Testimony of

Jeffrey P. Mahoney

General Counsel

Council of Institutional Investors

before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

of the

Committee on Financial Services

March 12, 2009

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Table of Contents

TABLE OF CONTENTS

Prepared Statement

Full Text of Statement

Attachments

1. Council of Institutional Investors (“Council”) General Members
2. Council Board
3. Council Policy on Independence of Accounting and Auditing Standard Setters
4. Council White Paper, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch*
5. Council Correspondence Referenced in Full Text of Statement

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Prepared Statement

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee:

Good morning. I am Jeff Mahoney, general counsel of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. I have brief prepared remarks and would respectfully request that the full text of my statement and all supporting materials be entered into the public record.

The Council is a not-for-profit association of more than 130 public, corporate, and labor pension funds with assets exceeding $3 trillion. Our members are obviously quite diverse and include the Pennsylvania State Employees' Retirement System, Johnson & Johnson, and the IUE-CWA Pension Fund.

Council members are generally long term shareowners responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average Council member invests approximately 60 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance, including issues relating to financial accounting and reporting, are of great interest to our members.

As an initial matter, the Council's policies reflect our members' views that:

(1) The goal of financial accounting and reporting and accounting standard setters should be to satisfy the information needs of investors—the key consumers of financial reports; and

(2) The needs of investors are most likely to be met if the responsibility to promulgate accounting standards resides with an independent private sector organization that employs a thorough public due process that actively solicits and gives preeminence to the views of investors.

Although we believe that the current US accounting standard setting structure and process can, and should be, further improved, we would strongly oppose any legislative or regulatory effort that would diminish the independence of accounting standard setting and provide certain industries with direct or indirect control over the outcome of the process. In our opinion, we must avoid changes to accounting standard setting that may cater to the short term self-interests of a particular industry to the detriment of the short and long-term interests of investors and other market participants.

Second, we generally agree with the findings of the United States Securities and Exchange Commission's ("Commission") recent report and recommendations to Congress on "Mark-to-Market Accounting." More specifically, we agree with the Commission's findings that existing fair value accounting standards for financial instruments increases the quality of information provided to investors about those contracts by better reflecting current economic reality.

We note that the Commission's findings are generally supported by a July 2008 Council-commissioned White Paper, entitled "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" ("White Paper"). The White Paper is included as an attachment to the full text of my testimony for your information and review.

Consistent with the Commission's findings, the White Paper concludes that because of its timeliness and relevance, fair value accounting reduces uncertainty over time much more quickly than other existing accounting measurement approaches. As a result, fair value accounting has the ability to assist in mitigating the duration of a financial crisis. Many financial experts agree that Japan's failure to embrace fair value accounting for the financial assets of its troubled financial institutions in the 1990's unnecessarily exacerbated that country's economic woes for an entire decade.

Finally, we believe that the most appropriate approach to addressing concerns about the pro-cyclical effects of fair value accounting is not to change accounting standards, but instead to encourage the US financial institution regulators to exercise their authority, which they have done on a number of occasions in the past, to modify, if they deem necessary, fair value accounting for regulatory capital purposes. That approach allows the regulators to appropriately address their responsibilities to foster safety and soundness and financial stability of US financial institutions without further lowering investor confidence by denying investors the information they need to make economic decisions.

When I receive my quarterly 401(k) statement, I see current economic reality. Those who invest in US financial institutions and other US companies deserve to see the same economic reality. Fair value accounting for financial instruments gets investors closer to that goal.

In closing, we look forward to continuing to work cooperatively with the FASB, the SEC, this Subcommittee, and other interested parties to further improve financial accounting and reporting. Our aim is always to provide constructive input and support to ensure that financial reporting continues to evolve to better serve the needs and demands of US investors, the US capital markets, and the US economy.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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Full Text of Statement

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee:

Good morning. I am Jeffrey P. Mahoney, general counsel of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. My testimony includes a brief overview of the Council and a discussion of the Council's policies, including our policy supporting independent accounting standard setting. The remainder of my testimony includes our views on two specific issues you asked to be addressed in our testimony: (1) How fair value accounting affects investors and the broader economy; and (2) Potential proposals for regulators and accounting standard setters relating to fair value accounting.[1]

The Council[2]

The Council is a not-for-profit association of more than 130 public, corporate, and labor pension funds with assets exceeding $3 trillion. Our members are obviously quite diverse and include the Pennsylvania State Employees Retirement System, Johnson & Johnson, and the IUE-CWA Pension Fund.[3]

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[1] *See* Letter from Chairman Paul E. Kanjorski & Ranking Member Scott Garrett to Jeff Mahoney 1 (Mar. 5, 2009) (on file with Council).

[2] For more information about the Council of Institutional Investors ("Council"), see the Council's website at http://www.cii.org/about.

[3] See Attachment 1 for a listing of the general members of the Council.

Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average Council member invests approximately 60 percent of its entire pension portfolio in US stocks and bonds,[4] issues relating to US corporate governance, including issues relating to US financial accounting and reporting, are of great interest to our members.

Council Corporate Governance Policies[5]

An important part of the Council's activities involves the development of corporate governance policies. The policies set standards or recommended practices that the Council members believe companies should adopt. The policies are a living document that is constantly reviewed and updated.

The Council's policies neither bind members nor corporations. The policies are designed to provide guidelines that the Council has found to be appropriate in most situations.

Council staff uses the policies to determine whether and how the Council can respond to certain issues, including rules proposed by the US Securities and Exchange Commission ("SEC" or "Commission") and accounting standards proposed by the standard setting bodies. Council staff may without additional approval, take action on an issue that is within its policies and also within budgetary limits, subject to oversight of those actions by the Council's board.

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[4] *See* Council, Asset Allocation Survey 2 (2008) (on file with Council).
[5] For complete copies of the Council's existing policies, see the Council's website at http://www.cii.org/policies.

The nine non-officers on the Council's board of directors make up the policies committee and suggest subjects for policies, review staff policy drafts and decide which policies should be submitted to the full board.[6] All general members of the Council are invited to submit ideas for policies to Council staff or Council directors.

The full board votes on whether to approve a proposed policy. Once approved by the board, the policy is either subject to a vote by the full membership at the next meeting or by mail ballot if the board believes time is of the essence.

Independence of Accounting and Auditing Standard Setters[7]

Last fall, after months of research and deliberations by the Council's staff, policies committee, and board, the Council's general members approved an update to our policy on the independence of accounting and auditing standard setting ("Policy"). The Policy continues to reflect our long-held views that:

- The responsibility to promulgate accounting standards should reside with independent private sector organizations that provide for a thorough public due process;

- The technical decisions and judgments of the private sector accounting standard setter should be respected and should not be overridden by government officials or bodies;

[6] See Attachment 2 for a list of the Council's board of directors and officers.
[7] See Attachment 3 for a copy of the Council's policy on "Independence of Accounting and Auditing Standard Setters."

- High quality accounting standards are those that produce comparable, reliable, timely, transparent and understandable financial information that meets the needs of investors and other consumers of financial reports; and

- The goal of financial accounting and reporting and accounting standard setters should be to satisfy, in a timely manner, the information needs of investors and other consumers of financial reports.[8]

As we, and the Center for Audit Quality, the Consumer Federation of America, the CFA Institute, and the Investment Management Association explained in a recent joint letter to the Commission:

> If reported financial information is going to be believed, trusted, and used by investors and the business community, it is critical that the standards used to prepare that information are set by bodies that are truly **independent**.
>
> An independent standard setter makes it more likely that accounting standards will serve the needs of those who read and review financial reports, not those that are responsible for creating them. Those responsible for creating financial reports may recommend accounting rules that, intentionally or unintentionally, obfuscate an objective reporting of the real performance and condition of a company at the expense of outside shareowners. Accounting standards should be promulgated to serve the interests of investors and the capital markets.

[8] Attachment 3, at 1. We note that the United States Securities and Exchange Commission continues to share our support for independent standard setting as "best positioned to develop unbiased financial reporting standards that foster investor confidence and financial transparency . . . ." Letter from Conrad Hewitt, Chief Accountant, United States Securities and Exchange Commission to Ms. Cindy Fornelli, Executive Director, Center for Audit Quality 2 (Nov. 26, 2008) [See Attachment 5].

> In adopting the Sarbanes-Oxley Act of 2002, Congress recognized the benefits of having accounting standards set by an independent and adequately funded body, and wisely endorsed the current standards-setting process. Further political invention by Congress or the Commission runs the risk of impeding the FASB's ability to promulgate and issue standards for financial reporting, which serves investors and the capital markets of the United States. Accounting standards must faithfully represent the economic substance of business transactions and provide information that meets the needs of investors in a neutral manner to all financial market participants.[9]

Although we believe, and have publicly commented, that the US accounting standard setting structure and process can, and should, be improved,[10] we would strongly oppose, consistent with our Policy, any changes to the existing process or structure that diminishes the independence of accounting standard setting.

