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

**Testimony of Cynthia Fornelli**
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**Before the**
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**Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises**
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**Full Text of Testimony**

## Introduction

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, I want to thank you for giving me the opportunity to participate in today's hearing on the future of fair value accounting. My name is Cindy Fornelli and I am Executive Director of the Center for Audit Quality (CAQ). The Center for Audit Quality was created to serve investors, public company auditors and the capital markets. The Center's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Our Governing Board consists of leaders from the public company audit profession, the American Institute of Certified Public Accountants (AICPA), as well as individuals representing the issuer, investor and academic communities.[1]

The views of the CAQ and the public company audit profession on the issue of fair value are grounded in two fundamental beliefs: first, that transparent and relevant financial information is the foundation of our capital markets; and second, that investor confidence depends on this transparency and relevancy.

Promoting sound capital markets in the interest of the investing public is the core mission of the public company audit profession. Auditors contribute to this vital goal by conducting high-quality, independent audits of public company financial statements and attesting whether those reports have been prepared consistent with U.S. Generally Accepted Accounting Principles (U.S. GAAP). Auditors do not promote the success of any company or pick winners and losers. That is the job of the markets themselves. Investors will only feel confident in the legitimacy of the markets when they know that the financial reporting rules are clear and that there is a neutral party — the auditor — assessing that the standards are being followed.

It is from this perspective — and in recognition of the extraordinary crisis facing the markets and our entire economy — that the CAQ views the issue of fair value accounting. We would offer the following points for consideration by the Committee:

- First, over the last 30 years, fair value accounting has contributed to increased transparency in financial reporting. While the specific standard for applying fair value measurements at issue

[1] The Center for Audit Quality (CAQ) is an autonomous public policy organization serving investors, public company auditors and the capital markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. For more information, visit www.thecaq.org.

today — FAS 157 — has room for clarification and improvement, neither this standard nor fair value accounting generally are the root cause of the current financial crisis.

- Second, the challenges facing financial institutions in meeting the capital adequacy requirements of existing prudential regulations are legitimate policy issues. But, changing accounting standards to address capital adequacy requirements or to remove much-needed transparency would likely undermine investor confidence and could prolong the current crisis. Capital adequacy concerns are more appropriately addressed by the relevant regulatory agencies.

- Third, while we support continued use of fair value measurements, we recognize that there is value in considering ways to improve its application.

- Finally, irrespective of the specific issue of fair value accounting, the existence of an independent, unbiased standard setter for accounting standards is fundamental to investor confidence and must be reaffirmed and preserved. Any changes to accounting standards should be subject to the unbiased, open, and independent process of the Financial Accounting Standards Board (FASB).

**The Value of Fair Value**

The CAQ recognizes that the critique of fair value standards is rooted in the desire to address issues that have arisen in today's urgent, complex and far-reaching financial crisis. The crisis has been caused by loan losses and runs on the bank, not fair value accounting. While we support further clarification and improvement of how fair value measurements are made and presented in the financial statements, the CAQ believes that (1) the current use of fair value measurements for financial instruments in the financial statements should not be changed at this time; (2) the basic objectives of fair value measurements under FAS 157 are appropriate; and (3) neither currently required or permitted fair value measurements nor FAS 157 should be suspended. Significantly altering or suspending fair value would not only fail to mitigate the crisis, but such a move would make it worse by further undermining investor confidence by raising suspicions that the rules were changed in order to obfuscate current asset values.

In analyzing the merits of fair value accounting, it is important to recognize that it is not a new concept. In fact, fair value has been used for more than 30 years and has steadily emerged as a critical driver of increased transparency in financial reporting. There are two significant examples where many have suggested that a requirement to measure distressed assets at fair values, rather than historical values, could have resulted in declines that were less severe, less protracted or both, due to the earlier identification of losses and the associated corrective action that could have been taken.

First, during the savings and loan crisis in the 1980s, financial statements prepared for regulatory capital purposes, using principles other than U.S. GAAP, obscured the then-declining state of certain financial institutions' assets and liabilities. In any of these institutions that later failed, the resulting damage to the federal deposit insurance funds was much larger than it otherwise would have been had fair value principles been required.

