly reveals gains trading for these securities. However, such disclosures are not required for most other financial assets and liabilities for which gains trading is feasible, although they could be.

Traditional bankers and other advocates of amortized cost accounting often argue that unrealized gains and losses on fixed-rate or imperfectly floating-rate positions that arise due to changes in risk-adjusted discount rates (i.e., both riskless rates and credit risk premia) are irrelevant when firms intend to hold positions to maturity, because firms will eventually receive or pay the promised cash flows on the positions. Absent issues regarding the measurement of unrealized gains and losses, this argument is clearly incorrect. Changes in risk-adjusted discount rates yield economic gains and losses to the current holders of the positions compared to the alternative of acquiring identical positions at current rates. For example, when risk-adjusted discount rates rise old assets yielding interest at lower historical rates are worth less than identical new assets yielding higher current rates. These old and new assets do not have the same values and should not be accounted for as if they do. This is true regardless of whether the firms currently holding the old assets intend to dispose of them before maturity or not.

The incorrectness of this argument is most obvious at the portfolio level, which is the right level to analyze most financial institutions. For example, if interest rates rise, then traditional banks' old assets yielding lower historical rates may have to be financed with new liabilities yielding higher current rates.

Amortized cost accounting usually is not applied in a pure fashion. Assets accounted for at amortized cost typically are subject to impairment write-downs. These write-downs can adjust the asset balance to fair value or to another measurement attribute (typically one that results in an asset balance above fair value). Depending on how impairment write-downs are measured, some or all of the fair value measurement issues discussed in Section II.A also apply to these write-downs. Moreover, additional issues arise for impairment write-downs that are recorded only if judgmental criteria are met, such as the requirement in FAS 115 and some other standards to record impairment write-downs only if the impairments are "other than temporary." Similarly, certain economic liabilities accounted for at amortized cost (e.g., most loan commitments) are subject to judgmental accruals of probable and reasonably estimable losses under FAS 5, *Accounting for Contingencies*.

## **C. The Unsatisfying Mixed-Attribute Accounting Model for Financial Instruments**

GAAP requires various measurement attributes to be used in accounting for financial instruments. This is referred to as the "mixed attribute" accounting model.

1. Most traditional financial instruments (e.g., banks' loans held for investment, deposits, and debt) are reported at amortized cost.
  - a. As just discussed, financial assets typically are subject to (other-than-temporary) impairment write-downs. Economic financial liabilities may be subject to accrual of probable and reasonably estimable losses.
2. A few financial instruments—including trading securities under FAS 115, nonhedge and fair value hedge derivatives and fair value hedged items under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and instruments for which the fair value option is chosen under FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*—are reported at fair value on the balance sheet with unrealized gains and losses included in net income each period.
3. Two distinct hybrids of amortized cost and fair value accounting are required for other financial instruments.

- a. Available-for-sale securities under FAS 115 and cash flow hedge derivatives under FAS 133 are recorded at fair value on the balance sheet but unrealized gains and losses are recorded as they occur in accumulated other comprehensive income, a component of owners' equity, not in net income.
- b. Loans held-for-sale are recorded at lower of cost or fair value under FAS 65, *Accounting for Certain Mortgage Banking Activities* (mortgages) and SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) that Lend or Finance the Activities of Others* (other loans).

The mixed attribute model often allows firms to choose the measurement attribute they desire for a position through how they classify the position. For example, under FAS 115 a firm may choose to classify a security as any one of trading, available for sale, or held to maturity, and thereby obtain one of three different accounting treatments. Relatedly, the SEC (2005) states “the mixed-attribute model has prompted a significant amount of accounting-motivated transaction structures.”

