Testimony of

Lawrence W. Smith

Member

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Transparency in Accounting:
Proposed Changes to Accounting for Off-Balance Sheet Entities

Introduction

Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

Good afternoon. I am Larry Smith, a member of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I want to thank you for inviting me to participate at this very important hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the growth and stability of the United States economy because creditors, investors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make economic decisions. In other words, financial accounting and reporting is meant to tell it like it is, not to distort or skew information to favor particular industries, types of transactions, or particular political, social, or economic goals.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment.

In setting our standards, the FASB gives priority to the needs of investors because, in our view, the primary reason for developing high-quality accounting and external financial reporting standards is to enhance the efficiency of the capital markets by giving potential investors the information to confidently make lending and investing decisions. We also give careful consideration to the costs and benefits to companies that prepare the accounting information as well as the costs imposed on auditors, regulators, and the rest of society. In our view, these costs are important but secondary criteria for setting external financial reporting policy.

As significant reporting issues arise, the Board endeavors to understand those issues and to identify the reasons why they arose. Once the Board understands the underlying issues, it is able to assess whether there are potential accounting standard-setting matters that may need to be addressed. The events that have occurred recently in the credit markets resulted in such a review, and the Board accelerated its work in several specific areas.

For example, in May 2008, the Board issued guidance to improve disclosures related to derivative instruments and to improve accounting for revenues and expenses relating to financial guarantee insurance contracts. And, in 2005, the Board, aware that the volume of "nontraditional" loan products was proliferating and could increase the exposure of the originator, holder, investor, guarantor, and/or servicer to the risk of nonpayment or realization, issued guidance to reinforce the extensive existing accounting and disclosure requirements that would be applicable to such products.

The Board also is working on projects to improve disclosures about (a) credit derivatives and certain guarantees, (b) loans and loan losses, and (c) assets held in employer-sponsored postretirement benefit plans. While the work on all of these projects is important in light of recent economic events, the Board considers its work in the areas of transfers of financial instruments (i.e., Statement 140) and consolidations of variable interest entities (i.e., Interpretation 46(R)) to be of paramount importance.

Proposed Improvements to Statement 140 Influenced by Recent Events in the Credit Markets

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, addresses the accounting and disclosure of transfers of financial instruments. Its fundamental purpose is to address when the transfer of a financial instrument (such as a loan receivable) should be accounted for as a sale rather than as a secured borrowing. One of the fundamental criteria that must be met under Statement 140 to qualify as a sale is that the transferee, that is, the buyer of the financial instrument, must be able to sell or pledge the financial instrument. Nevertheless, transfers to special-purpose entities (that meet certain criteria) qualify for sale accounting under Statement 140 despite provisions that prohibit the SPE from selling or pledging its assets. This special provision for transfers to qualifying special-purpose entities (QSPEs) is what enables transferors to derecognize loans sold through securitization transactions. The criteria to qualify as a QSPE relate to restrictions on the permitted activities of a QSPE. Specifically, Statement 140 requires that the activities of a QSPE must be "significantly limited" and "entirely specified" in the legal documents creating the QSPE. In other words, the QSPE has very restricted decision-making authority because the entity was supposed to be able to function on "autopilot." This lack of decision-making authority is the basis for allowing transfers to QSPEs to be accounted for as sales despite the restriction on a QSPE's ability to pledge or sell its assets. The QSPE was viewed as a way of selling financial instruments to a number of buyers, that is, the holders of the beneficial interests in the QSPE, while restricting the ability of the transferor to benefit from the operation of the QSPE.

The Board has a project under way to amend Statement 140 to address (a) practices that have developed since that Statement's issuance that are not consistent with the original intent and key requirements of the

Statement and (b) concerns of financial statement users that many of the financial assets (and related obligations) that have been derecognized should continue to be reported in the financial statements of transferors. The Board's current deliberations to revise the Statement are the result of an extensive review of comments received on earlier Exposure Drafts to amend Statement 140, subsequent constituent inquiries (including financial statement user requests for greater transparency), and market conditions over recent years including, but not limited to, the impact of the recent credit crisis in the United States. This research and analysis have led Board members to the conclusion that because of the range of financial assets being securitized and the complexity of securitization structures and arrangements, the current qualifying SPE criteria are being stretched well beyond the original intent and requirements of Statement 140 that its activities be "significantly limited" and "entirely specified."

