Testimony Concerning Transparency in Accounting, Proposed Changes to Accounting for Off-Balance Sheet Entities

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Before the Subcommittee on Securities, Insurance, and Investment Committee on Banking, Housing, and Urban Affairs, United States Senate

September 18, 2008

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

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (Commission) concerning transparency in accounting and the FASB's proposed off-balance sheet accounting improvements. This testimony is presented jointly on behalf of the Office of the Chief Accountant, which advises the Commission on accounting and auditing matters, and of the Division of Corporation Finance, which is responsible for overseeing disclosures by domestic and foreign issuers of securities.

The Commission's Commitment to High Quality Accounting Standards

High quality accounting standards are the foundation of a financial reporting system that is responsive to investor needs. An open process that allows standard setters to seek and thoughtfully consider the views of market participants is critical to establishing, maintaining, and continually improving financial accounting and reporting standards. We are committed to high quality accounting standards and a transparent financial reporting system that meets the needs of investors and other market participants.

The Commission's Commitment to Improving Transparency in Financial Reporting

Transparency is the cornerstone of world class financial reporting. Transparent and unbiased financial reporting allows investors to make informed decisions based upon a company's financial performance and disclosures. A clear, concise, and balanced view into the companies that participate in our capital markets is fundamentally important to those who choose to invest in our markets. Informed decision making results in efficient capital allocation.

Transparent financial reporting that conveys a complete and understandable picture of a company's financial position reduces uncertainty in our markets. Surprises are reduced or avoided when a company provides clear and understandable information about existing risk and uncertainty, particularly where such risk and uncertainty is reasonably likely to have a current or future impact on that company. However, we do not live in a static world. Circumstances and risks change and, as a result, disclosure about those risks evolves.

No better example of this exists than our recent experience with off-balance sheet accounting and disclosure in the financial services sector. In response to the Sarbanes-Oxley Act of 2002, the Commission adopted a number of new and revised disclosure requirements. Among these were the specific changes in Item 303(a)(4) of Regulation S-K relating to off-balance sheet transactions. Under this disclosure requirement, financial institutions with off-balance sheet arrangements are required to provide certain disclosure regarding those arrangements if those arrangements are reasonably likely to have a current or future effect on the company's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. An institution is not required to provide this disclosure until it determines that a current or future effect is material and reasonably likely. A financial institution with a large off-balance sheet arrangement may not provide disclosure about that arrangement in one period because, at the date of the balance sheet for that period, the institution determined that it was not reasonably likely to have a future material impact upon the institution's financial statements. However, circumstances can, and often do, change. In a subsequent period, the institution may reach a different materiality conclusion and determine that it is appropriate to provide disclosure about that off-balance sheet arrangement. As its exposure to loss evolves, the associated disclosure about the likely financial statement impact will evolve as well.

We remain focused on enhancing financial reporting transparency. We continue to work with companies to improve their disclosure about off-balance sheet transactions. As part of our mandate, the Division of Corporation Finance (the Division) regularly evaluates public company financial disclosure transparency. Through its regular and systematic review of public companies, in 2007 the Division determined it would be appropriate to identify a number of items companies with off-balance sheet arrangements may want to consider in preparing their Management's Discussion and Analysis of Financial Condition and Results of Operations. In a December 2007 letter to a number of large financial institutions, the Division highlighted these items and encouraged these companies to consider whether they could improve the transparency of their financial reporting based on this disclosure guidance.

Another example of efforts to improve the transparency of financial reporting is the Division's March 2008 letter to large financial institutions concerning fair value disclosure practices. Like the December 2007 letter regarding off-balance sheet transaction disclosure, this letter highlighted items companies may wish to consider in providing transparent disclosure of fair value accounting. Our ongoing reviews of public companies suggested that additional guidance would be helpful, and as a result, just this week, the Division issued a similar letter in which it provided additional guidance on this topic.

Although we have noted an improvement in the transparency of financial reporting relating to off-balance sheet transactions and fair value accounting, the Division continues to monitor and evaluate disclosure about them. We will, as necessary, ask companies to improve the transparency of their disclosure. Where we are unable to achieve improved disclosure through the review and comment process, we stand ready to take any necessary action, including referring companies with material disclosure deficiencies to the Division of Enforcement.

