TESTIMONY
OF

JAMES KROEKER, ACTING CHIEF ACCOUNTANT
U.S. SECURITIES AND COMMISSION

CONCERNING

MARK–TO-MARKET ACCOUNTING: PRACTICES AND IMPLICATIONS

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

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Testimony Concerning Mark-to-Market Accounting: Practices and Implications

James L. Kroeker
Acting Chief Accountant
U.S. Securities and Exchange Commission

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services

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

I am Jim Kroeker, Acting Chief Accountant in the Office of the Chief Accountant (OCA), which advises the Commission on accounting and auditing matters. Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (Commission) on mark-to-market accounting practices and implications.

The Focus of Financial Reporting

Our financial reporting system has long been considered world class and a major asset of our capital markets. This world class reputation was earned through our system's ongoing commitment to provide investors with the transparent financial information they need to make better capital allocation decisions.

Our system's reputation continues to be enhanced as investors and other capital market participants reap the benefits of transparency provided by accounting standards that focus on investors as the consumers of financial reports. This reputation should be safeguarded by those charged with stewardship of our capital markets by continuing to hold the needs of investors paramount. Interruptions to financial stability caused by real economic factors should not lure us into suspending the transparency, and accompanying clear financial picture and investor confidence, on which our capital markets depend.

The federal securities laws set forth the Commission's broad authority and responsibility to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under those laws, as well as its responsibility to ensure that investors are furnished with other information necessary for investment decisions.[1] As part of its fulfillment of this responsibility, the Commission has recognized the role of the Financial Accounting Standards Board (FASB) and the importance of the FASB's independence.[2]

An independent standard setter is best positioned to promulgate financial reporting standards for all private industries free from undue influence. It is important to note that the accounting standards that are the subject of this hearing – those related to fair value – are used not just by financial institutions, but by all industries. Of course, open due process, including thoughtfully considering the input and views of investors and the many others who participate and play a role in our capital markets, is also critical to the FASB fulfilling its mission of establishing and improving financial reporting.

We continue to support the FASB in its role as our independent accounting standard setter, and investors in our capital markets have and continue to benefit from their expertise and careful judgment. We also continue to believe the FASB must be responsive to the needs of capital market participants, particularly investors. To be responsive, the FASB must continue, on a timely basis, to enhance the tools available to assist preparers and auditors when making difficult judgments. We believe that responsiveness is enhanced by collaboration among investors, preparers, auditors, regulators, and independent accounting standard setters, and we will take all prudent actions to continue to encourage such collaboration.

The History of Fair Value Accounting

Previous generations, after considering the causes of financial crises experienced during their times, concluded that fair value accounting was an important tool to communicate investment values to capital market participants. In particular, fair value was chosen after careful consideration, including consideration of the causes of previous financial crises and the tools that would best equip future generations when crises reemerged, such as we find ourselves in today.[3]

Although the use of fair value dates back many decades, the use of fair value measurement expanded significantly in 1975 due to concerns about the appropriate measurement attribute for securities. This expansion of the use of fair value measurements was precipitated by the financial crisis of the early 1970s when the accounting literature was inconsistent, resulting in diversity in practice, specifically with respect to marketable securities. Accounting practices at that time included recording such securities at cost, at market, and, in some cases, a combination of both measurements for different classes of securities.

The banking and savings and loan crisis of the 1980s further exposed challenges to the historic cost model of accounting for financial institutions. Specifically, savings and loan institutions accepted short-term deposits and used these deposits to fund long-term fixed-rate (e.g., 30-year) mortgage loans, their primary asset. In the late 1970s and early 1980s, interest rates were driven up by high inflation. As a result, the "current value" of assets in many cases was significantly less than the value of many reported liabilities, and these institutions were economically insolvent. However, under the historic cost accounting model, these losses were often not reflected in financial statements, which reduced transparency about their solvency.