Similar to (and in some respects worse than) amortized cost accounting, the mixed attribute model poorly describes the net value and risks of financial institutions' portfolios of financial instruments. In particular, this model can make effective risk management by these institutions appear to be speculation, and vice-versa. For example, consider a bank that acquires fixed-rate securities that it classifies as trading and that finances those securities with fixed-rate debt with the same duration and other risk characteristics, so that the bank has no interest rate risk. If interest rates rise, then the bank's trading assets will experience an unrealized loss that is recorded in net income, while its debt will experience an unrealized gain that is not immediately recognized for any accounting purpose. Hence, this bank will appear to have been speculating on interest rate movements. Conversely, consider a bank that acquires floating-rate securities and finances those securities with the same fixed-rate debt as before, so that the bank is speculating that interest rates will rise. If interest rates do rise, then the unrealized gain on the bank's debt will not be immediately recognized for any accounting purpose and so the bank will appear to be immune to interest rate risk.

Because of these severe limitations, in the author's view consistent fair value accounting for all of financial institutions' financial instruments is clearly preferable to either the current mixed-attribute accounting model or to a pure amortized cost model.<sup>4</sup> Because amortized costs are useful as a check on fair values and for specific types of investment and other decisions, however, the FASB should require firms to disclose the amortized costs of financial instruments. Fair value accounting with amortized cost disclosures would be essentially the reverse of the current mixed-attribute accounting model with disclosures of the fair values under FAS 107, *Disclosures about Fair Value of Financial Instruments*.

### **III.FAS 157**

FAS 157 contains essentially all of the current GAAP guidance regarding how to measure fair values. FAS 157 does not require fair value accounting for any position; its guidance is relevant only when other accounting standards require or permit positions to be accounted for at fair value. While FAS 157 became effective for fiscal years beginning after November 15, 2007, most large financial institutions early adopted the standard in the first quarter of 2007, and so it has been applicable for these institutions during the entirety of the credit crunch. Not surprisingly, these institutions have reported a large portion of the losses resulting from the credit crunch.

This section describes the critical aspects of FAS 157's definition of fair value and hierarchy of fair value measurement inputs. It also indicates where this guidance does not deal with the issues raised by the credit crunch with sufficient specificity.

#### **A.Definition of Fair Value**

FAS 157 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This definition of fair value reflects an ideal “exit value” notion in which firms exit the positions they currently hold through orderly transactions with market participants at the measurement date, not through fire sales.

“At the measurement date” means that fair value should reflect the conditions that exist at the balance sheet date. For example, if markets are illiquid and credit risk premia are at unusually high levels at that date, then fair values should reflect those conditions. In particular, firms should not incorporate their expectations of market liquidity and credit risk premia returning to normal over some horizon, regardless of what historical experience, statistical models, or expert opinion indicates.

An “orderly transaction” is one that is unforced and unhurried. The firm is expected to conduct usual and customary marketing activities to identify potential purchasers of assets and assumers of liabilities, and these parties are expected to conduct usual and customary due diligence. During the credit crunch, these activities could take considerable amounts of time because of the few and noisy signals about the values of positions being generated by market transactions and because of parties' natural skepticism regarding those values. As a result, a temporal slippage arises between the “at the measurement date” and “orderly transaction” aspects of FAS 157's fair value definition that raises practical problems for preparers of financial reports. This slippage is discussed in more detail in Section III.B.

“Market participants” are knowledgeable, unrelated, and willing and able to transact. Knowledgeable parties are not just generally sophisticated and aware of market conditions; they have conducted the aforementioned due diligence and ascertained as best as possible the fair values of the positions under consideration. FAS 157 presumes that, after conducting these activities, either market participants are as knowledgeable as the firms currently holding the positions or they can price any remaining information asymmetry. The standard does not contemplate the idea that information asymmetry between the current holders of positions and potential purchasers or assumers of positions is so severe that markets break down altogether, as appears to have effectively occurred for some positions during the credit crunch.

## **B. Hierarchy of Fair Value Measurement Inputs**

FAS 157 creates a hierarchy of inputs into fair value measurements, from most to least reliable. Level 1 inputs are unadjusted quoted market prices in active markets for identical items. With a few narrow exceptions, FAS 157 explicitly requires firms to measure fair values using level 1 inputs whenever they are available.