Similarly, in Japan in the 1990s, in the face of steep losses at some of its largest banks, the Central Bank of Japan instituted a system of establishing loan loss allowances that were not fully consistent with the declines in recoverable value of those loans. Instead of stimulating growth, however, this action undermined the confidence necessary for growth. Investors lost confidence in their ability to assess the economic strength of financial institutions — and absent that confidence they decided not to invest in those companies. This move away from transparency did not lead to stability. It simply led to uncertainty, which in turn contributed to the so-called “lost decade” in Japan.

More recently, FASB issued FAS 157, which contrary to popular misconception did not introduce a single new instance under which fair value accounting was required. Rather FAS 157 provided a consistent definition of fair value and a consistent framework for its application. FAS 157 is best understood as the latest evolution in an ongoing effort to provide investors transparent information about the economic realities of companies, including financial institutions, in which they may choose to invest their money. The call to suspend FAS 157, or to do away with fair value accounting, runs counter to this historical drive toward increased transparency at a time when that transparency is of critical importance.

FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. FASB issued FAS 157 to address the complexities caused by differing definitions of fair value, the lack of related implementation guidance, and difficulties caused by multiple fair value methodologies. Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting. Rather, it provides a consistent measurement methodology for applying existing fair value requirements, centralized in one standard. In addition, FAS 157 simplifies and codifies related guidance within generally accepted accounting principles (GAAP) and requires increased disclosure of the methods and inputs used in fair value measurements of a company’s assets and liabilities.

These improvements were intended to result in increased consistency and comparability in fair value measurements as well as provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period. Thus, FAS 157 permits investors to better assess for themselves the reliability of the fair value measurements that have been included, and the overall picture that a company presents in its financial statements.

To accomplish this goal, FAS 157 establishes a consistent fair value objective to measure the price to sell an asset or transfer a liability in a transaction between a willing buyer and a willing seller. Embedded in FAS 157 is a hierarchy of valuation techniques that varies based on the availability of observable market information.

The CAQ believes that the objective of fair value measurements of financial instruments is just as important to investors when markets are illiquid as in other times. Valuing financial instruments absent a uniform methodology such as that prescribed by FAS 157, particularly in illiquid markets, would result in inconsistent measurements and would not provide users with the most transparent or relevant information about the value of a company’s financial instruments.

Suspending fair value accounting or FAS 157 would eliminate an important tool for making transparent the economic health of publicly traded companies. It would not address the underlying economic problems and would create a new set of challenges as investors lose confidence in the relevance, reliability and transparency of financial reporting generally. As the Securities and Exchange Commission (SEC) reported in its December 2008 study, recent bank failures primarily were caused by problems in the quality of loan portfolios and inadequate liquidity and were not caused by fair value and mark-to-market accounting. Further, the SEC concluded that abruptly removing fair value and mark-to-market accounting would erode investor confidence in financial statements.[2] As discussed below, the question we should be asking is not whether to eliminate or suspend fair value accounting, but rather what steps can be taken to improve the application of fair value.

**Addressing Capital Adequacy Concerns**

The impact of the financial crisis on financial institutions has raised questions about the impact of accounting on regulatory capital requirements and has caused some to question whether the primary focus of financial reporting on the needs of investors remains appropriate, or whether financial reports should serve also a prudential and regulatory purpose. In an August 2008 report of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR), it was recommended that financial reporting should be undertaken primarily for the benefit of investors.[3] Earlier, the CFA Institute reached a similar conclusion and asserted that "[investors] and creditors need timely, relevant, complete, accurate, understandable, comparable, and consistent information ... to evaluate the potential risk and return properties of securities and to determine appropriate valuations for them. The purpose of audited financial statements, prepared according to high-quality financial reporting standards, is to provide the needed information."[4]

The financial stability of regulated institutions is, in part, the responsibility of their respective regulators. While we do not advocate departure from fair value accounting for either regulatory capital or investor reporting purposes, clearly, regulators need to form their own judgment on capital requirements. We support appropriate moves to improve regulation to respond to recent events, but we also believe that regulatory requirements should be kept separate from setting accounting standards and should not dilute the quality of financial reporting that is so important to investors. We should not confuse the independent FASB'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.