Moreover, this also caused a moral hazard problem whereby the management of economically less solvent institutions had an incentive to take on more risky investments in the hope that they could trade their way out of their current economically less solvent position. In effect, the historical-cost-based financial statements obscured underlying economic losses and allowed troubled financial institutions to go undetected.

The experience gained by navigating these crises led to various calls for the expanded use of fair value measurements by financial institutions.[4] These calls for action, which were predicated on the experience of those that led this country during those crises, ultimately led to the fair value accounting standards we have today.

Further, it should be noted that FASB Statement No. 157, *Fair Value Measurements* (FAS 157), issued in 2006, does not itself require mark-to-market or fair value accounting. Rather, other accounting standards in various ways have required what is more broadly known as "fair value" accounting, of which mark-to-market accounting is a subset. FAS 157 was adopted to improve existing accounting requirements, because before its adoption, there was no common framework for measuring fair value, which led to inconsistent application. FAS 157 defines fair value, establishes a framework for measuring fair value, and requires expanded disclosures and transparency about fair value measurements.

As more fully described in the Commission staff's study on mark-to-market accounting, the scope of fair value accounting's use is important to appreciate when considering the issue of fair value measurements.[5] Financial institutions apply mark-to-market accounting (that is, they report changes in the fair value directly in earnings) in only limited cases. In fact, many more assets are currently recognized with changes in value not reported in earnings but rather reported directly in equity, or are currently carried at amortized cost. Loans held for investment purposes, for example, are not generally subject to mark-to-market accounting.

When mark-to-market accounting is not applied, unrealized investment losses are only recognized if the value of the investment is impaired. For debt securities that will be held to maturity, such impairment is generally only recognized if it is probable the investor will fail to recoup the investment's contractual cash flows – that is, when a credit loss has occurred.

Efforts to Improve Fair Value Accounting

On December 30, 2008, the Commission delivered its staff study on mark-to-market accounting to Congress. In this study, the staff did not recommend a suspension of fair value accounting standards. Rather, as discussed further below, we recommended improving existing fair value accounting standards and related guidance. However, our efforts to improve the standards began before the current extent of the financial crisis was fully known, and continue today.

For example, in March and September of 2008, the Commission's Division of Corporation Finance (Division) issued illustrative letters to large financial institutions concerning fair value disclosure practices. These letters highlighted best practices in transparent disclosure of fair value accounting garnered from the Division's ongoing review of public companies' financial reporting. The Division highlighted these disclosures and encouraged companies to incorporate them into their financial reporting.

As pointed out earlier, we steadfastly believe that financial reporting and transparency is improved by all capital market participants collaborating on the most difficult financial reporting issues. Consistent with this view, in the summer and fall of 2008, the SEC hosted three public roundtables on the topic of fair value accounting. At these roundtables, leaders representing preparers, auditors, investors, regulators, valuation experts and independent accounting standard setters exchanged views about the benefits and challenges of fair value accounting. Most participants at these roundtables expressed a belief that fair value accounting provides useful information to users of financial reporting. However, participants also expressed the desire for accounting standard setters to continue to address accounting issues arising out of the financial crisis, including improvements to the guidance on the measurement of fair value, particularly in inactive or illiquid markets.

In part due to the calls for additional guidance heard at the public roundtables, on September 30, 2008, the Commission staff and FASB staff issued a joint public statement clarifying the application of existing fair value accounting guidance, including the guidance in FAS 157. Among its clarifications, that statement pointed out that it is acceptable for management to use estimates of future cash flows that incorporate current market participant assumptions, and include appropriate risk premiums, as a part of the total mix of information used to measure fair value in certain circumstances. The clarifications also made clear that disorderly transactions are not determinative when measuring fair value, and that distressed or forced liquidation sales are not orderly transactions.

FASB Chairman Herz will likely discuss his Board's efforts in more detail, but closely following the joint public statement, the FASB issued additional guidance on how to measure fair value in inactive or illiquid markets, thereby supplementing, in near real time, the clarifications included in the joint public statement. The timely responsiveness of the FASB to this situation should be commended.