Investors, analysts, auditors, and preparers of financial disclosure play a fundamental role in improving the transparency of financial reporting. We continually receive input on and suggestions for changes in the financial reporting framework from a broad range of interested persons. In some instances this exchange of information is informal and in others, it is more formal.

As an example, when we and market participants became concerned about compliance with our disclosure rules relating to certain off-balance sheet securitization arrangements, the FASB, at the request of the Commission's Office of Chief Accountant, hosted an educational forum in June 2007 where a diverse range of market participant representatives discussed their concerns. The discussion in this forum provided the necessary background information for staff guidance on the accounting for mortgage loan modifications – guidance that was vital given the growing concerns about the nation's housing market.[1] Ongoing market developments and the insight we gained at this forum highlighted the need for the FASB to quickly address certain aspects of the accounting for off-balance sheet arrangements. In a January 2008 letter to leaders in the financial reporting community, the Commission's Office of Chief Accountant provided additional staff guidance on the accounting for mortgage loan modifications. In this letter, we asked the FASB to prioritize its efforts to address the accounting for off-balance sheet arrangements.[2]

As another example, the Commission held a roundtable in July 2008 during which a broad range of market participants discussed fair value accounting standards and the transparency of financial reporting. At that meeting, panelists discussed their experience with fair value, or "mark-to-market," accounting, and the challenges they face in applying the accounting standard. Panelists agreed that fair value accounting increases transparency and provides relevant financial information. Panelists also agreed that the FASB's recent guidance on fair value accounting helps improve transparency. However, the panelists shared their views on how difficult it was to implement fair value accounting in the current market environment. To address this feedback, we understand that the FASB is working closely with its counterparts at the International Accounting Standards Board (IASB) to consider whether additional real time guidance would be useful.

Finally, last month, the Commission hosted a roundtable at which panelists discussed how International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP) have performed during the recent period of market turmoil.[3] Again, the Commission asked a broad range of market participants to describe their experiences and share their thoughts. The Commission invited the FASB and IASB to participate in the meeting as well. At the meeting, while panelists generally agreed that the FASB and the IASB should continue to work to improve the accounting for, and disclosures of, off-balance sheet arrangements, a number of panelists clarified that international consolidation standards, such as SIC 12,[4] place a greater emphasis on control, which often results in greater levels of assets and liabilities remaining on balance sheet.

We have found educational forums and meetings to be extremely useful ways to solicit market participant views on how we can improve transparency in financial reporting. However, they are not the only source of this important input. For instance, in July 2007, Chairman Cox established the Advisory Committee on Improvements to Financial Reporting (CIFiR) and asked it to provide recommendations on how our financial reporting system could be improved to the benefit of investors. The CIFiR members represented a diverse group of capital market leaders who provided a fresh perspective on the use of financial reporting. In the 25 recommendations it presented in its August 2008 report, CIFiR made clear that a straight-forward, understandable, and balanced financial reporting framework provides investors with transparent information.[5] The Commission and its staff look forward to working with the FASB and other market participants as it considers the CIFiR recommendations.

FASB's Proposal on Off-Balance Sheet Arrangements

The continued review of the effectiveness of existing accounting standards for off-balance sheet arrangements and recent capital market pressures have highlighted areas for improvement in the existing accounting guidance for off-balance sheet arrangements.

The primary guidance for accounting for off-balance sheet arrangements for financial instruments is contained in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*. FAS 140 and FIN 46R are the two sources of guidance market participants have identified for improvement.

In FAS 140, the FASB provides guidance on how a company should determine whether it should account for cash received for a financial asset (for example, a mortgage loan) as a sale (off-balance sheet) or as a secured loan (on balance sheet). If the company does not account for the transaction as a sale, it must record the mortgage loan and related borrowing of cash separately (i.e., grossed up) on the balance sheet.