More specifically, we would oppose any changes that would permit government agencies or departments, particularly the regulators of financial institutions whose mission is not focused on serving the needs of investors, to have the authority to make decisions or judgments about the substance or timing of accounting standards for the companies that we invest in.[11] We believe that such a change would ultimately reduce the quality of financial accounting and reporting, harm investor confidence, and inhibit the short and long-term prospects for US economic growth.

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[9] Letter from Cindy Fornelli, Executive Director, Center for Audit Quality to The Honorable Christopher Cox 1 (Nov. 14, 2008) [See Attachment 5] [Hereinafter Cox].

[10] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Ms. Teresa S. Polley, Chief Operating Officer, Financial Accounting Foundation 1-4 (Feb. 11, 2008) [See Attachment 5].

[11] We note that one such legislative proposal, H.R. 1349, is publicly supported by the banking industry whose members include many firms whose management and boards actively participated in creating the current crisis. Jessica Holzer, *House Bill Would Create New Board For Accounting Standards*, Dow Jones Newswires Wash. 1 (Mar. 6, 2009) (on file with author), *available at* *http://www.easybourse.com/bourse-actualite/american-internation/house-bill-would-create-new-board-for-accounting-standards-US0268741073-629434* (noting that American Bankers Association President Edward Yingling issued a statement hailing the introduction of the legislation).

How Fair Value Accounting Affects Investors and the Overall Economy

As indicated by the Commission in their recent "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting" ("SEC Report"), the purpose of financial accounting and reporting

> is to provide transparent information to investors as they make decisions. Accordingly, the primary factor to consider when evaluating the role of fair value accounting is the impact of such accounting on the information provided to investors. [12]

The Council believes, consistent with the findings of the SEC Report, the views of most investors,[13] many auditors, consumers, and other market participants, that:

> Existing fair value accounting standards, particularly as they relate to fair value accounting for financial instruments, . . . increase[s] the quality of the information available [to investors] . . . . [F]air value provides more relevant information, reflecting current economic reality that should not be replaced by alternative accounting measures.[14]

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[12] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, Office of the Chief Accountant, Division of Corporation Finance, United States Securities and Exchange Commission 202 (Dec. 13, 2008) (on file with Council), *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf [hereinafter SEC Report].
[13] We note that an April 2008 survey of 2006 professional investors by the CFA Institute revealed that "79 percent of respondents believe that fair value measurements improve transparency and contribute to investor understanding of financial institutions' risk and 74 percent think fair value requirements will improve market integrity." Press Release, CFA Institute, CFA Institute Centre Says Fair Value "Smoothing" Will Mask the Reality of Market Conditions and Allow Companies to Hide Risk 1-2 (Apr. 17, 2008). We also note that in his most recent letter to the shareholders of Berkshire Hathaway Inc., Warren E. Buffett, Chairman of the Board, stated "[w]e endorse mark-to-market accounting." Berkshire Hathaway Inc., Letter to Shareholders 19 (Feb. 27, 2009) (on file with Council), *available at* http://www.berkshirehathaway.com/letters/2008ltr.pdf.
[14] SEC Report, *supra* note 12, at 202; *see, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission 4 (Oct. 29, 2008) [See Attachment 5].

Our belief about the benefits of fair value accounting for financial instruments is also supported by a July 2008 Council-commissioned white paper, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" ("White Paper").[15] The White Paper, authored by Professor Stephen G. Ryan, a leading expert on fair value accounting, describes the following five reasons why most investors support fair value accounting for financial instruments:

> 1. . . . [F]air values are more accurate, timely, and comparable across different firms and positions than are alternative measurement attributes . . . .
>
> . . . .
>
> 2. . . . [W]hile 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.
>
> . . . .
>
> 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.
>
> . . . .

[15] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [See Attachment 4] [Hereinafter Ryan].

> 4. . . . [W]hen 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 . . . .[16]

The Council White Paper also notes that the overall economy, particularly during a financial crisis, likely benefits from the use of fair value accounting.[17] The White Paper explains:

> 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 . . . [alternative measurement approaches] would, thereby mitigating the duration of the credit crunch.[18]

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[16] *Id*. at 16-18.
[17] *See id.* at 16.
[18] *Id.*; *see also* Editorial, *All's Fair, The Crisis and Fair Value Accounting,* Economist, Sept. 18, 2008, at 1-2 (on file with Council), *available at* http://www.economist.com/finance/displaystory.cfm?story_id=12274096 (Referring to Japan's failure to embrace fair value accounting for financial instruments during the 1990's, Yoshimi Watanabe, Japan's minister for financial services, commented that "Japanese banks exacerbated their country's economic woes by 'avoiding ever facing up to losses'").

Similarly, the SEC Report found that eliminating fair value accounting would likely increase financial instability in the economy.[19] The SEC Report explains:

> [I]nvestor confidence is reinforced by providing transparency relating to the underlying asset value of their investments, and a removal of . . . [fair value accounting] information would, in fact, lead to additional financial instability.[20]

Potential Proposals for Regulators and Standard Setters Relating to Fair Value Accounting

<u>*Financial Institution Regulators*</u>

As indicated in the SEC Report, the objective of financial reporting is to provide information useful to investors and creditors in their decision-making processes.[21] In contrast, the primary objective of the regulatory capital requirements for financial institutions is to "foster safety and soundness and financial stability."[22]

The regulatory capital requirements in the US start with financial information provided in accordance with US generally accepted accounting principles ("GAAP").[23] The financial institution regulators, however, have considerable leeway in determining whether certain adjustments should be made to US GAAP for regulatory capital purposes to reflect the differences between the objectives of US GAAP reporting and the objectives of regulatory capital requirements.[24]

[19] SEC Report, *supra* note 12, at 202.
[20] *Id.*
[21] *Id.* at 114.
[22] *Id.*
[23] *Id.*
[24] *Id.*

In fact, in a number of circumstances, the financial institution regulators have determined that the calculation of capital should exclude items required by US GAAP or include items not required by US GAAP.[25] For example, although fair value gains or losses for some debt securities are required to be included as an addition or reduction of the reported equity of financial institutions for US GAAP purposes, the financial institution regulators generally exclude those gains and losses from regulatory capital.[26]

The Council would not oppose proposals by the financial institution regulators to make further adjustments to regulatory capital for the effects of fair value accounting standards if they believe those adjustments are necessary to foster safety and soundness and financial stability, but only if those adjustments do not impact the financial accounting and reporting information made available to investors. As explained in a recent article co-authored with my fellow hearing witness Cindy Fornelli:

> Critics of fair value may have some legitimate concerns. Any such concerns, however, can be addressed without suspending our best existing approach to financial instrument valuation, and without suspending our independent, thorough and public accounting standard-setting process.
>
> Some banking industry allies worry that reduced asset valuations could put some financial institutions out of compliance with government regulations requiring a minimum amount of capital. Some have suggested that banks might hoard capital to avoid such a fate—a tactic that would thwart efforts to stimulate lending.

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[25] *Id.* at 114-15.
[26] *Id.* at 115.

> It's a fair point, but it misses the fact that fair-value accounting is just the first step in a two-step process. Step one involves valuing a financial instrument to reflect today's worth. Step two involves factoring that new, lower value into the bank regulators' formulas for capital requirements.
>
> Investors and regulators need to know the current values of loans and securities in order to make rational investment and policy decisions. Whether or how those new values affect the capital requirements, and whether they should result in institutions' running afoul of capital requirements, is a decision to be made by bank regulators. If there is a problem with financial institutions meeting capital requirements, the solution should focus on step two, not on denying the realistic valuation that results from step one.[27]

Accounting Standard Setters

The Council is aware of the recommendations included in the SEC Report that the Financial Accounting Standards Board ("FASB") should consider further "improvement to . . . the application of SFAS No. 157 to illiquid investments . . . [and] additional measures relating to the assisting in the understanding of the impact of fair value through presentation and disclosure requirements."[28]

We note that last month the FASB issued a news release indicating that they would be addressing the following fair value projects:

> - The projects on application guidance will address determining when a market for an asset or a liability is active or inactive; . . .

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[27] Cindy Fornelli and Jeff Mahoney, *Opinion: The Fair Value Fallacy,* Fin. Wk., Nov. 30, 2008, at 1-2 (on file with Council), *available at* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081130/REG/811259978/1023/otherviews; *accord* Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to Mr. Timothy F. Geithner et al. 1-2 (Feb. 13, 2009) [See Attachment 5].

[28] SEC Report, *supra* note 12, at 202; *see also* Cox, *supra* note 9, at 2.

