

Remarks of Cynthia Fornelli
Executive Director, Center for Audit Quality
Before the
United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets,
Insurance and Government-Sponsored Enterprises
Thursday, March 12, 2009

Good afternoon, Chairman Kanjorski, Ranking Members Bachus and Garrett, and members of the Subcommittee. You have my written testimony, so I will simply highlight 3 critical points.

First, for over 30 years, fair value accounting has contributed to increased transparency in financial reporting. Fair value's application has room for improvement; but as the recent SEC study confirms, loan losses and runs on the banks caused the current financial crisis, not fair value accounting. Therefore, suspending fair value accounting will not fix the problem and, as the SEC noted, could further erode investor confidence.

Thus far, Congress, regulators and standard-setters wisely have resisted pressure to abandon the basic principle of fair value accounting, which is to provide current financial information to investors. To suddenly stop reporting current values – especially in a time of crisis – would make matters worse by adding uncertainty for investors.

Just as we wouldn't want our doctor to hold back unpleasant results from our annual check-up, investors would not want information withheld about the companies in which they might invest. Whether from our doctors or financial institutions, we need to know the current status of information so we can intelligently make decisions and address problems.

Second, the challenges faced by financial institutions in meeting their capital requirements are legitimate policy issues for prudential regulators. But dealing with capital adequacy concerns by suspending or significantly altering fair value accounting would only serve to obscure current realities, further undermine investor confidence, and prolong the current crisis. Investors need to know the current values of loans and securities in order to make rational investment decisions. Regulators need to know the current values of loans and securities in order to make rational policy decisions.

Yes, the application of fair value accounting standards can be improved. However, banking regulators have the authority to determine whether or how current valuations affect capital requirements and make adjustments accordingly. While accounting standard-setters need to consider improving the application of their standards, prudential regulators should consider improving application of their capital requirements.

Third, while we vigorously support the continued use of fair value measurements, we believe there are ways to improve the application of those measurements. The CAQ put forward a number of specific recommendations in its comment letter to the SEC during its fair value study, including:

1. how to value an asset in a time of changing, disrupted, or illiquid market conditions, such as we have now;
2. how fair value measurements might differ for different types of assets and liabilities under various market conditions;
3. how companies present periodic changes in asset values in their financial statements; and,
4. how to achieve clearer and more transparent disclosures about the assumptions and methods applied in the fair value measurement process, as well as the conditions present in a particular market. Such disclosures would help address assertions that fair value accounting forces institutions to use overly pessimistic market prices to value their assets and liabilities.

Recognition of non credit related investment losses outside of income would help address assertions that fair value accounting forces institutions to use overly pessimistic market prices to value their assets and liabilities.

The CAQ and the audit profession stand ready to assist in the application of these improvements once they are in place.

The bottom line is we all want swift and meaningful action to address the current crisis. But as we respond to the crisis, we should remain true to fundamental market principles. Investor confidence in the reliability and transparency of financial reporting is critical to our financial system's long-term well being. We must pursue only those solutions that do not put that confidence at risk, and there are such solutions on the table.

Thank you for the opportunity to share my views. I am happy to answer any questions you have.

###