The FASB adopted FIN 46R to address off-balance sheet arrangements after the Enron fallout. In FIN 46R, the FASB provides guidance on how a company should determine whether it should include the assets and liabilities held in special-purpose entities, or SPEs, including commercial paper conduits and other structured finance vehicles, or SIVs, in its balance sheet. Following FIN 46R, a company must consolidate the assets and liabilities of a SPE if it has the majority of the associated risks or rewards. However, it is important to note that if assets and liabilities are held by a securitization trust that is a Qualified SPE, or a passive trust with limited and predetermined activities, FAS 140 prohibits their consolidation and the company must keep those assets and liabilities off its consolidated balance sheet. This exception is commonly referred to as a "QSPE scope exception." We believe that "scope outs" or "scope exceptions" should be used sparingly since economically similar transactions will result in different accounting outcomes. Such a result can unnecessarily increase the complexity of financial reporting and, it is for this reason, the CIFiR recommended that the FASB reduce or eliminate the use of scope exceptions when they develop standards.

In January 2008, the Commission staff asked the FASB to consider the need for further improvements to the accounting and disclosure for off-balance sheet transactions involving securitization arrangements. Further, in March 2008, the President's Working Group on Financial Markets made similar recommendations to improve the accounting and disclosure for these transactions. To address these requests, the FASB has thoughtfully undertaken a project on off-balance sheet arrangements and has moved expeditiously to expose proposed guidance. Based on the potential far-reaching impact of this accounting topic and the important due process procedures required to evaluate and implement any potential changes to it, the speed at which the FASB has moved this project forward is commendable.

On Monday, September 15, 2008, the FASB proposed amendments to FAS 140 and FIN 46R. Under the proposed amendments, the FASB would eliminate what is commonly referred to as the QSPE scope exception. Eliminating the QSPE scope exception would subject all securitization transaction trusts and other vehicles to a single consolidation accounting model. The FASB's proposal would introduce a new accounting model that will focus the consolidation analysis on qualitative indicators of control and reduce the reliance on mathematical calculations. The new model, which more closely aligns with relevant international standards than the current guidance, would become the relevant guidance for companies to follow when determining whether they should consolidate their SPEs.

In response to a number of other issues we have referred to the FASB as a result of our ongoing review of company filings, the FASB's revised model would also require a company to take into account the impact of current economic conditions at each balance sheet date as it makes its consolidation assessment. The existing FIN 46R model generally requires a company to re-evaluate its consolidation of off-balance sheet transactions only when there is a change in the SPE's structure or upon the company's purchase of an additional interest in the SPE. As a result, the existing model can result in a company's identification of significant asset exposure in the notes to its financial statements rather than in its balance sheet.

If the FASB adopts the proposed rule changes, we believe SPE sponsors would consolidate a significant portion of existing off-balance sheet arrangements, including some portion of the existing QSPEs, SIVs and commercial-paper conduits. However, an accurate assessment of the full impact of the proposed amendments will not be possible until companies have an opportunity to study and measure their effects. It is difficult, if not impossible, to predict how structured finance will evolve and how the proposed amendments will affect the accounting for yet unforeseen arrangements. However, the Commission staff strongly believes that the proposed amendments hold promise in enhancing financial reporting transparency and we will monitor their effectiveness and mandate further change if necessary.

In November 2008, after a 60-day public comment period, we expect the FASB to host a public roundtable on the proposed amendments. While we strongly support the FASB's objective of improving the accounting and disclosure for off-balance transactions, public input is critical to the development of high quality accounting standards. We cannot predict the nature and extent of public response to the proposed amendments, nor at this time can we predict the full impact the proposed amendments may have on capital formation and the operation of our capital markets. The Commission staff will monitor public comments on the proposals as well as the views of all market participants and will work closely with the FASB and other regulators as this important due process proceeds.

To ensure that market participants have adequate time to fully consider the proposed amendments before the FASB finalizes and implements them, the FASB has proposed that most companies apply changes in the reporting for off-balance sheet transactions on January 1, 2010. Additionally, to provide enhanced financial reporting transparency prior to completing its work on the proposed amendments, the FASB plans to adopt requirements for additional information regarding the risk and involvement with SPEs before the end of this year. Under the new requirements, companies will provide enhanced SPE disclosure no later than first quarter 2009.

We remain committed to the ongoing review of our accounting framework to identify enhancements to financial reporting transparency. Echoing our commitment to continual review, CIFiR reaffirmed the benefits of a post-adoption review of new accounting standards in its August 2008 report. Our work in the area of the accounting for off-balance sheet arrangements is just an example of why a post-adoption review is necessary to our ongoing efforts to improve financial reporting.