Level 2 inputs are other directly or indirectly observable market data. There are two broad subclasses of these inputs. The first and generally preferable subclass is quoted market prices in active markets for similar items or in inactive markets for identical items. These inputs yield adjusted mark-to-market measurements that are less than ideal but usually still pretty reliable, depending on the nature and magnitude of the required valuation adjustments. The second subclass is other observable market inputs such as yield curves, exchange rates, empirical correlations, et cetera. These inputs yield mark-to-model measurements that are disciplined by market information, but that can only be as reliable as the models and inputs employed. In the author’s view, this second subclass usually has less in common with the first subclass than with better quality level 3 measurements described below.

Level 3 inputs are unobservable, firm-supplied estimates, such as forecasts of home price depreciation and the resulting credit loss severity on mortgage-related positions. These inputs should reflect the assumptions that market participants would use, but they yield mark-to-model valuations that are largely undisciplined by market information. Due to the declining price transparency during the credit crunch, many subprime positions that firms previously fair valued using level 2 inputs inevitably had to be fair valued using level 3 inputs.

As discussed in more detail in Section IV.B, while level 2 inputs generally are preferred to level 3 inputs, FAS 157 does not necessarily require firms to use level 2 inputs over level 3 inputs. Firms should use “the assumptions that market participants would use in pricing the asset or liability.” When markets are illiquid, firms can make the argument that available level 2 inputs are of such low quality that market participants would use level 3 inputs instead.

If a fair value measurement includes even one significant level 3 input, then it is viewed as a level 3 measurement. FAS 157 sensibly requires considerably expanded disclosures for level 3 fair value measurements.

## **IV. Potential Criticisms of Fair Value Accounting During the Credit Crunch**

This section discusses the three potential criticisms of fair value accounting during the credit crunch previously mentioned in Section I. It also indicates the guidance in FAS 157 that is most relevant to these criticisms and provides some factual observations as well as the author's views about these criticisms and guidance.

### **A. Unrealized Gains and Losses Reverse<sup>5</sup>**

This section discusses two distinct reasons why unrealized gains and losses may reverse with greater than 50% probability. First, the market prices of positions may be bubble prices that deviate from fundamental values. Second, these market prices may not correspond to the future cash flows most likely to be received or paid because the distribution of future cash flows is skewed. For example, the distribution of future cash flows on an asset may include some very low probability but very high loss severity future outcomes that reduce the fair value of the asset.

#### **1. Bubble Prices**

The financial economics literature now contains considerable theory and empirical evidence that markets sometimes exhibit "bubble prices" that either are inflated by market optimism and excess liquidity or are depressed by market pessimism and illiquidity compared to fundamental values. Bubble prices can result from rational short-horizon decisions by investors in dynamically efficient markets, not just from investor irrationality or market imperfections.<sup>6</sup> Whether bubble prices have existed for specific types of positions during the credit crunch is debatable, but it certainly is possible.<sup>7</sup>

In FAS 157's hierarchy of fair value measurement inputs, market prices for the same or similar positions are the preferred type of input. If the market prices of positions currently are depressed below their fundamental values as a result of the credit crunch, then firms' unrealized losses on positions would be expected to reverse in part or whole in future periods. Concerned with this possibility, some parties have argued that it would be preferable to allow or even require firms to report amortized costs or level 3 mark-to-model fair values for positions rather than level 2 adjusted mark-to-market fair values that yield larger unrealized losses.<sup>8</sup>



If level 1 inputs are available, then with a few narrow exceptions FAS 157 requires firms to measure fair values at these active market prices for identical positions without any adjustments for bubble pricing. However, if only level 2 inputs are available and firms can demonstrate that these inputs reflect forced sales, then FAS 157 (implicitly) allows firms to make the argument that level 3 mark-to-model based fair values are more faithful to FAS 157's fair value definition.