The Board considered an approach that would have clarified and strengthened the existing criteria for a qualifying SPE. After careful consideration Board members concluded that it is not possible to create an entity that functions on "autopilot" because few classes of financial assets are truly passive as envisioned in the qualifying SPE concept. As a result, the Board decided to remove the concept of a qualifying SPE from Statement 140. This change is a fundamental change in the accounting for transfers of financial instruments and, as discussed in the next section, has significant implications on the consideration of who, if anyone, should consolidate entities that were previously considered QSPEs.

Proposed Improvements to Interpretation 46(R) Influenced by Recent Events in the Credit Markets

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* was created post Enron to address weaknesses in financial reporting of interests in thinly capitalized entities for which the traditional concepts of consolidation for voting interest entities do not work. In creating Interpretation 46(R) the

Board considered the existing restrictions surrounding the powers and activities of a QSPE and concluded that QSPEs should not be subject to the consolidation model created by the Interpretation. The basis for that decision was that the QSPE's activities are extremely limited such that they are on "autopilot"; hence, no one controls the QSPE.

As a result of its decision to remove the concept of the qualifying SPE from Statement 140, the Board decided to remove the scope exception for qualifying SPEs from consolidation guidance, including the guidance in Interpretation 46(R). The Board considered the potential impact of the elimination of the qualifying SPE concept on the application of Interpretation 46(R) to formerly qualifying SPEs and noted that the elimination would put additional pressure on the framework of the existing model under Interpretation 46(R). Additionally, in light of recent events in the credit markets, financial statement users have expressed concerns that many variable interest entities have not been consolidated by the entity that maintains effective control over those SPEs. As a result of these and other concerns, the Board decided to add a separate but related project to reconsider the guidance in Interpretation 46(R).

Currently, the guidance in Interpretation 46(R) requires an enterprise to consolidate a variable interest entity if the enterprise has a variable interest or interests that will absorb the majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. The Board created this requirement because it believed that the party that has the obligation and right to absorb a majority of the entity's expected losses or expected residual returns would be the party in control of the entity. That assessment is performed by calculating the variable interest entity's expected losses and expected residual returns (a quantitative analysis) to determine which enterprise, if any, is required to consolidate the variable interest entity. A variable interest entity's expected losses and expected residual returns are determined by calculating the expected negative variability (for losses) and positive variability (for returns) in the fair value of its net assets, exclusive of variable interests.

Investors were troubled that the quantitative analysis often seems to identify a different primary beneficiary of a variable interest entity from that identified by applying a qualitative analysis to the same entity. For example, the Board understands that sponsors of certain structured finance vehicles that are variable interest entities avoid consolidation of the entities by selling interests to third parties that would absorb the majority of the expected losses (expected loss note holders). The expected loss note holder receives a substantial return on its investment but typically has very limited power, if any, to direct matters that most significantly impact the activities of the variable interest entity. Additionally, the maximum exposure to economic losses that can be absorbed by the expected loss note holders is typically limited to their investment in the notes, while other variable interest holders may be at risk of incurring significantly larger economic losses. The Board understands that the expected loss note holders frequently held a very minor position in the variable interest entity, yet, as a result of the judgments behind the expected loss calculations, they were deemed to be the holder of the majority of expected losses.

The Board generally agreed with the concerns about the application of the quantitative analysis required by Interpretation 46(R) and the related results. Some Board members believed that the predominant issues may not be attributed to the calculation itself but to the quality of inputs into the analysis, including the use of overly optimistic assumptions that did not contemplate all the relevant risks. However, Board members acknowledged that the calculation was complex and difficult to apply.

The Board decided to propose amending Interpretation 46(R) to require that an enterprise initially perform a qualitative analysis about the enterprise's power to direct the activities of the variable interest entity. A quantitative analysis based on the expected losses calculation would be performed only when an enterprise cannot determine whether or not it meets the qualitative criteria. The Board expects there will be few situations in which an enterprise must perform a quantitative analysis and, thus, has proposed requiring that the enterprise disclose an explanation for its use of that analysis.

In addition to the change discussed above, the Board decided that an entity's status as a variable interest entity and an enterprise's status as primary beneficiary should be assessed in an ongoing manner rather than performed only upon certain triggering events.