- The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels.[29]

We caution that as the FASB develops additional guidance in these areas, they should only do so as part of a thorough public due process that includes solicitation of investor input and careful consideration of investor views.[30]

Moreover, and also consistent with the Council Policy, additional guidance should only be issued by the FASB if it can conclude that the guidance is responsive to and satisfies investors' information needs.[31] Any other process and result would, in our view, likely only increase the complexity of financial reporting while at the same time exacerbating the instability in the capital markets by further lowering investors' confidence in the financial reporting of US companies.[32]

In closing, we look forward to continuing to work cooperatively with the FASB, the SEC, this Subcommittee, and other interested parties to continue to improve financial accounting and reporting. Our aim is to continue to provide constructive input and support to ensure that financial reporting continues to evolve to better serve the needs and demands of US investors, the US capital markets, and the US economy.

Thank you, Mr. Chairman, for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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[29] News Release, FASB Initiates Projects to Improve Measurement and Disclosure of Fair Value Estimates 1 (Feb. 18, 2009) (on file with Council), *available at* http://www.fasb.org/news/nr021809.shtml.
[30] Attachment 3, at 2.
[31] *Id*. at 1.
[32] *See* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Russell Golden, Technical Director, FASB 6 (Dec. 24, 2008) [See Attachment 5].

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Attachment 1

Council General Members

Council of Institutional Investors

General Members[*]

Last Updated: 2008

AFL-CIO Pension Plan
AFSCME Employees Pension Plan
Agilent Technologies Benefit Plans
Alameda County Employees' Retirement Association
Alaska Permanent Fund
Altria Corporate Services Pension Plan
American Federation of Teachers Pension Plan
Arkansas Public Employees Retirement System
Arkansas Teacher Retirement System
Bank of America Pension Plans
BP America
Bricklayers & Trowel Trades Pension Fund
Building Trades Pension Trust Fund-Milwaukee and Vicinity
California Public Employees' Retirement System
California State Teachers' Retirement System
Campbell Soup Retirement & Pension Plans
Carpenters United Brotherhood Local Unions & Councils Pension Fund
Casey Family
CERES Defined Contribution Retirement Plan
Chevron Master Pension Trust
Coca-Cola Retirement Plan
Colgate-Palmolive Employees' Retirement Income Plan
Colorado Fire and Police Pension Association
Colorado Public Employees' Retirement Association
Communications Workers of America Pension Fund
Connecticut Retirement Plans and Trust Funds
Contra Costa County Employees' Retirement Association
CWA/ITU Negotiated Pension Plan
Dallas Employees' Retirement Fund
Delaware Public Employees Retirement System
Detroit General Retirement System
Disney (Walt)
District of Columbia Retirement Board
Eastern Illinois University Foundation
ELCA Board of Pensions
EMC

[*] General membership in the Council is open to any employee benefit plan, state or local agency officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. General Members participate in all meetings and seminars sponsored by the Council and are the only voting members of the Council. Annual dues are $1.30 per $1 million in fund assets, but no less than $3,000 and no more than $30,000.

Fairfax County Educational Employees' Retirement System
FedEx
Florida State Board of Administration
Gap
General Mills Retirement Plan
General Motors Investment Management
Hartford Municipal Employees Retirement Fund
Hewlett-Packard
Houston Firefighters' Relief & Retirement Fund
I.A.M. National Pension Fund
IBEW Pension Benefit Fund
Idaho Public Employee Retirement System
Illinois State Board of Investment
Illinois State Universities Retirement System
Illinois Teachers' Retirement System
Iowa Municipal Fire & Police Retirement System
Iowa Public Employees Retirement System
ITT Industries Pension Fund Trust
IUE-CWA Pension Fund
Jacksonville Police and Fire Pension Fund
Jeffrey Company Pension Plan
Johnson & Johnson
Kentucky Retirement Systems
Kern County Employees' Retirement Association
KeyCorp Cash Balance Pension Plan
Laborers' Central Pension Fund
Laborers National Pension Fund
Lens Foundation for Corporate Excellence
LIUNA Staff and Affiliates Pension Fund
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Los Angeles Fire and Police Pension System
Los Angeles Water and Power Employees' Retirement Plan
Lucent Technologies Pension Plan
Maine Public Employees Retirement System
Marin County Employees' Retirement Association
Maryland, State Retirement Agency
Massachusetts Bay Transportation Authority Retirement Fund
Massachusetts PRIM
McDonald's Employee Benefits Plan
Michigan Municipal Employees Retirement System
Microsoft
Milwaukee Employees' Retirement System
Minnesota State Board of Investment
Missouri Public School & Non-Teacher School ERS
Missouri State Employees' Retirement System
Montgomery County Employees' Retirement System
Nathan Cummings Foundation
National Education Association Employee Retirement Plan

Navy-Marine Corps Relief Society
New Hampshire Retirement System
New Jersey Division of Investment
New York City Employees' Retirement System
New York City Pension Funds
New York City Board of Education Retirement System
New York City Fire Department Pension Fund
New York City Police Pension Fund
New York City Teachers' Retirement System
New York State and Local Retirement Systems
New York State Teachers' Retirement System
New York Times Company Pension Plan
North Carolina Retirement System
North Dakota State Land Department
Ohio Police & Fire Pension Fund
Ohio Public Employees Retirement System
Ohio School Employees Retirement System
Ohio State Teachers' Retirement System
Operating Engineers Central Pension Fund
Orange County Employees Retirement System
Pennsylvania Public School Employees’ Retirement System
Pennsylvania State Employees' Retirement System
Pfizer
Pitney Bowes Pension Plan
Plumbers & Pipefitters National Pension Fund
Prudential Employee Savings Plan
Sacramento County Employees' Retirement System
San Diego City Employees' Retirement System
San Francisco City & County Employees' Retirement System
San Jose City Retirement Funds
Santa Barbara County Employees’ Retirement System
Sara Lee Salaried Pension Plan
Schering-Plough Employees' Savings Plan
Sealed Air Retirement Plans
SEIU Union Pension Fund
Sheet Metal Workers’ Local 19 Pension Plan
Sheet Metal Workers’ National Pension Fund
Sonoma County Employees’ Retirement Association
South Carolina Retirement System
Sunoco
Target
Teamster Affiliates Pension Plan
Tennessee Consolidated Retirement System
Texas Employees Retirement System
Texas Municipal Retirement System
Texas Teacher Retirement System
UAW
UFCW Staff Trust Fund
ULLICO Pension Plan Trust

UNITE HERE Laundry & Dry Cleaning Workers Pension Fund
UNITE HERE National Retirement Fund
UnitedHealth Group Retirement Plans
United States Steel and Carnegie Pension Fund
Vermont Pension Investment Committee
Washington State Investment Board
West Virginia Investment Management Board
Wisconsin State Investment Board
World Bank Staff Retirement Plan
Writers Guild of America, West

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Attachment 2

Council Board

Board Officers

Joe Dear, California Public Employees' Retirement System
Board Chair
Joe Dear is chief investment officer of California Public Employees' Retirement System

D. Craig Nordlund, Agilent Technologies Benefit Plans
Co-Chair
D. Craig Nordlund is svp, general counsel & secretary at Agilent Technologies

Bruce Raynor, UNITE HERE National Retirement Fund
Co-Chair
Bruce Raynor is general president of UNITE HERE

Shelley Smith, Los Angeles City Employees' Retirement System
Co-Chair
Shelley Smith is vice chair of Los Angeles City Employees' Retirement System

Gail Stone, Arkansas Public Employees Retirement System
Treasurer
Gail Stone is executive director of Arkansas Public Employees Retirement System

Warren Mart, I.A.M. National Pension Fund
Secretary
Warren Mart is general secretary-treasurer of the International Association of Machinists and Aerospace Workers

Board Members

Lydia Beebe, Chevron Master Pension Trust
Lydia Beebe is corporate secretary & chief governance officer at Chevron

Kenneth Colombo, Sheet Metal Workers' National Pension Fund
Kenneth Colombo is fund coordinator for the Sheet Metal Workers' National Pension Fund

Gail Hanson, State of Wisconsin Investment Board
Gail Hanson is deputy executive director of State of Wisconsin Investment Board

Eric Henry, Texas Municipal Retirement System
Eric Henry is executive director and CIO of the Texas Municipal Retirement System

Richard Metcalf, LIUNA Staff and Affiliates Pension Fund
Richard Metcalf is director of the corporate affairs department at LIUNA Staff and Affiliates Pension Fund

Meredith Miller, Connecticut Retirement Plans and Trust Funds
Meredith Miller is assistant treasurer for policy at Conneticut Retirement Plans and Trust Funds

Jody Olson, Idaho Public Employees Retirement System
Jody Olson is board chair of Idaho Public Employees Retirement System

Gregory Smith, Colorado Public Employees' Retirement Association
Gregory Smith is general counsel of Colorado Public Employees' Retirement Association

Michael Travaglini, Massachusetts Pension Reserves Investment Management Board
Michael Travaglini is executive director of Massachusetts Pension Reserves Investment Management Board

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Attachment 3

Council Policy on Independence of Accounting and Auditing Standard Setters

The Council of Institutional Investors
Policies on Other Governance Issues
Independence of Accounting and Auditing Standard Setters