The author agrees with the FASB's decision in FAS 157 that the possible existence of bubble prices in liquid markets should not affect the measurement of fair value. It is very difficult to know when bubble prices exist and, if so, when the bubbles will burst. Different firms would undoubtedly have very different views about these matters, and they likely would act in inconsistent and perhaps discretionary fashions. To be useful, accounting standards must impose a reasonably high degree of consistency in application.

It should also be noted that amortized costs reflect any bubble prices that existed when positions were incepted. In this regard, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.

## **2. Skewed Distributions of Future Cash Flows**

Fair values should reflect the expected future cash flows based on current information as well as current risk-adjusted discount rates for positions. When a position is more likely to experience very unfavorable future cash flows than very favorable future cash flows, or vice-versa—statistically speaking, when it exhibits a skewed distribution of future cash flows—then the expected future cash flows differ from the most likely future cash flows. This implies that over time the fair value of the position will be revised in the direction of the most likely future cash flows with greater than 50% probability, possibly considerably greater. While some parties appear to equate this phenomenon with expected reversals of unrealized gains and losses such as result from bubble prices, it is not the same thing. When distributions of future cash flows are skewed, fair values will tend to be revised by relatively small amounts when they are revised in the direction of the most likely future cash flows but by relatively large amounts when they are revised in the opposite direction. Taking into account the sizes and probabilities of the possible future cash flows, the unexpected change in fair value will be zero on average.

Financial instruments that are options or that contain embedded options exhibit skewed distributions of future cash flows. Many financial instruments have embedded options, and in many cases the credit crunch has accentuated the importance of these embedded options. Super senior CDOs, which have experienced large unrealized losses during the credit crunch, are a good example. At inception, super senior CDOs are structured to be near credit riskless instruments that return their par value with accrued interest in almost all circumstances. Super senior CDOs essentially are riskless debt instruments with embedded written put options on some underlying set of assets. Super senior CDOs return their par value with accrued interest as long as the underlying assets perform above some relatively low threshold (reflecting the riskless debt instruments), but they pay increasingly less than this amount the more the underlying assets perform below that threshold (reflecting the embedded written put options). As a result of the embedded written put options, the fair values of super senior CDOs typically are slightly less than the values implied by the most likely cash flows. During the credit crunch, the underlying assets (often subprime mortgage-backed securities) performed very poorly, increasing the importance of the embedded put option and decreasing the fair value of super senior CDOs further below the value implied by the most likely outcome, which for some super seniors may still be to return the par value with accrued interest.

To illustrate this subtle statistical point, assume that the cash flows for a super senior CDO are driven by home price depreciation, and that the distribution of percentage losses is modestly skewed with relatively small probability of large losses, as indicated in the following table.

<i>home price depreciation</i>	<i>probability occurs</i>	<i>estimated loss on (value of) super senior CDO as a percentage of par value</i>
<10%	20%	0% (100%)
15%	40%	5% (95%)
20%	25%	20% (80%)
25%	10%	40% (60%)
30%	5%	80% (20%)

In this example, the most likely percentage loss on the super senior is 5%, which occurs 40% of the time. The expected percentage loss is a considerably larger  $15\% = (40\% \times 5\%) + (25\% \times 20\%) + (10\% \times 40\%) + (5\% \times 80\%)$ , because it reflects the relatively small probabilities of large losses. The fair value of the super senior is reduced by the expected percentage loss and so is 85% of face value. Over time, this fair value will be revised upward with 60% probability, to either 95% of face value (with 40% probability) or 100% of face value (with 20% probability). The fair value will be revised downward with only 40% probability, to 80% of face value (with 25% probability) or 60% of face value (with 10% probability) or 20% of face value (with 5% probability). The expected change in fair value is zero, however, because the lower probability but larger possible fair value losses are exactly offset by the higher probability but smaller possible fair value gains. The difference between the most likely and expected change in fair value would be larger if the distribution of cash flows was more skewed.