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. Whether or how those values affect capital requirements, and whether they should result in an institution running afoul of capital requirements, is a decision to be made by regulators. If there is a problem with a financial institution meeting capital requirements, the solution should focus on

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

[3] Securities and Exchange Commission, Final Report of the Advisory Committee on Improvements to Financial Reporting (Aug. 2008), available at http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

[4] CFA Institute, A Comprehensive Business Reporting Model 6 (July 2007), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n6.4818.

regulatory requirements, not on denying the current valuation that results from the underlying fair value principle.

**Proposals for Improving Fair Value and Addressing the Financial Crisis**

It is critical to the transparency of financial reporting and confidence of investors that fair value accounting standards be preserved. The question we should be asking is not whether to retain fair value reporting, but what steps can be taken to improve the application of fair value standards going forward. As a relatively new standard for applying fair value measurements, it is not surprising that FAS 157 could benefit from certain clarifications.

On Feb. 18, 2009, in response to recommendations in the SEC's study on mark-to-market accounting as well as input received from FASB's own Valuation Resource Group, FASB added multiple important projects to its agenda. Those agenda projects are intended to improve (1) the application guidance used to determine fair values and (2) disclosures of fair value estimates. (The FASB's Valuation Resource Group is a group of valuation and accounting professionals who provide FASB staff and Board with information on implementation issues surrounding fair value measurements used for financial statement reporting purposes.)

One major criticism of fair value accounting is that it can be difficult to apply in illiquid markets. FASB's projects on application guidance will address this concern by helping to: determine when a market for an asset or a liability is active or inactive; determine when a transaction is distressed; and apply fair value to interests in alternative investments, such as hedge funds and private equity funds. 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.

FASB has indicated that its timetable for completion of the application guidance is in time for financial reporting for the quarter commencing April 1 of this year and the completion of the disclosure guidance will occur in time for the annual report of the current calendar year.

In addition, FASB has also recently initiated projects to require disclosures about the value of financial instruments included in quarterly as well as annual reporting effective with the current quarter. Further, predating the SEC's fair value study, on Dec. 15, the FASB added an item to its agenda to consider permitting entities to recover certain previous write downs, or impairments, when evidence exists that the impairment has reversed.

In all, FASB has seven active projects that it has classified as "credit crisis" projects. Of these projects, three are directed at valuation of assets in difficult-to-value situations, two are directed at enhanced disclosures about fair value, and the additional two are directed at accounting for credit derivatives and the previously mentioned project to consider reversals of write downs under some circumstances.

The CAQ is supportive of the efforts of FASB to address these improvements in financial reporting, and while there may be additional aspects of fair value that need to be considered, the FASB's open deliberative process and its current timetable should provide us and others the opportunity to address these concerns on a very current basis. For example, in its comment letter to the SEC during its study of the fair value issues, the CAQ made several recommendations that could be considered by FASB, including some of which are likely to be addressed by the newly added projects. Those recommendations included the following:

- First, FAS 157 does not provide clear guidance about how to evaluate inputs when valuing an asset in a time of changing or disrupted market conditions. Guidance to aid in determining when a market is active or inactive, or when a particular transaction would be considered a "distressed" or "forced" sale not constituting evidence of fair value, would assist in exercising judgment in this area.

- Second, while FAS 157 creates a valuation method based first on principles and then provides certain examples in its appendices, providing more specific examples of the fair value measurements of various types of assets and liabilities under varying assumed market conditions would be very useful.

- Third, additional guidance on presenting, in financial statements and notes, the periodic changes in asset valuation would be helpful to provide more useful information to investors.