Although the guidance issued by the FASB relates to U.S. generally accepted accounting principles (U.S. GAAP), the International Accounting Standards Board (IASB) publicly expressed its support for the Commission staff and FASB efforts. The IASB's support is critical to the world-wide financial markets because fair value measurement is clearly a global issue.

As a global issue, work is ongoing internationally to develop better fair value measurement guidance. For instance, in October 2008, an expert advisory panel sponsored by the IASB issued information and educational guidance for measuring and disclosing fair value.

The FASB and IASB have also formed a Financial Crisis Advisory Group (FCAG) to help consider how improvements in financial reporting could help enhance investor confidence. OCA participates as an observer on FCAG, which began meeting monthly in January 2009. We expect the FASB to carefully consider the work of this body as it considers improvements to the guidance available in the U.S.

To address the assessment of security impairment, in our September 30, 2008 joint public statement, the Commission and FASB staffs also clarified that no bright-line thresholds exist for determining when an investment is impaired and also emphasized the need for judgment in this area. To further provide clarity to the issue of investment impairment, in October 2008, OCA, in consultation with the FASB staff, provided additional guidance for assessing perpetual preferred security impairments to address an acute practice issue that had arisen for those investments. Additionally, OCA requested that the FASB move expeditiously to address changes in the existing impairment accounting models, including the calculation and presentation of impairments, which I am glad to report they are doing.

OCA will continue to work with the FASB to further clarify the assessment of investment impairment when mark-to-market accounting is not applied. We supported the FASB's efforts in January 2009 to stream-line the guidance on impairments through harmonization of the impairment models used for different types of securities. We also support the FASB as it considers additional improvements to the impairment model for all investments, and we will continue to encourage the FASB to prioritize these improvements either through their own projects or on a joint basis with the IASB, as appropriate.

Congressional Mark-to-Market Study

As previously mentioned, the Commission delivered its staff study on mark-to-market accounting to Congress on December 30, 2008. In this comprehensive study, conducted in consultation with the Department of Treasury and the Federal Reserve, the Commission staff did not recommend a suspension of fair value accounting standards. Rather, we recommend improving existing fair value accounting standards and related guidance.

Our report includes eight recommendations that, if adopted, we believe will further enhance the already world class reputation of our financial reporting system. While I will outline the individual recommendations in a moment, it is worthwhile to first highlight their consistent theme: fair value accounting provides transparent financial information to investors, and better guidance can and should be provided to assist those responsible for making fair value measurement judgments.

The events leading up to the Congressional call for this study illustrated the need for identifying and understanding the linkages that exist between fair value accounting standards and the usefulness of information provided by financial institutions. In the months preceding passage of the Emergency Economic Stabilization Act of 2008 (Act), some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under FAS 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities. These voices pointed out the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions, highlighting that this correlation could lead to the failure of financial institutions if sufficient additional capital is unavailable to offset investment write-downs. Further, they believed the need to raise additional capital, the effect of failures, and the reporting of large write-downs would have broader negative impact on markets and prices, leading to further write-downs and financial instability, or so-called pro-cyclicality.

Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public. These participants indicated that fair value information is vital in times of stress, and a suspension of this information would weaken investor confidence and result in further instability in the markets. They pointed to what they believe are the potential causes of the crisis, namely poor lending decisions and inadequate risk management, combined with needed improvements in the current approach to supervision and regulation, rather than accounting.

Suspending the use of fair value accounting, these participants warned, would be akin to "shooting the messenger" and hiding from capital providers the economic condition of a financial institution. These participants noted that they were aware of the arguments about the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions. However, they pointed out that adjustments to the calculation of regulatory capital can be made to reduce this correlation where appropriate for prudential purposes. For example, today adjustments are made for "available-for-sale" securities, which are carried on the balance sheet by financial institutions at fair value with changes directly reported in equity subject to impairment assessments.