In the author's view, it is more informative to investors for accounting to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than for it to be right most of the time but to ignore relatively low probability but highly unfavorable or favorable future cash flows. Relatedly, by updating the distribution of future cash flows each period, fair value accounting provides investors with timelier information about changes in the probabilities of large unfavorable or favorable future cash flows. Such updating is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.

## **B. Market Illiquidity**

Together, the "orderly transaction" and "at the measurement date" elements of FAS 157's fair value definition reflect the semantics behind the "fair" in "fair value." Fair values are not necessarily the currently realizable values of positions; they are hypothetical values that reflect fair transaction prices even if current conditions do not support such transactions.

When markets are severely illiquid, as they have been during the credit crunch, this notion yields significant practical difficulties for preparers of firms' financial statements. Preparers must imagine hypothetical orderly exit transactions even though actual orderly transactions might not occur until quite distant future dates. Preparers will often want to solicit actual market participants for bids to help determine the fair values of positions, but they cannot do so when the time required exceeds that between the balance sheet and financial report filing dates. Moreover, any bids that market participants might provide would reflect market conditions at the expected transaction date, not the balance sheet date.

When level 2 inputs are driven by forced sales in illiquid markets, FAS 157 (implicitly) allows firms to use level 3 model-based fair values. For firms to be able to do this, however, their auditors and the SEC generally require them to provide convincing evidence that market prices or other market information are driven by forced sales in illiquid markets. It may be difficult for firms to do this, and if they cannot firms can expect to be required to use level 2 fair values that likely will yield larger unrealized losses.

In the author's view, the FASB can and should provide additional guidance to help firms, their auditors, and the SEC individually understand and collectively agree what constitutes convincing evidence that level 2 inputs are driven by forced sales in illiquid markets. The FASB could do this by developing indicators of market illiquidity, including sufficiently large bid-ask spreads or sufficiently low trading volumes or depths. These variables could be measured either in absolute terms or relative to normal levels for the markets involved. When firms are able to show that such indicators are present, the FASB should explicitly allow firms to report level 3 model-based fair values rather than level 2 valuations as long as they can support their level 3 model-based fair values as appropriate in theory and with adequate statistical evidence. Requiring firms to compile indicators of market illiquidity and to provide support for level 3 mark-to-model valuations provides important discipline on the accounting process and cannot be avoided.

Relatedly, the author also believes that the FASB should require firms to disclose their significant level 3 inputs and the sensitivities of the fair values to these inputs for all of their material level 3 model-based fair values. If such disclosures were required, then level 3 model-based fair values likely would be informationally richer than poor quality level 2 fair values.

## **C. Adverse Feedback Effects and Systemic Risk**

By recognizing unrealized gains and losses, fair value accounting moves the recognition of income and loss forward in time compared to amortized cost accounting. In addition, as discussed in Section IV.A.1 unrealized gains and losses may be overstated and thus subsequently reverse if bubble prices exist. If firms make economically suboptimal decisions or investors overreact because of reported unrealized gains and losses, then fair value accounting may yield adverse feedback effects that would not occur if amortized cost accounting were used instead. For example, some parties have argued that financial institutions' write-downs of subprime and other assets have caused further reductions of the market values of those assets and possibly even systemic risk. These parties argue that financial institutions' reporting unrealized losses has caused them to sell the affected assets to raise capital, to remove the taint from their balance sheets, or to comply with internal or regulatory investment policies.<sup>9</sup> These parties also argue that financial institutions' issuance of equity securities to raise capital have crowded out direct investment in the affected assets.