Proposed Enhanced Disclosure Requirements

Disclosures serve to provide complete and transparent information to users of financial statements. This information enhances information contained in an enterprise's financial statements by describing both qualitative and quantitative information. Statement 140 currently includes disclosure requirements regarding the transferor's continuing involvement in a securitization transaction including, but not limited to, servicing, recourse, and restrictions on retained interests. Likewise, Interpretation 46(R) requires an enterprise that holds a significant variable interest in a variable interest entity to disclose the nature of its involvement; the nature, purpose, size, and activities of the variable interest entity; and the entity's maximum exposure to loss as a result of its involvement with the variable interest entity. Despite these requirements, the Board is making disclosure improvements to Statement 140 and Interpretation 46(R).

First, the Board is proposing a short-term improvement designed to provide users with additional information about transfers of financial assets and interests in variable interest entities until the recognition and measurement amendments discussed earlier are effective. This short-term improvement will include principal objectives of the disclosure requirements for both Statement 140 and Interpretation 46(R), which, if not met by the specific requirements, would require reporting entities to expand their disclosures until the objectives are met. Second, the short-term improvement will require certain disclosures about (a) a sponsor that has a variable interest in a variable interest entity (irrespective of the significance of the variable interest) and (b) a nontransferor enterprise that holds a significant variable interest in a qualifying SPE. And, third, the final amendments to Statement 140 and Interpretation 46 (R) discussed above will include the applicable disclosure principal objectives and requirements that are included in the short-term improvement. All of these disclosure improvements will provide users of financial statements with (a) an improved understanding of a transferor's continuing involvement with transferred financial assets, the risks inherent in the transferred financial assets that have been transferred or retained, and the nature and financial effect of restrictions on the transferor's assets that continue to be reported in the statement of financial position and (b) information about an enterprise's involvement in a variable interest entity, including a requirement for sponsors of a variable interest entity to disclose information even if they do not hold a significant variable interest in the variable interest entity.

Expected Impact of Proposed Changes

We expect that these improvements to financial reporting will provide users with more relevant, comparable, and transparent information about the past and potential effects of a transferor's continuing involvement and the current or potential financial effects of an enterprise's involvement with a variable interest entity. This will better enable investors to understand the impact on an enterprise's financial position, financial performance, and cash flow.

Effective Dates of Proposed Amendments

Given the current economic environment, the Board concluded that the requirements of the proposed Statements to amend Statement 140 and Interpretation 46(R) should be effective as soon as reasonably possible. The Board considered various alternatives for the effective date; however, the majority of users asserted that a single effective date would provide for a more rational and understandable implementation. The Board recognizes the urgency of addressing these issues, but it ultimately concluded that the proposed Statements should have one single effective date so as to provide sufficient time for preparers and regulators to review the capital adequacy of regulated financial institutions and to provide preparers with ample time to renegotiate items such as debt covenants, if necessary. When the Board concluded that the proposed Statements should be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2009, the Board decided to issue the short-term disclosure improvements discussed earlier (which will be effective at the end of the reporting period in which the guidance is issued, regardless of whether it is an annual or interim period) to serve as interim guidance until the final Statements become effective.

Future Project Plans

The Board issued the Exposure Drafts of the proposed amendments to Statement 140 and Interpretation 46(R) and the draft FASB Staff Position (FSP) on the short-term disclosure improvements on September 15 for public comment, and it plans to hold a public roundtable in November. The Board invites individuals and organizations to send written comments on all matters of the proposed amendments. The Board will consider all comments received during its redeliberations of the proposed amendments. The

Board currently plans to complete its redeliberations and issue the final FSP in November and the final amendments to Statement 140 and Interpretation 46(R) in the first quarter of 2009.

The FASB and the IASB have agreed to long-term objectives to improve, simplify, and reach convergence on financial reporting requirements for financial instruments. A joint research project is under way to simplify and improve the accounting for financial instruments. The FASB and the IASB plan to discuss the status of the projects and future plans to work together at our upcoming joint Board meeting in October.

Conclusion

I have provided an overview of the recent actions and activities at the FASB relating to "off-balance-sheet entities." We share your Subcommittee's concerns about the role these entities have played in the current financial crisis. The fundamental issue relates to shortcomings in the transparency of information available to investors to enable them to understand the true financial reporting status of reporting entities, particularly in the financial services industry. This is why the Board has undertaken these projects to clarify and improve the standards for transfers of financial instruments and off-balance-sheet entities.

Thank you again, Mr. Chairman, Ranking Member Allard, and all of the Members of the Subcommittee. I very much appreciate your continuing interest in, and support of, the mission and activities of the FASB.

I would be happy to respond to any questions.