Testimony of
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before the
Securities, Insurance, and Investment Subcommittee
of the
Committee on Banking, Housing, and Urban Affairs

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

Thank you for your interest in improving Financial Reporting and promoting American leadership in Capital Markets.

Accounting standards have been a major factor in reducing transparency for investors and have directly contributed to the current credit crisis. I do not believe the proposed Financial Accounting Standards Board (FASB) solution will stop the 'cycle of crisis' that we have now repeated. And I believe it would be a mistake to focus on expanded regulation alone.

A better solution is to provide transparency in the reporting of securitizations and increase investor involvement in Financial Reporting to end the 'cycle of crisis'.

The FASB Proposed Solution

Under the proposed FASB solution, the self-administered test for "special purpose entities" in Statement of Financial Accounting Standards No. 140 (FAS 140) will be replaced by another self-administered test in a revised FASB Interpretation No. 46 (revised) (Fin 46R).

These custom designed entities that are the subject of the self-administered test provide little transparency to investors and are largely free from market forces. Their business purpose is to get favorable accounting treatment.

The proposed rules will likely force consolidation of special purpose entities designed in the past. But the more important question is: " Will future securitization structures enable management to inappropriately de-recognize financial assets and liabilities and book gains?" I believe preparers will continue to pass the self-administered test.

Market transparency would be better served and the accounting simplified if the FASB had pursued a model where an originator/arranger continues to recognize financial assets and liabilities while there is any continuing involvement. The determination of whether a sale has occurred is shifted from management and auditors to investors and markets.

Senator Reed's letter of September 2, 2008 specifically asks about the implications of the deferral of the proposed changes. I believe this is a critical question because it appears an option will be provided to certain preparers to adopt International Financial Reporting Standards (IFRS) and International Accounting Standard 39 at the same time as the proposed changes to FAS 140 and Fin 46R.

In my discussions with International Accounting Standard Board (IASB) members and the examination of 20F reconciliations by foreign filers with US GAAP, it is not clear whether international standards are any better or worse than the existing FAS 140 application. (Ciesielski, 2007)

But this I can say. It is rare, if ever, that market transparency or investor's needs are aided by optional accounting treatments.

The Cycle of Crisis.

In early 2005 when I first joined the Financial Accounting Standards Board, the board was very aware of the problems in accounting for securitizations. It was the subject of a joint conference with the American Accounting Association where research was presented that indicated investors' near complete distrust of FAS 140 accounting. Investors generally reversed the sale accounting propagated by the standard. (Yohn, 2005)

The FAS Board was working on changes to statement 140 which were exposed for comment in 2005 (this in turn followed a failed exposure draft in 2003) but very little progress was made in 2006 and 2007 when the sub-prime securitization was rapidly expanding.

For most of the period - there was an unending series of issues related to FAS 140 where we made little progress:

1. Can an affiliate of the securitization/originator/transferor provide credit support and still get "sale accounting"?
2. What are limits to activities in the passive securitization entities? (Can an entity that has invested in financial instruments with long-term maturities and refinances with short-term debt be a passive entity?)
3. What activities can a "servicer" perform and still get "sale accounting"?

There is no question that the FASB knew it had a serious problem in the financial reporting of securitizations.

The question is: " Why was it not addressed until after this crisis was evident?"

When I asked the staff the reasons for the delay, I was informed that there were concerns over the standard setting actions we were considering, which would more accurately reflect the underlying economics, would in turn undermine companies' ability to execute securitization worth many billions of dollars. It would be bad for business to provide transparency … at least in the short term.

There was unending lobbying of the FASB not just by preparers, which should be expected, but also by their regulators – all looking to preserve 'sale accounting' for activities that clearly indicate that there was 'no sale'.

The SEC, for example, was actively involve in expanding the originator's ability as a servicer to renegotiating loans yet still keep 'sale accounting' and potentially harming investors in the securitization (Hewitt, 2007 and Ashcraft, 2007)

The FAS 140 exposure draft issued in 2005 failed to make much progress in 2006 and 2007. Another factor noted by the FASB staff was resistance from Federal Reserve regulators.

My purpose is not to argue that company managements need to be protected from harming themselves – because in the end that is what happened. Nor is it to criticize regulators but rather to recognize their limitations.

The essential problem is that the FASB is not capable of providing financial reporting transparency – until a crisis provides the political cover to overcome lobbying efforts that are in conflict with serving investors and providing transparency to the markets.

Need for Governance to Be Aligned With Investors

Because managements and regulators control the financial reporting process, we will continue to be in the 'cycle of crisis' where we are unable to address financial reporting problems until a major crisis unfolds.

You can end the 'cycle of crisis' only by engaging the markets and investors in the financial reporting process, which requires a fundamental change in the composition of standard setters and their trustees. Instead of token investor representation, or in the case of the FASB today – no investor representation, we need investors to be equally represented. Then we would have a chance of stopping the 'cycle of crisis'.

Thank you again Mr. Chairman for inviting me to testify at this hearing. I look forward to responding to your questions.

References

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