In the author's view, it is possible that fair value accounting-related feedback effects have contributed slightly to market illiquidity, although he is unaware of any convincing empirical evidence that this has been the case. However, it is absolutely clear that the subprime crisis that gave rise to the credit crunch was primarily caused by firms, investors, and households making bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, not by accounting. The severity and persistence of market illiquidity during the credit crunch and any observed adverse feedback effects are much more plausibly explained by financial institutions' considerable risk overhang<sup>10</sup> of subprime and other positions and their need to raise economic capital, as well as by the continuing high uncertainty and information asymmetry regarding those positions. Financial institutions actually selling affected assets and issuing capital almost certainly has mitigated the overall severity of the credit crunch by allowing these institutions to continue to make loans. Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than amortized cost accounting would, thereby mitigating the duration of the credit crunch.

Moreover, even amortized cost accounting is subject to impairment write-downs of assets under various accounting standards and accrual of loss contingencies under FAS 5. Hence, any accounting-related feedback effects likely would have been similar in the absence of FAS 157 and other fair value accounting standards.

## **V. Summary of Reasons Why Some Believe that Fair Value Accounting Benefits Investors**

In the author's observation, the FASB and IASB, most trading-oriented financial institutions, most investor associations,<sup>11</sup> and most accounting academics<sup>12</sup> believe that overall fair value accounting benefits investors compared to accounting based on alternative measurement attributes, including amortized cost accounting. This section summarizes the benefits of fair value accounting and indicates the prior section of the paper in which these benefits are discussed.

1. Even if markets exhibit bubble prices, fair values are more accurate, timely, and comparable across different firms and positions than are alternative measurement attributes, as discussed in Section II.
  - a. Fair values reflect current information about future cash flows and current risk-adjusted discount rates, as discussed in Section II.A.
    - i. In contrast, amortized costs can differ dramatically from fundamental values and be very untimely for long-lived positions, as discussed in Section II.B.

- ii. Amortized costs reflect any bubble prices that existed when positions were incepted. In particular, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.
  - b. Fair value accounting self-corrects over time in a timely fashion, as discussed in Section II.A.
    - i. This self-correcting quality is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.
    - ii. In contrast, amortized cost accounting does not self-correct until gains and losses are realized, as discussed in Section II.B.
  - c. The comparability of the fair values of different positions is particularly important in assessing the net value and risks of financial institutions' portfolios of financial instruments, as discussed in Section II.C.
    - i. In contrast, amortized costs are inconsistently untimely across positions incepted at different times, as discussed in Section II.B.
- 2. As discussed in Section III, while the credit crunch raises issues for fair value measurements, under FAS 157 fair values need not reflect fire sale values. When level 2 inputs are driven by fire sales, firms can make the argument that level 3 model-based fair values are allowed under FAS 157. Requiring firms to make this argument provides important discipline on the accounting process.
  - a. One should not confuse the need for the FASB to provide additional guidance regarding how to measure fair values in illiquid markets with amortized cost accounting being preferable to fair value accounting. As discussed in Section II.B, amortized cost accounting has severe limitations even in liquid markets. These limitations become more significant in illiquid markets, because it is then that investors most need to be able to assess firms' value and risks accurately and that firms' incentives to manage their owners' equity and net income through gains trading are highest.
- 3. Fair value accounting does not allow firms to manage their income through gains trading, because gains and losses are recognized when they occur, not when they are realized.
  - a. In contrast, amortized cost accounting allows gains trading, especially by financial institutions, as discussed in Section II.B.

4. As discussed in Section IV.A.2, when the distributions of future cash flows are skewed, it is more informative to investors to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than to be right most of the time but ignore relatively low probability but highly favorable or unfavorable future cash flows. It is also important to update the distribution of future cash flows for new information on a timely basis, as fair value accounting does.
5. Fair value accounting is the best platform for mandatory and voluntary disclosure and for investors to be aware of what questions to ask management, as discussed in Section II.A.
  - a. GAAP already mandates some useful disclosures, which the FASB can and surely will improve and extend to more positions over time.
  - b. When firms report unrealized gains and losses under fair value accounting, their managements are motivated to explain what went right or wrong during the period and the nature of any fair value measurement issues.
    - i. Firms have begun to make useful fair value-related voluntary disclosures, and leading-practices are developing.
  - c. If managements do not provide adequate explanations, then investors at least are aware that something value-relevant happened during the period and can prod managements to explain further.
  - d. In contrast, amortized cost accounting ignores unrealized gains and losses until they are realized, as discussed in Section II.B. Hence, firms typically are not required or motivated to explain economic gains and losses prior to realization. Investors may not even be aware when valuation relevant events occur during periods.