As mandated by the Act, our study addressed six key issues and provided recommendations on these issues. We studied these issues using a combination of techniques. Where practicable, we analyzed data empirically from a broad-based population that included a cross-section of financial institutions. For issues that did not lend themselves to empirical analysis, we undertook alternative methods, including research of public records, analysis of public comment letters received regarding this study, and the hosting of the three previously mentioned public roundtables to obtain a wide range of views and perspectives from all parties. Careful attention was given to maximize the opportunities to hear from all sides about the use fair value measurements.

The six issues mandated for study by the Act included:

1) The effect of fair value accounting standards on financial institutions' balance sheets;
2) The impact of fair value accounting on bank failures in 2008;
3) The impact of fair value accounting standards on the quality of financial information available to investors;
4) The process used by the FASB in developing accounting standards;
5) Alternative accounting standards to those provided in FAS 157; and
6) The advisability and feasibility of modifications to fair value accounting standards.

Among the study's findings, we found that investors generally believe fair value accounting increases financial reporting transparency and facilitates better investment decision making. In addition, after careful study of the factors that led to bank failures occurring in 2008, fair value accounting did not appear to play a meaningful role. Rather, we found that the failures appeared to be the result of growing credit losses, concerns about asset quality, and in certain cases, the erosion of investor confidence.

We also observed, as noted above, that fair value and mark-to-market accounting have been in place for years. That being the case, we concluded that their abrupt removal would erode investor confidence, further exacerbating instability in our financial markets.

Based on the findings of the study, we made the following eight recommendations:

1. FAS 157 should be improved, but not suspended;
2. Existing fair value and mark-to-market requirements should not be suspended;
3. Additional measures should be taken to improve the application and practice related to existing fair value requirements;
4. The accounting for financial asset impairments should be readdressed;
5. Further guidance to foster the use of sound judgment should be implemented;
6. Accounting standards should continue to be established to meet the needs of investors;
7. Additional formal measures to address the operation of existing accounting standards in practice should be established; and
8. The accounting for investments in financial assets should be simplified.

A full description of each of these recommendations is included in our study, and action has already been taken on some of its key recommendations. For instance, in his testimony, FASB Chairman Herz will likely address the FASB's recent agenda decisions to provide guidance on the measurement of securities in inactive or illiquid markets and better disclosure of fair value measurements. We will work closely with the FASB and others to implement the remaining recommendations in due course.

Conclusion

We should not forget that transparent financial information and investor confidence are at the heart of market efficiency and capital formation. Transparency increases financial stability by increasing investor confidence, and serving the needs of investors should continue to be the primary focus of financial reporting. As transparency is critical to the Commission fulfilling its mission of investor protection, we remain committed to enhancing it.

We continue to encourage collaboration among all capital market participants on financial reporting issues, including fair value measurement issues. The FASB is well-positioned to neutrally consider the input of all interested parties, while also safeguarding the financial reporting needs of investors.

The staff is working closely with the FASB and others to adopt the recommendations included in our study on mark-to-market accounting. We understand the urgency and gravity of the matter as companies continue to cope with the economic crisis. We look forward to the continued dialogue on the important issue of fair value measurements, and we will continue in the Commission's mission to protect investors and the capital formation process.

Thank you for the opportunity to appear today, and I would be pleased to respond to any questions.

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[1] See, e.g., sections 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); sections 5(b), 14, 15 and 20 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79e(b), 79n, 79o and 79t; and sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

[2] Policy Statement Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003) [68 FR 23333 (May 1, 2003)].

[3] For instance, see FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, Appendix A, Background Information and Basis for Conclusions.

[4] See, e.g., Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance (1985); Lawrence J. White, On Measurement of Bank Capital, 13 Journal of Retail Banking 2 (1991), at 27-34; and George Benston, Market Value Accounting: Benefits, Costs and Incentives, Proceedings of the Conference on Bank Structure and Competition, Chicago: Federal Reserve Bank of Chicago (1989), at 547-563.

[5] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, available at: http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.