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the wellbeing of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the financial reporting standards that: (1) enterprises use to recognize, measure and report their economic activities and events; and (2) auditors use in providing assurance that the preparers' recognition, measurement and disclosures are free of material misstatements or omissions. The result should be timely, transparent and understandable financial reports. The Council has consistently supported the view that the responsibility to promulgate accounting and auditing standards should reside with independent private sector organizations. The globalization of financial markets has brought calls from some regulators, stock exchanges, corporations, auditing firms and other parties for the replacement of U.S. accounting and auditing standards and standard setters with international standards and standard setters. The Council supports U.S. accounting and auditing standard setters cooperatively working with their international counterparts toward a common goal of convergence to a single set of high quality standards designed to produce comparable, reliable, timely, transparent and understandable financial information that will meet the needs of institutional investors and other consumers of audited financial reports. The Council, however, does not support replacing U.S. accounting or auditing standards or standard setters with international standards or standard setters unless and until all of the following steps have been achieved:

- In the aggregate, the information that results from the application of international accounting and auditing standards is, at a minimum, of the same quality as the information resulting from U.S. accounting and auditing standards;
- The application (by U.S. companies and their auditors) and enforcement (by U.S. regulators) of the international accounting and auditing standards are at least as rigorous and consistent as the application and enforcement of U.S. accounting and auditing standards;
- The international standard setter has sufficient resources—including a secure stable source of funding that is not dependent on voluntary contributions of those subject to the standards;
- The international standard setter has a full-time standard-setting board and staff that are free of bias and possess the technical expertise necessary to fulfill their important roles;
- The international standard setter has demonstrated a clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs. This includes having significant, prominent and adequately balanced representation from qualified investors on the standard setter's staff, standard-setting board, oversight board and outside monitoring or advisory groups;

- The international standard setter has a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards; and
- The international standard setter has a structure and process that adequately protects the standard setter's technical decisions and judgments (including the timing of the implementation of standards) from being overridden by government officials or bodies.

(updated Oct. 7, 2008)

Testimony of
Jeffrey P. Mahoney
General Counsel
Council of Institutional Investors
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services
March 12, 2009

Attachment 4

Council White Paper, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch*

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

Prepared by

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July 2008

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for the Council of Institutional Investors*

July 2008

* 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

Table of Contents

Executive Summary 1
I. Introduction 2
II. Background Information Abstracting from the Credit Crunch 3
  A. Fair Value Accounting 3
  B. The Limited Alternative of Amortized Cost Accounting 5
  C. The Unsatisfying Mixed-Attribute Accounting Model for Financial Instruments 7
III. FAS 157 9
  A. Definition of Fair Value 9
  B. Hierarchy of Fair Value Measurement Inputs 10
IV. Potential Criticisms of Fair Value Accounting During the Credit Crunch 11
  A. Unrealized Gains and Losses Reverse 11
    1. Bubble Prices 11
    2. Skewed Distributions of Future Cash Flows 12
  B. Market Illiquidity 14
  C. Adverse Feedback Effects and Systemic Risk 15
V. Summary of Reasons Why Some Believe that Fair Value Accounting Benefits Investors 16
VI. Summary of Reasons Why Some Believe that Fair Value Accounting Hurts Investors 18

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,[1] 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[2] 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.[3]

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.[4] 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[5]

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.[6] Whether bubble prices have existed for specific types of positions during the credit crunch is debatable, but it certainly is possible.[7]

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.[8]

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.

home price depreciation	*probability occurs*	*estimated loss on (value of) super senior CDO as a percentage of par value*
<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%×5%) + (25%×20%) + (10%×40%) + (5%×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.[9] 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[10] 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,[11] and most accounting academics[12] 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[13] and other traditional financial institutions, most bank regulators (although this is changing with Basel II and other recent regulatory decisions),[14] and some investors and accounting academics[15] 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

[1] 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.

[2] 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.

[3] 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.

[4] 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.

[5] 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.

[6] Barlevy (2007) is a very readable discussion of asset price bubbles and the related financial economics literature.

[7] 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.

[8] See Johnson (2008a,b) and Rummell (2008) for discussion of parties holding such views.

[9] 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).

[10] 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.

[11] See Center for Financial Market Integrity (2005).

[12] See American Accounting Association Financial Accounting Standards Committee (2000).

[13] See the American Banking Associations website (policy positions index, fair value accounting).

[14] See Bies (2008).

[15] See Nissim and Penman (2008).

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Testimony of
Jeffrey P. Mahoney
General Counsel
Council of Institutional Investors
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services
March 12, 2009

Attachment 5

Council Correspondence Referenced in Full Text of Statement

Council Correspondence Referenced in Full Text of Statement

1. Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to Mr. Timothy F. Geithner, Secretary, Department of the Treasury et al. (Feb. 13, 2009)

2. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Russell Golden, Technical Director, FASB (Dec. 24, 2008)

3. Letter from Conrad W. Hewitt, Chief Accountant, United States Securities and Exchange Commission to Ms. Cindy Fornelli, Executive Director, Center for Audit Quality et al. (Nov. 26, 2008)

4. Letter from Cindy Fornelli, Executive Director, Center for Audit Quality et al. to The Honorable Christopher Cox, Chairman, Securities and Exchange Commission (Nov. 14, 2008)

5. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission (Oct. 29, 2008) (excluding attachments)

6. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Ms. Teresa S. Polley, Chief Operating Officer, Financial Accounting Foundation (Feb. 11, 2008)

Consumer Federation of America

February 13, 2009

Mr. Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Mr. Ben S. Bernanke
Chairman
Federal Reserve Board
20th and C Streets, NW
Washington, D.C. 20551

Ms. Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Secretary Geithner, Chairman Bernanke, and Chairman Schapiro:

We are writing to applaud your efforts to restore investor confidence in the U.S. capital markets during this time of extreme uncertainty. As you seek solutions, we caution against taking action that could further undermine the confidence of investors.

We appreciate the challenges of dealing with the financial instability resulting from the toxic assets held by banks. However, changing financial accounting standards because of valuation challenges is not the way to solve regulatory capital problems. Retreating from fair value in response to political pressure would raise suspicions that the rules were changed in order to falsely inflate asset values. We must avoid a further crisis of investor confidence in our government and the regulatory bodies overseeing those institutions.

We should not confuse the independent private sector Financial Accounting Standards Board's role to develop and improve financial accounting and reporting standards with the role and responsibilities of the regulatory bodies charged with the oversight of the safety and soundness of financial institutions. We do not believe the FASB is the body to effect capital adequacy goals for the financial institution sector.

We applaud Treasury Secretary Geithner's efforts to find asset valuations that are fair, realistic, and provide the government with a good assessment of risk. However, this should not be done at the expense of fair value accounting information that best serves the interests of investors both now and over the long term.

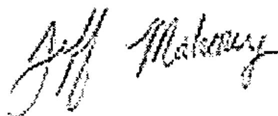
We would be pleased to meet with you at your convenience to elaborate on our views.

Sincerely,

Cindy Fornelli
Executive Director
Center for Audit Quality

Patrick Finnegan
Director, Financial Reporting Policy Group
CFA Institute Centre for Financial Market Integrity

Barbara Roper
Director of Investor Protection
Consumer Federation of America



Jeff Mahoney
General Counsel
Council of Institutional Investors

cc:
Kathleen L. Casey, Commissioner, SEC
Elisse B. Walter, Commissioner, SEC
Luis A. Aguilar, Commissioner, SEC
Troy A. Paredes, Commissioner, SEC
Mark W. Olson, Chairman, PCAOB
Robert H. Herz, Chairman, FASB
Honorable Christopher J. Dodd
Honorable Richard C. Shelby
Representative Barney Frank
Representative Spencer Bachus

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

December 24, 2008

Russell Golden
Technical Director
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference: Proposed FSP EITF 99-20-a

Dear Mr. Golden:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 140 public, corporate and union pension funds with combined assets of over $3 trillion.[1] As a leading voice for long-term, patient capital, we appreciate the opportunity to provide comments in response to the proposed Financial Accounting Standards Board ("FASB") Staff Position ("FSP") 99-20-a to amend Emerging Issues Task Force ("EITF") Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets" ("Proposal").[2]

At our October 7, 2008 meeting, the Council's general membership approved an update to our policy on independence of accounting and auditing standard setting ("Policy").[3] The Policy continues to reflect our long-held view that the quality, comparability, and reliability of financial information contained in financial statements and related disclosures depends directly on the quality of financial reporting standards and the standard setters that develop those standards.[4]

The following two criteria contained in the Policy appear particularly relevant to the Proposal:

- The . . . standard setter has demonstrated a clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of . . . financial reports should be to satisfy in a timely manner investors' information needs. . . .[5]

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[1] For more information about the Council of Institutional Investors ("Council") and its members, visit our website at http://www.cii.org/.

[2] *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, Proposed FSP on EITF Issue 99-20 (Fin. Accounting Standards Bd. Proposed FSP 99-20-a Dec. 2008), http://www.fasb.org/fasb_staff_positions/prop_fsp_eitf99-20-a.pdf [hereinafter Proposal].