## **VI. Summary of Reasons Why Some Believe that Fair Value Accounting Hurts Investors**

In the author's observation, virtually all traditional banks<sup>13</sup> and other traditional financial institutions, most bank regulators (although this is changing with Basel II and other recent regulatory decisions),<sup>14</sup> and some investors and accounting academics<sup>15</sup> believe that fair value accounting hurts investors compared to accounting based on amortized cost or other measurement attributes, at least in some circumstances. This section catalogs the potential harms of fair value accounting and indicates the prior sections of the paper in which these potential harms are discussed. Some additional discussion of the author's views is provided regarding points not addressed in prior sections of the paper.

1. When markets are illiquid, fair value is a poorly defined notion involving hypothetical transaction prices that cannot be measured reliably, regardless of how much measurement guidance the FASB provides.
  - a. In the author's view, while this point contains considerable truth as discussed in Section IV.B, it is not really a criticism of fair value accounting per se. There are many contexts in accounting where measurements are difficult to make, such as noncash exchanges and bundled sales of goods that are never sold separately as well as impairment write-downs of illiquid real and intangible assets that are otherwise accounted for at amortized cost. In these contexts, accounting measurements often involve hypothetical transactions. Hence, this point essentially boils down to the true statement that some difficult measurement settings necessarily involve hypothetical transactions. In fact, one could argue that fair value accounting for financial instruments is unusual for the opposite reason that the fair values of these instruments often can be based on actual current market transactions, not hypothetical transactions.
2. When fair values are provided by sources other than liquid markets, they are unverifiable and allow firms to engage in discretionary income management and other accounting behaviors.
  - a. The comparative advantage of accounting is to provide verifiable and auditable information.
  - b. In the author's view, while this point also contains considerable truth as discussed in Section II.A, it ignores the mitigation of the limitations of fair value accounting through disclosure as well as the severe limitations of amortized cost accounting discussed in Section II.B. It also ignores the fact that many amortized cost accounting estimates (e.g., goodwill impairments) are difficult to verify and audit.
3. By recognizing unrealized gains and losses, fair value accounting creates volatility in firms' owners' equity (including financial institutions' regulatory capital) and net income that need not correspond to the cash flows that will ultimately be realized.
  - a. If firms are willing and able to hold positions to maturity, unrealized gains and losses resulting from changes in riskless rates and credit risk premia are meaningless because the firms will ultimately receive or pay the promised cash flows.
    - i. In the author's view, this point is clearly incorrect, as discussed in Section II.B.



- b. Unrealized gains and losses resulting from bubble prices or skewed distributions of future cash flows reverse with more than 50% probability over the positions' lives.
    - i. In the author's view, this point is true but not a good reason to use a measurement attribute other than fair value, as discussed in Section IV.A.2.
  - c. Market participants' reaction to unrealized gains and losses can yield adverse feedback effects and asset prices and even systemic risk.
    - i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.
  - d. Volatility in financial institutions' regulatory capital yields systemic risk.
    - i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.
4. Fair value accounting mixes normal/permanent components of income, such as interest, with transitory unrealized gains and losses.
- a. In the author's view, to the extent that this issue arises in practice it is properly and easily addressed by the FASB requiring disaggregation of permanent and transitory components of income on firms' income statements. The FASB and IASB currently are addressing this issue in their joint financial statement presentation project.
  - b. Moreover, this issue applies in a different and in some respects more significant fashion to amortized cost accounting. Realized gains and losses also are not permanent, and they depend on whether firms have cumulative unrealized gains and losses available to be realized and firms' discretionary choices whether or not to realize those cumulative gains and losses.