Enforcement Related Activities

You asked us to discuss the adequacy of the Commission's enforcement mechanisms and any contemplated changes and to discuss planned enforcement actions should companies fail to comply with required disclosure requirements. As you probably know, it is the Commission's policy to conduct investigations on a confidential basis, and generally not to disclose the existence or non-existence of an investigation until it is made a matter of public record in proceedings before the Commission or the courts. That said, the Commission regularly investigates allegations of possible accounting irregularities or reporting violations by issuing subpoena requests for documents, taking sworn testimony of witnesses, and otherwise vigorously investigating meritorious allegations, and it is fair to say that, were the Commission to become aware of possible disclosure or accounting issues involving FAS 140, the Division of Enforcement ("Enforcement") would undertake an initial investigation of those allegations and the Commission would direct Enforcement to pursue a formal investigation if the facts warrant.

And, while we cannot comment on pending investigations, the Commission has brought significant actions for failing to comply with the requirements of FAS 140 or its predecessor, FAS 125. Enforcement recently concluded a financial fraud investigation involving improper accounting for mortgage-related transactions under FAS 140 by three NYSE-listed Puerto Rico financial institutions: Doral Financial, R&G Financial and First BanCorp. The Commission alleged that Doral Financial improperly recognized gain on sales of approximately $3.9 billion in mortgages to First BanCorp. Those transactions allegedly were not true sales under FAS 140 because of oral agreements or understandings between Doral Financial's former treasurer and former director emeritus and First BanCorp senior management providing for recourse beyond the limited recourse established in the written contracts. The Commission alleged that R&G Financial improperly recognized gain on sales of mortgages under FAS 140 because of full recourse provisions in the written contracts.

Doral Financial settled for a fraud injunction and a $25 million penalty [*SEC v. Doral Financial Corporation*, LR-19837 (Sept. 19, 2006)]; First Bancorp settled for a fraud injunction and $8.5 million penalty [*SEC v. First BanCorp*, LR-20227 (August 7, 2007); R&G Financial settled for a fraud injunction [*SEC v. R&G Financial Corporation*, LR-20455 (Feb. 13, 2008)]; a former Morgan Stanley Vice President pleaded guilty to lying during the investigation; Doral Financial's former Treasurer was indicted on related criminal securities fraud charges; and First BanCorp's former CEO and CFO settled for fraud injunctions, officer and director bars and civil money penalties [*SEC v. Alvarez and Astor*, LR-_______ (Sept. ___, 2008).

Additionally, the Commission has brought actions against Canadian Imperial Bank of Canada, PNC and Raytheon for transactions accounted for under FAS 125 or FAS 140. The Commission has also named individuals for their role in certain FAS 125 and FAS 140 transactions, including former Enron CEO and Chairman Ken Lay, former Enron CEO Jeff Skilling, former Enron CFO Andrew Fastow and former Enron CAO Richard Causey.

Going forward, in the event companies fail to comply with disclosure requirements, the Commission would consider the individual facts and circumstances as to why the companies failed to comply, and would take the fact of failed compliance as well as other applicable facts into consideration in determining whether enforcement action would be appropriate.

Conclusion

We are committed to our role in setting high quality accounting standards. We are committed to supporting the FASB's role in this process. The FASB's recent proposals regarding the accounting for off-balance sheet arrangements represent a positive step in a necessary process of continually reevaluating our accounting standards to make sure they result in transparent financial information. Evaluating the views of all market participants is essential to developing effective accounting standards. We believe the Commission's and the FASB's ongoing efforts to improve the accounting for off-balance sheet arrangements are consistent with our role in setting high quality accounting standards and improving transparency in financial reporting information.

[1] http://www.house.gov/apps/list/press/financialsvcs_dem/sec_response072507.pdf.

[2] Letter from SEC Chief Accountant to Arnold Hanish, Chairman, Committee on Corporate Reporting, Financial Executive International and Sam Ranzilla, Chairman, Professional Practice Executive Committee, The Center for Audit Quality, American Institute of Certified Public Accountants concerning the American Securitization Forum's Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans, January 8, 2008 .

[3] http://www.sec.gov/spotlight/ifrsroadmap/ifrsround080408-transcript.pdf.

[4] SIC Interpretation No. 12, "Consolidation – Special Purpose Entities"

[5] Final Report of the Advisory Committee on Improvements to Financial Reporting, August 1, 2008.