[3] The Council of Institutional Investors, Policies on Other Governance Issues, Independence of Accounting and Auditing Standard Setters (Updated Oct. 7, 2008), http://www.cii.org/UserFiles/file/council%20policies/CII%20Policies%20on%20Accounting%20and%20Auditing%2010-7-08(1).pdf [Hereinafter Policy]. For more information about the Council's policies, visit our website at http://www.cii.org/policies.

[4] *See* Policy, *supra,* at 1.

[5] *Id*. Of note, this criterion is consistent with Recommendation 2.1 of the August 1, 2008, Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission which states, in part, "***investor perspectives should be given pre-eminence by all parties involved in standards-setting***" (footnote omitted), http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

- The . . . standard setter has a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards . . . .[6]

Consistent with the Policy, and the view of many other investors, accountants, auditors, and other market participants, we generally believe that:

> In the specific case of fair value reporting, investors require an accounting standard that reports a relevant and useful value of financial instruments regardless of the direction of the markets. Fair value accounting with robust disclosures provides more reliable, timely, and comparable information than amounts that would be reported under other alternative accounting approaches.[7]

Our belief about the benefits of fair value accounting for financial instruments is also supported by a July 2008 Council-commissioned white paper, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch."[8] The attached white paper, authored by Professor Stephen G. Ryan, a leading expert on fair value accounting, provides the following insightful comments on fair value accounting and the ongoing credit crisis:

> [I]t is absolutely clear that the subprime crisis that gave rise to the credit crunch was primarily caused by . . . bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, not by accounting. . . . 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.[9]

The Council, therefore, cannot support the Proposal for at least two fundamental reasons: (1) We do not believe the Proposal is consistent with the needs of investors; and (2) We do not believe an eleven day comment period (which includes significant ethnic, religious, and national holidays) constitutes a thorough public due process.

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[6] Policy, *supra*, at 1.
[7] Letter from Cindy Fornelli et al. to The Honorable Christopher Cox 1-2 (Nov. 14, 2008), http://www.sec.gov/comments/4-573/4573-175.pdf; *accord* Letter from Jeff Mahoney to Ms. Florence E. Harmon 4 (Oct. 29, 2008), http://www.sec.gov/comments/4-573/4573-95.pdf ("We believe that fair value accounting for financial instruments, complemented by robust disclosures, is superior to other accounting alternatives in (1) providing investors clear and accurate information, and (2) restoring the free flow of money and credit to the U.S. and global capital markets").
[8] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [hereinafter Attachment].
[9] *Id.* at 16.

The Proposal Does Not Meet the Needs of Investors

As indicated, the Council agrees with many other investors, accountants, auditors, and other market participants that the needs of investors and other consumers of financial reports are best satisfied by requiring that all financial instruments be accounted for at fair value accompanied by robust disclosures. We note that such an approach would eliminate the need for the Proposal because other-than-temporary impairment ("OTTI") models would not be necessary if all financial instruments were reported at fair value.

We also share FASB Chairman Herz's doubts about the usefulness of OTTI models to investors generally.[10] Chairman Herz recently commented:

> I think all of this impairment stuff is voodoo . . . . I see a lot of utility for understanding what's happening to particular instruments, market values, cash flows currently and projected. I don't see a lot of value to some of these calculations that get done now *under any of the impairment models. . . . For those who believe impairment is an important element of the accounting model, I invite them to try to persuade me*.[11]

Notwithstanding the questionable usefulness of current impairment models, until the goal of reporting all financial instruments at fair value is achieved, we would not necessarily oppose any effort by the FASB to align disparate OTTI models for instruments with similar economics at least to the extent that that alignment is directionally consistent with the ultimate goal.[12] The Proposal, however, clearly fails in that regard.[13]

More specifically, the Proposal moves further away from fair value reporting by proposing to replace the OTTI model of EITF Issue No. 99-20 ("99-20") based on "market participant assumptions regarding future cash flows," with the FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115"), OTTI model permitting "management judgment of the probability that the holder will be unable to collect the amounts due."[14] We generally agree with the following analysis of this proposed change authored by accounting & valuation experts Sarah Deans and Dane Mott of J.P. Morgan:

> 1. Moving from the 99-20 [OTTI model] . . . to the weaker FAS 115 [OTTI model] . . . actually moves the measure of these assets further away from fair value and makes their OTTI determinations more subject to gaming, in our view.

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[10] Tammy Whitehouse, *FASB Racing Through Impairment Revisions*, Compliance Wk. 1 (Dec. 23, 2008), http://www.complianceweek.com/article/5196/fasb-racing-through-impairment-revisions.
[11] *Id*. at 1 (emphasis added).
[12] *See* Proposal, *supra,* ¶5.
[13] *See, e.g.*, Sarah Deans & Dane Mott, *Accounting Issues—Financial Instrument Proposals: Standard Setters Ditch Normal Due Process*, J.P. Morgan Global Equity Res. 6 (Dec. 19, 2008) (on file with the Council) [hereinafter Deans & Mott].
[14] Proposal, *supra,* ¶4.

> 2. Even though the 99-20 [OTTI model] . . . is inconsistent with FAS 115 [OTTI model], there are numerous inconsistencies in the OTTI models throughout GAAP. If the FASB is sharply focused on the objective of providing the most useful information possible to investors, how exactly does this change accomplish this mission especially if . . . a large contingent of investors have indicated that fair value measures are more relevant to investors? This seems to be a waste of valuable board time and resources that could be used more effectively elsewhere, in our view.[15]

We also note that at the November 11, 2008, meeting of the FASB's own Investors Technical Advisory Committee ("ITAC"), ITAC members voiced strong opposition to the FASB pursuing any project—like the Proposal—designed to amend the existing OTTI guidance for financial instruments.[16] Views expressed by various ITAC members explaining their opposition to the Proposal include the following:

> ITAC does not believe any changes are necessary to the other-than-temporary impairment guidance. . . . ITAC supports measuring financial instruments at fair value, which would make impairment testing unnecessary.
>
> ITAC does not see any reason for an other-than-temporary impairment project at this time. . . . ITAC thinks that those who are encouraging the Boards to add an other-than-temporary impairment project may be looking to minimize losses that are real, which is not in the best interests of investors. . . . [C]hanging US GAAP in [this] . . . area actually would put US GAAP companies at a disadvantage because the cost of capital would increase and investors would be fearful that companies have real losses that have not been recognized. . . . [A] project to revisit the other-than-temporary guidance should not be a high priority for the Board. . . . [A] more desirable project would be one that involves measuring all financial instruments at fair value and developing more robust disclosures about how fair value changes evolve over time. . . . [C]oncerns about other-than-temporary impairment are influenced by concerns over regulatory capital requirements. Those concerns should not result in changes to accounting standards that would decrease the transparency of information for investors and can be addressed through other means.[17]

We generally share ITAC's views on this issue.

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[15] Deans & Mott, *supra,* at 6.
[16] Minutes of Meeting, FASB Investors Technical Advisory Committee ¶¶ 7-9 (Nov. 1, 2008), http://www.fasb.org/investors_technical_advisory_committee/itac_11-11-08.pdf.
[17] *Id.* ¶¶ 7-8.

The Comment Period Is Inadequate

The FASB's rules of procedure require that the "FASB will expose all proposed Statements of Financial Accounting Standards for public comment for at least 60 days, unless a shorter period (not less than 30 days) is considered appropriate by the FASB."[18] Similarly, with respect to proposed interpretations that "clarify, explain, or elaborate on a pronouncement as an aid to its understanding," FASB's rules of procedure require exposure for public comment "for at least 30 days."[19] Finally, with respect to "Technical Bulletins" designed to provide guidance for applying standards that is, among other factors, "not expected to cause a major change in accounting practice for a significant number of entities," FASB's rules of procedure require exposure for public comment of "not . . . less than 15 days."[20]

We acknowledge that on October 1, 2008, the FASB approved the following resolutions temporarily modifying the FASB's rules of procedure to potentially shorten the required public comment periods ("Resolutions"):

> RESOLVED, that effective immediately, and solely in respect to technical standard-setting activities of the FASB . . . that address and/or are responsive to the current spectrum of severe instability in the U.S. and global financial and capital markets, the FASB shall, to the extent and as determined by a majority of the FASB Members on a case-by-case basis to be necessary or advisable, have authority to accelerate FASB's normal due process practices and procedures for . . . receiving public . . . comments on, the FASB's and/or its staff's issuance of, any and all forms of FASB pronouncements . . . .
>
> RESOLVED, that, absent a re-vote to extend the term of the limited modifications to the FASB's standards-setting processes permitted by the foregoing resolution, the foregoing resolution shall expire and be of no further force or effect on January 1, 2009.[21]

Although not explicitly discussed in the Proposal, it appears that the FASB is relying on the Resolutions to accelerate the Proposal's required comment period from not less than fifteen days to only eleven days. Of note, this scrooge-like comment period includes the following ethnic and religious holidays: Boxing Day, Hanukkah, Kwanzaa, Las Posadas, Christmas Eve, and Christmas Day—a national holiday.[22]

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[18] Rules of Procedure 14 (Fin Accounting Standards Bd. Amended & Restated Dec. 1, 2002) (on file with Council).
[19] *Id*. at 15-16.
[20] *Id*. at 16-17.
[21] *Authorization of Limited and Temporary Modifications to Standards-setting Processes* (Fin Accounting Standards Bd. Oct. 1, 2008) (on file with Council) [hereinafter Resolutions].
[22] KU Medical Center, *Ethnic and Religious Cultural Holidays, Celebrations, and Festivals* 5, http://www3.kumc.edu/diversity/ethnic_relig/ethnic.html (last visited Dec. 23, 2008); *see also* Deans & Mott, *supra,* at 7 ("The fact that it is a 10-day comment period over a period when a considerable amount of stakeholders will be on a holiday and have limited opportunities to respond when, in our view, one of the key deficiencies of this project is that inadequate due diligence has been performed is of concern to us").