We also believe that the concerns expressed about the application of FAS 157 in distressed or illiquid markets could be addressed, at least in part, through clearer and more transparent disclosures. These disclosures could include information about the conditions present in a particular market and the assumptions and methods applied in the fair value measurement process. The recently added FASB projects provide an opportunity for consideration of these enhanced disclosures.

The SEC could also provide interpretive guidance that would clarify that entities that apply fair value accounting to financial assets and liabilities could provide any other relevant information regarding those assets and liabilities in Management's Discussion and Analysis. Of course, there is nothing to prevent a financial institution from providing such disclosures voluntarily, as contemplated by the letters from the SEC staff to public company management in March and September 2008. Such disclosures would help address the assertions of some who believe that fair value accounting forces institutions to use overly pessimistic market prices to value their assets. Investors and other financial statements users could look to these disclosures to make an informed judgment about the current financial position and estimated future cash flows of the entity.

**The Importance of Independent Standard Setting**

Accounting standards derive their legitimacy from the confidence that they are established, interpreted and, when necessary, modified based on independent, objective considerations. The development process must be free — in both fact and appearance — of outside influences that inappropriately benefit any particular participant or group of participants in the financial reporting system. Even the appearance of outside influence could create doubts about the integrity of the system. That's dangerous because once confidence in the process is lost, then confidence in the standards themselves and the willingness to follow them will erode as well.

In the context of accounting standards, that independent, objective standard-setting function has been fulfilled for more than three decades by FASB. Since 1973, FASB has engaged in an extensive deliberative process before it adopts any accounting standard. FASB's standards-setting process permits robust participation by all constituents, including the SEC. In fact, the SEC's CIFiR, which was established "to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors," recently studied this very question and concluded that, "[i]n general, we believe the design of the U.S. standards-setting process, including the process of issuing authoritative interpretive implementation guidance, and the role played by each participant are appropriate." The CAQ supports that conclusion.

CIFiR, in its final report to the Commission, found that five steps could improve FASB's standards-setting process: (i) increase consideration of investor perspectives; (ii) enhance governance and oversight; (iii) improve process; (iv) clarify the role of interpretations; and (v) improve standard design. The CAQ generally supports CIFiR's recommendations.

The CAQ firmly believes, however, that any changes to the standards-setting process should enhance, or at least be consistent with, the most important characteristic of any standards-setting process: independence. The current FASB process is independent, transparent, and subject to full public scrutiny. FASB's independent status contributes greatly to investor confidence by developing the accounting standards that define our financial reporting system based on objective analysis and not special interest preferences.

The urgency of the economic crisis only increases the need for procedural safeguards to protect against interventions that, while well-intentioned, are ultimately misplaced. Open process and independence are important to ensure the legitimacy of the standards-setting process, and to protect the goals of transparency, relevance and usefulness in financial reporting that have been hallmarks of decades of standards-setting efforts in the United States. Irrespective of one's views of any particular accounting standard, our entire system is best served by preserving the independence of the standard-setter.

**Conclusion**

The current crisis has created an appropriate desire for swift and meaningful action. Members of Congress and others who have contributed to the policymaking process deserve credit for summoning the will to confront this challenge directly and boldly.

Yet in responding to the crisis of the moment we must not lose sight of the fundamental underpinnings of our system. None is more critical than investor confidence in the reliability and transparency of financial reporting. That confidence is preserved by relying on an independent standard setter to promulgate accounting standards based on unbiased consideration; that confidence is bolstered by the assurance that those standards, independently and objectively derived, will not be suspended or changed in response to outside pressure; and that confidence is secured by all market participants working collaboratively to improve the quality of financial reporting through improved standards and implementation.

Reaffirming these core principles is the best and surest path toward bolstering investor confidence. In doing so, Congress can avoid the risk of exacerbating the current crisis and can help keep us on the road to a swift recovery. Fair value accounting did not cause our difficulties, and abandoning it will not solve them. Steps can be taken to improve the application of fair value standards going forward, and the CAQ stands ready to work with policymakers, regulators, standard setters and preparers to help accomplish this.

Thank you for the opportunity to be here. I look forward to working with the Subcommittee on these issues.