## NOTES

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<sup>1</sup> Ryan (2008) provides a detailed description of the causes and evolution of the subprime crisis, which began in February 2007, and the credit crunch it engendered, which began in July 2007.

<sup>2</sup> For example, U.S. Representative Barney Frank, the chairman of the United States House of Representatives' Financial Services Committee, has asked for fair value accounting rules to be reconsidered.

<sup>3</sup> More subtly, under current GAAP and accounting practices, interest revenue and expense generally are calculated on an amortized cost basis even when fair value accounting is used. As discussed in Ryan (2007, Chapter 6), this has the unfortunate effect of making unrealized gains and losses appear to reverse each period by the difference between fair value interest and amortized cost interest (i.e., the error in the measurement of interest). The FASB can and should remedy this problem by requiring interest to be calculated on a fair value basis.

<sup>4</sup> Whether fair value accounting is desirable for non-financial (e.g., manufacturing and retailing) firms that primarily hold tangible and intangible assets with very different risk characteristics than their primarily financial liabilities is a more complicated question that is beyond the scope of this white paper. Nissim and Penman (2008) argue that amortized cost accounting has a transaction/outcome-oriented focus that better reveals how these firms deliver on their business plans and thereby earn income over time.

<sup>5</sup> This section does not discuss apparent reversals of unrealized gains and losses that result from interest being calculated on an amortized cost basis even when fair value accounting is used. See footnote 3.

<sup>6</sup> Barlevy (2007) is a very readable discussion of asset price bubbles and the related financial economics literature.

<sup>7</sup> In the author's view, there is little or no reason to believe that relatively junior subprime positions have exhibited bubble pricing during the credit crunch. For example, Markit's indices for relatively junior subprime MBS positions generally have declined toward zero with no significant reversals over time, even after market liquidity improved somewhat beginning in March 2008. Moreover, the Bank of England (2008, pp. 7 and 18-20) finds these indices to be fairly close to the model-based values given reasonable loss scenarios. In contrast, there is at least some reason to believe that relatively senior subprime positions may have exhibited bubble pricing during this period. For example, Markit's indices for these positions exhibited sizeable reversals of prior losses during November-December 2007 and again in March-May 2008, although both these reversals can be explained by interventions by policymakers (the first by the Treasury Department's rescue plan for SIVs and the second by various aggressive actions taken by the Federal Reserve in March 2008). Moreover, the Bank of England concludes that these indices are considerably below modeled values even in extremely adverse loss scenarios. This could be explained by the fact the credit derivatives on which Markit's indices are based are themselves subject to illiquidity and counterparty risk.

<sup>8</sup> See Johnson (2008a,b) and Rummell (2008) for discussion of parties holding such views.

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<sup>9</sup> For example, the International Monetary Fund (2008) states that “[a]ccounting standard setters will increasingly need to take into account the financial stability implications of their accounting practices and guidance” (p. xiv). Also, while “fair value accounting gives the most comprehensive picture of a firm’s financial health...investment decision rules based on fair value accounting outcomes could lead to self-fulfilling forced sales and falling prices when valuations fell below important thresholds (either self-imposed by financial institutions or by regulation)” (p. 127).

<sup>10</sup> Gron and Winton (2001) show that financial institutions’ risk overhang (i.e., risk remaining from past business decisions that cannot be eliminated due to market illiquidity) can cause them to reduce or eliminate their trading activity in positions whose risks are correlated with their risk overhang.

<sup>11</sup> See Center for Financial Market Integrity (2005).

<sup>12</sup> See American Accounting Association Financial Accounting Standards Committee (2000).

<sup>13</sup> See the American Banking Associations website (policy positions index, fair value accounting).

<sup>14</sup> See Bies (2008).

<sup>15</sup> See Nissim and Penman (2008).

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