Notwithstanding our policy supporting a thorough public due process, we generally would not object to the FASB accelerating its due process in truly extreme and unusual circumstances in which a statement, interpretation, or other guidance was necessary to "address and/or . . . respon[d] [to] . . . severe instability in the U.S. global financial and capital markets."[23] There is, however, no evidence that we are aware of contained in, or outside, the Proposal indicating that aligning the impairment models of 99-20 with Statement 115 before year end is necessary or appropriate to address or respond to "severe instability" in the capital markets.[24]

In contrast, we believe the more supportable and far better view is that if the Proposal is adopted by the FASB before year end, it is likely, if anything, to exacerbate instability in the capital markets by further lowering investors' confidence in (1) the reporting by companies, and (2) the related independence of the accounting standard-setting process.[25] On this point, we generally agree with the following critique of the Proposal's due process by expert accountant/analyst Jack Ciesielski:

> So – should there be such a rush? No. Understandably, there are year end consequences. But the FASB looks pretty bad in rushing this project through – it's almost as if they're racing the IASB to find ways to screw up due process. The FASB takes years and years to complete projects – or not complete them – then rushes through something like this. It trivializes the importance of independent standard-setting.[26]

In summary, we strongly oppose the Proposal. We, however, appreciate the opportunity to provide our comments thereon.

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[23] Resolutions, *supra.*

[24] *See, e.g.,* Attachment**,** *supra,* at 16.

[25] *See, e.g.,* Bob Herz, *Lessons Learned, Relearned, and Relearned Again from the Global Financial Crisis—Accounting and Beyond*, Remarks before the AICPA National Conference on Current SEC & PCAOB Developments 18 (Dec. 8, 2008), http://www.fasb.org/articles&reports/12-08-08_herz_speech.pdf ("[A]ccounting and financial reporting are meant to inform investors and the capital markets and that straying from that objective or subordinating that objective to any other corporate, industry, social or economic objective other than sound and transparent reporting, can also cause financial instability due to loss of investor confidence in the reporting by companies").

[26] Jack Ciesielski, *Like a Train In the Night*, AAO Weblog (Private) (Dec. 18, 2008) (on file with Council); *accord* Deans & Mott, *supra,* at 6 ("We fear that this project could be another example of the FASB and IASB succumbing to political pressure that overrides their long-established system of due process. We believe the regulatory capture of the accounting standard setting process is becoming a real threat based on recent political concessions made by both the IASB and FASB in recent months").

Please feel free to contact me at 202.261.7081 or jeff@cii.org with any questions or if any additional information about the Council's views on the Proposal or related matters would be helpful to your redeliberations.

Sincerely,

Jeff Mahoney
General Counsel
Council of Institutional Investors

Attachment

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 26, 2008

Ms. Cindy Fornelli
Executive Director
Center for Audit Quality
601 13th Street NW
Suite 800N
Washington, DC 20005

Mr. Jeffery J. Diermeier, CFA
President & Chief Executive Officer
CFA Institute
560 Ray C. Hunt Dr.
Charlottesville, VA 22903

Ms. Barbara Roper
Direction of Investor Protection
Consumer Federation of America
1620 I Street NW – Suite 200
Washington, DC 20006

Mr. Jeff Mahoney
General Counsel
Council of Institutional Investors
888 17th Street, NW – Suite 500
Washington, DC 20006

Ms. Liz Murall
Director of Corporate Governance and Reporting
Investment Management Association
65 Kingsway
London WC2B 6TD
United Kingdom

Dear Ms. Fornelli et al:

Thank you for your letter dated November 14, 2008.

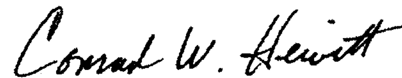
As you point out, issues encountered in the current crisis, particularly related to fair value accounting, have garnered national and international political attention. The credit crisis also has resulted in a renewed focus on the independence of those entrusted to develop accounting standards. The Commission has long supported the importance of independent standard setting, and I have been clear in my own support for the role of the

FASB and IASB. Their efforts to address current issues on a real-time basis, including mark-to-market accounting, fair value measurements, and other-than-temporary impairments, are essential. Equally as essential is the need for that process to be free from interference.

Like you, I believe that independent accounting standard setting has been integral in fostering a financial reporting system that remains robust and responsive to the needs of investors. Of course, open due process, including thoughtfully considering the input and views of your organization's constituents and the many others who participate and play a role in our capital markets, is also critical to the FASB and IASB fulfilling their mission of establishing and improving financial accounting and reporting standards.

Investors in our capital markets have benefited in the past, and will continue to benefit from in the future, both FASB and IASB expertise and careful judgment. We will need to draw upon this expertise as we continue to consider the important reporting issues arising from the global economic crisis. An independent standard setter is best positioned to develop unbiased financial reporting standards that foster investor confidence and financial transparency, and I look forward to their continued work.

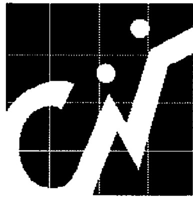
Sincerely,



Conrad Hewitt
Chief Accountant

Consumer Federation of America

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets



COUNCIL OF
INSTITUTIONAL
INVESTORS

Representing the managers of
£3¼ trillion of customers' savings

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November 14, 2008

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, Mail Stop 1070
Washington, DC 20549

Dear Chairman Cox:

Over the past several months there have been requests of the Securities and Exchange Commission to suspend or revise accounting standards issued by the Financial Accounting Standards Board (FASB). Such requests imply that the current economic crisis can be alleviated by simply de-recognizing economic events from financial statements. We recognize that the global financial system is experiencing levels of stress unprecedented since the Great Depression. The great insight and wisdom shown by Congress in creating the SEC during that time of severe economic distress lies in the Commission's mission of protecting investors, and maintaining fair, orderly, and efficient markets through full disclosure of the information that materially affects investment decisions. That mission has our strong and undivided support, and we hope it will be reflected in the Congressionally-mandated study of mark-to-market accounting.

If reported financial information is going to be believed, trusted, and used by investors and the business community, it is critical that the standards used to prepare that information are set by bodies that are **truly independent.**

An independent standard setter makes it more likely that accounting standards will serve the needs of those who read and review financial reports, not those that are responsible for creating them. Those responsible for creating financial reports may recommend accounting rules that, intentionally or unintentionally, obfuscate an objective reporting of the real performance and condition of a company at the expense of outside shareowners. Accounting standards should be promulgated to serve the interests of investors and the capital markets.

In adopting the Sarbanes-Oxley Act of 2002, Congress recognized the benefits of having accounting standards set by an independent and adequately funded body, and wisely endorsed the current standards-setting process. Further political intervention by Congress or the Commission runs the risk of impeding the FASB's ability to promulgate and issue standards for financial reporting, which serves investors and the capital markets of the United States. Accounting standards must faithfully represent the economic substance of business transactions and provide information that meets the needs of investors in a neutral manner to all financial market participants.

In the specific case of fair value reporting, investors require an accounting standard that reports a relevant and useful value of financial instruments regardless of the direction of markets. Fair

value accounting with robust disclosures provides more reliable, timely, and comparable information than amounts that would be reported under other alternative accounting approaches.

We acknowledge that disclosures about the application of fair value reporting may be improved, particularly with respect to the absence of liquid markets for a broad cross section of securities. Making those improvements, however, will require a partnership among standard setters, common shareowners, other investors, preparers and regulators, to bring full transparency and the highest integrity to the standards, as well as to the processes by which those standards are developed. Those goals can be achieved only through your steadfast support of investor interests. We look forward to working with you as you complete your study.

Sincerely,

/s/
Cindy Fornelli
Executive Director, Center for Audit Quality

/s/
Jeff Diermeier, CFA
President and CEO, CFA Institute

/s/
Barbara Roper
Director of Investor Protection, Consumer Federation of America

/s/
Jeff Mahoney
General Counsel, Council of Institutional Investors

/s/
Liz Murall
Director of Corporate Governance and Reporting, Investment Management Association

Cc:

- Hon. Harry Reid, U.S. Senate Majority Leader
- Hon. Christopher Dodd, Chairman, U.S. Senate Committee on Banking, Housing and Urban Affairs
- Hon. Charles Schumer, U.S. Senate Committee on Banking, Housing and Urban Affairs
- Hon. Barney Frank, Chairman, U.S. House Committee on Financial Services
- Hon. Richard Shelby, Ranking Member, U.S. U.S. Senate Committee on Banking, Housing and Urban Affairs
- Henry Paulson, U.S. Treasury Secretary
- Guido Mantega, Brazil Minister of Finance
- Henrique Meirelles, Governor of the Brazil Central Bank
- Luis Aguilar, U.S. Securities and Exchange Commission
- Kathleen Casey, U.S. Securities and Exchange Commission
- Conrad Hewitt, U.S. Securities and Exchange Commission
- Troy Paredes, U.S. Securities and Exchange Commission
- Elisse Walter, U.S. Securities and Exchange Commission

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

October 29, 2008

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number 4-573

Dear Ms. Harmon:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 140 public, corporate and union pension funds with combined assets of over $3 trillion.[1] As the leading voice for long-term, patient capital, we appreciate the opportunity to provide comments to the Securities and Exchange Commission ("Commission" or "SEC") related to the study to be conducted by the Commission under the Emergency Economic Stabilization Act of 2008 of "mark-to-market" accounting applicable to financial institutions, including depositary institutions ("Study").[2]

At our October 7, 2008 meeting, the Council's general membership approved an update to our policy on independence of accounting and auditing standard setting [See Attachment I].[3] That policy encompasses the following Council views that we believe are relevant to the Study:

- The responsibility to promulgate accounting standards should reside with independent private sector organizations that have a thorough public due process,

- The technical decisions and judgments of the private sector accounting standard setter that have been reached after a thorough public due process should be respected and not be overridden by government officials or bodies,

- High quality accounting standards are those that produce comparable, reliable, timely, transparent and understandable financial information that meets the needs of investors and other consumers of financial reports, and

[1] For more information about the Council of Institutional Investors ("Council") and its members, visit our website at http://www.cii.org/.
[2] SEC Study of Mark to Market Accounting, Securities Act Release No. 8975, Exchange Act Release No. 58,747 (Oct. 8, 2008), http://www.sec.gov/rules/other/2008/33-8975.pdf.
[3] The Council of Institutional Investors, Policies on Other Governance Issues, 1. Independence of Accounting and Auditing Standard Setting 1 (Updated Oct. 7, 2008), http://www.cii.org/UserFiles/file/council%20policies/CII%20Policies%20on%20Accounting%20and%20Auditing%2010-7-08.pdf [hereinafter Independence Policy] [See Attachment I]. For more information about the Council's policies, visit our website at http://www.cii.org/policies.

- The goal of financial accounting and reporting and accounting standard setters should be to satisfy, in a timely manner, the information needs of investors and other consumers of financial reports.[4]

Consistent with the Council's policy, we do not support the self-serving views of the bank lobby and some other special interest groups that the Commission or the U.S. Congress should suspend, replace, or otherwise modify the requirements of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157").[5] As indicated in our recent joint letter to the Commission with the Center for Audit Quality, the CFA Institute, and the Consumer Federation of America [See Attachment II], we believe that such a move "would be a disservice to the capital markets, would be inconsistent with the views of investors, and would harm the credibility and independence of the standards setting process . . . ."[6]

We note that Statement 157 was the result of an extensive public due process that occurred over a period of more than three years.[7] That process involved the issuance of two documents for public comment, the receipt and consideration of the views expressed in approximately 125 comment letters, public board meetings and roundtable meetings with respondents to address issues raised in the comment letters, and input from the Valuation Resource Group, the Financial Accounting Standards Advisory Council, the User Advisory Council, members of the Investor Task Forces, and other interested parties.[8]

We believe the Financial Accounting Standards Board's ("FASB") public due process with respect to Statement 157 should be respected and supported. We, therefore, would generally oppose any further changes to Statement 157 without the FASB first conducting a thorough public due process in which the views of investors are actively solicited and carefully considered.

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[4] *See* Independence Policy, *supra* note 3, at 1. We note that our policy's focus on the needs of investors is generally consistent with Recommendation 2.1 of the United States Securities and Exchange Commission's ("Commission") Advisory Committee on Improvements to Financial Reporting ("Advisory Committee") 10 (Aug. 1, 2008), http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf ("investor perspectives should be given pre-eminence by all parties involved in standards-setting (footnote omitted)"). We also note that our policy's support for keeping the responsibility for promulgating accounting standard setting with independent private sector organizations rather than with the federal government is generally consistent with Recommendation 2.4 of the Advisory Committee. *Id*. at 11 ("the SEC should only issue broadly applicable interpretive implementation guidance in limited situations"). We are hopeful that the Commission, including the Office of the Chief Accountant, will soon adopt those elements of Recommendations 2.1 & 2.4 that are consistent with our policy.

[5] Fair Value Measurements, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. Sept. 2006), http://www.fasb.org/pdf/aop_FAS157.pdf [hereinafter Statement 157].

[6] Letter from Center for Audit Quality, CFA Institute, Consumer Federation of America, & Council of Institutional Investors, to Mr. Christopher Cox, Chairman, U.S. Securities and Exchange Commission 1 (Oct. 15, 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/10-10-08%20SEC%20joint%20letter-FINAL.pdf [See Attachment II].

[7] Statement 157, *supra* note 5, ¶ C5.

[8] *Id*. ¶¶ C6-C7.

In addition, we would again[9] like to bring to the attention of the Commission our July 2008 white paper entitled "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch" [See Attachment III].[10] The white paper, prepared by Stephen G. Ryan, Professor of Accounting and Peat Marwick Faculty Fellow, Stern School of Business, New York University, analyzes a number of issues that are pertinent to the Study.[11] For example, the following three conclusions contained in Professor Ryan's white paper are especially noteworthy and should be reflected in the final report that results from the Study:

1. There is no "convincing empirical evidence" that Statement 157 or fair value accounting contributed to the current credit crisis. The crisis is primarily the result of bad operating, investing, and financing decisions, poor risk management, and in some instances fraud.[12]

2. Fair value accounting for all of financial institutions' financial instruments provides investors with more informative reporting, particularly during a credit crisis, than other alternative accounting approaches.[13]

3. Fair value accounting for financial instruments, accompanied by robust disclosures, reduces uncertainty and information asymmetry faster over time than other alternative accounting approaches and, thereby, mitigates the duration of a credit crisis.[14]

We also note that Professor Ryan recommended that the FASB provide additional guidance for Statement 157 clarifying when firms may "report level 3 model-based fair values rather than level 2 valuations . . . ."[15] In our view, the FASB Staff Position issued on October 10, 2008, is largely responsive to that recommendation.[16]

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[9] *See, e.g.,* Letter from Paul Simenauer, Analyst, Council of Institutional Investors, to The Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission 1 (Sept. 25, 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/Fair%20Value%20Accounting%20Letter%20to%20SEC%20doc%20(final)(1).pdf.

[10] Stephen G. Ryan, *Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch* (July 2008), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Paper%20(final)%20%20071108.pdf [hereinafter Professor Ryan] [See Attachment III].

[11] *Id*.

[12] *See id.* at 16.

[13] *Id*. at 8; 14.

[14] *Id*. at 16; *see also* Editorial, *All's Fair, The Crisis and Fair Value Accounting,* Economist, Sept. 18, 2008, at 1-2, http://www.economist.com/finance/displaystory.cfm?story_id=12274096 (Referring to Japan's failure to embrace fair value accounting for financial instruments during the 1990's, Yoshimi Watanabe, Japan's minister for financial services, commented that "Japanese banks exacerbated their country's economic woes by 'avoiding ever facing up to losses'").

[15] Professor Ryan*, supra* note 10, at 15.

[16] Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, FASB Staff Position No. FAS 157-3 (Fin. Accounting Standards Bd. Oct. 10, 2008), http://www.fasb.org/pdf/fsp_fas157-3.pdf.

Finally, we strongly support and agree with the following statement of SEC Chairman Cox appearing recently in an op-ed in the New York Times:

> Transparency is a powerful antidote for what ails our capital markets. When investors have clear and accurate information, and when they can make informed decisions about where to put their resources, money and credit will begin to flow again.[17]

We believe that fair value accounting for financial instruments, complemented by robust disclosures, is superior to other accounting alternatives in (1) providing investors clear and accurate information, and (2) restoring the free flow of money and credit to the U.S. and global capital markets.

We again would like to thank the Commission for granting investors the opportunity to provide input on this important matter. Please feel free to contact me at 202.261.7081 or jeff@cii.org with any comments or questions regarding this letter or the related attached materials.

Sincerely,

Jeff Mahoney
General Counsel

Attachments

[17] Christopher Cox, Op-Ed., *Swapping Secrecy for Transparency,* N.Y. Times, Oct. 19, 2008, at 12.

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Via Email

February 11, 2008

Ms. Teresa S. Polley
Chief Operating Officer
Financial Accounting Foundation
401 Merritt 7
Norwalk, CT 06856-5116

Re: Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB[1]

Dear Ms. Polley:

The Council of Institutional Investors ("Council") appreciates the opportunity to provide our input on the Financial Accounting Foundation's ("FAF") Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB ("RFC"). The Council is an association of more than 130 U.S. public, corporate and union pension funds with combined assets of over $3 trillion.

As a leading voice for long-term patient capital, the Council strongly believes that independent private sector accounting standard setting is critical to the integrity of the capital markets. Last year, after months of research and deliberations by the Council's staff, policies committee, and board of directors, the Council's general members unanimously approved the following policy regarding the independence of accounting and auditing standard setting:

> . . . [F]inancial 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: (1) preparers use to recognize and measure their economic activities and events . . . . The result should be accurate, transparent, and understandable financial reporting.

[1] Financial Accounting Foundation ("FAF"), Request for Comments on Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB (2008), http://www.fasb.org/FAF%20Proposed%20Changes.pdf.

> 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 . . . standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.[2]

Consistent with the Council's conclusion that high quality accounting standards can best be achieved by an independent private sector organization, we would like to offer the following specific comments in response to several of the proposed actions raised in the RFC:

***Proposed Action*: Expand the breadth of individuals and organizations that are invited to submit nominations for the FAF Board of Trustees with the understanding that final authority for all appointments rests solely with the Board of Trustees.**

As indicated by the Council's policy, we believe that having significant investor representation in the private sector accounting standard setting process is critical to producing high quality accounting standards.[3] We, therefore, generally support reducing reliance on the non-user Financial Nominating Organizations ("FNOs") and Governmental Nominating Organizations ("GNOs") as the main source of nominations for the FAF Board of Trustees.

It is our understanding that the origin of the FNOs and GNOs involvement in the selection of the Board of Trustees appears to have been based, in part, on a commitment by those organizations to participate in the raising of funds required for the operation of the Financial Accounting Standards Board ("FASB") and the Governmental Accounting Standards Board ("GASB"), respectively.[4] That purpose is now less relevant (at least for the FASB) as a result of the accounting support fee requirements included in the Sarbanes-Oxley Act of 2002.[5]

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[2] Council of Institutional Investors ("Council") Policies, Pension Fund Issues, I. Independence of Accounting and Auditing Standard Setting (Mar. 20, 2007), http://www.cii.org/policies/Redesigned%20CII%20Policies%20on%20Other%20Governance%20Issues%201-29-08.pdf.
[3] Of note, the Council's policy supporting significant representation from investors and other users of financial reports on the boards and advisory groups of the organizations that establish accounting standards appears to have been adopted by the Advisory Committee on Improvements to Financial Reporting ("CIFiR"). CIFiR, Progress Report 37-38 (draft Feb. 11, 2008), http://www.sec.gov/about/offices/oca/acifr/acifr-dpr-021108.pdf.
[4] *See* American Institute of Certified Public Accountants ("AICPA"), Report of the Study on Establishment of Accounting Principles, Establishing Financial Accounting Standards 9 (Mar. 1972) (on file with the Council) (The original financial nomination organizations were the Financial Executives Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association).
[5] *See* Sarbanes-Oxley Act of 2002, Section 109(e) (2002), http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.

Our general support for the proposed action, however, is contingent on the expansion focusing on increasing the investor representation on the FAF. As the key customers of financial accounting and reporting, qualified investors should be offered a much greater role in the boards and advisory groups of those organizations that establish accounting standards.

***Proposed Action**: Reduce the size of the FASB from seven members to five.*

The Council generally does not support reducing the size of the FASB from seven members to five. We note that the RFC suggests that the proposed action will make the FASB "more nimble and responsive to domestic and global demands," and "more effective and efficient."[6] We are not convinced.

We believe that the better argument is that reducing the size of the FASB from seven members to five will make the Board *less* nimble and responsive and *less* effective and efficient for at least two reasons: (1) there will be fewer Board members available to take leadership roles on standard setting projects and related research and technical activities, and (2) there will be fewer Board members to engage in external communications and dialogue with investors and other interested parties—important elements of a high quality standard setting process.

Finally, we understand that in March 2002 the FAF considered a nearly identical proposal to reduce the size of the FASB from seven to five members to improve "the FASB's efficiency."[7] On that occasion the reaction from preparers, auditors, and users of financial reports was generally negative.[8] In response to those comments the FAF decided to retain a seven-member Board.[9] In our opinion, the RFC provides no basis for why a different conclusion is now appropriate.

***Proposed Action**: Realign the FASB composition.*

The Council generally supports realignment of the FASB composition. Our support, however, is contingent on the realignment resulting in an increase in the number of qualified investor representatives on the seven-member FASB Board. More specifically, we believe that, consistent with the view expressed in 1992 by then U.S. Securities and Exchange Commission ("SEC") Chairman Richard C. Breeden, at least two of the seven members of the FASB should be qualified investors or other qualified users of financial reports.[10]

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[6] FAF, *supra* note 1, at 5.
[7] News Release, Financial Accounting Standards Board ("FASB"), Financial Accounting Foundation Considers Changes to Streamline FASB Process; Emphasizes Need for Independent Accounting Standard Setter (Mar. 14, 2002), http://72.3.243.42/news/nr031402.shtml.
[8] *See, e.g.*, Letter from Richard J. Swift, Chairman, Financial Accounting Standards Advisory Council, to Joseph S. LaGambina, Executive Vice President, FAF 1 (Apr. 1, 2002) (on file with the Council) ("The general consensus of the FASAC members is that a reduction in the number of FASB members is not advisable, and they have asked me to express this concern to you.").
[9] News Release, FASB, Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency (Apr. 24, 2002), http://72.3.243.42/news/nr042402b.shtml.
[10] Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to Shaun O'Malley, President, FAF (Oct. 22, 1992). We also note that CIFiR has expressed support for "at least two investors" on the FASB Board if the FASB maintains a seven-member Board. CIFiR, *supra* note 3, at 39.

<u>Proposed Action</u>: Provide the FASB Chair with decision-making authority to set the FASB technical agenda.

The Council generally does not support providing the FASB Chair with the decision-making authority to set the FASB technical agenda. It is our understanding that the proposed action would result in a significant structural change to the FASB's standard setting process. That process was originally designed, in part, to broaden the base and variety of skills involved in standard setting decisions.[11] The original design is reflected in the FASB's current rules of procedure which require that the technical agenda be approved by the FASB Board.[12]

We are troubled by the fact that the proposed action would appear to provide the FASB Chair the authority to remove a project from the FASB's agenda even if the project was supported by all of the other Board members or by all investors. Our concern is heightened by the numerous public reports over the past year of efforts by the SEC to exert more control over the FASB.[13]

We, therefore, believe the existing agenda decision-making process should be maintained. We understand that that process includes solicitation of input from investors and other users of financial reports, and requires a majority vote of the Board to add or drop a project from the agenda. In our view, the existing thorough and public agenda process lessens the potential risk that FASB's independence might be impaired by the efforts of self interested special interest groups to the likely detriment of investors and the capital markets.

<u>Proposed Action</u>: Secure a stable mandatory funding source for the GASB.

As indicated by the Council's policy, we believe that independent private sector accounting standard setting organizations should have adequate resources to fulfill their important missions. We, therefore, generally support a stable mandatory funding source for the GASB. Such a funding source, if properly structured, would contribute to the GASB's independence and likely enhance the quality of its standards.

<u>Proposed Action</u>*: Retain the current size, term length, and composition of the GASB.*

The Council generally supports retaining the current size, term length, and composition of the GASB. To the extent, however, that additional funding sources become available, we generally would support, consistent with the Council's policy, seven full time members of the GASB.

<u>Proposed Action</u>: Provide the GASB Chair with decision-making authority to set the GASB technical agenda.

The Council generally opposes providing the GASB Chair with decision-making authority to set the GASB technical agenda for the same reasons we generally oppose providing such authority to the FASB Chair.

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[11] AICPA, *supra* note 4, at 10-11.
[12] FASB, Rules of Procedure 51 (amended and restated through Dec. 1, 2002).
[13] *See, e.g.,* Marie Leone & Alan Rappeport, SEC Said No to FASB Raises, CFO.com (Apr. 2, 2007), http://www.cfo.com/article.cfm/8952913.

The Council appreciates the opportunity to express its views on the RFC. Please do not hesitate to contact me if you have any questions or would like any additional information.

Sincerely,

Jeff Mahoney
General Counsel
Council of Institutional Investors