TESTIMONY OF

DONALD T. NICOLAISEN, CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING

ACCOUNTING FOR DEFERRED PURCHASE PRICE ADJUSTMENTS AND FOR DERIVATIVES AND HEDGING ACTIVITIES

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 9, 2005

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

Thank you for the opportunity to testify today concerning accounting issues related to deferred purchase price adjustments and to derivatives and hedging activities. My name is Donald T. Nicolaisen and I am the Chief Accountant for the Securities and Exchange Commission ("SEC" or "Commission"). As the Chief Accountant, I am the principal adviser to the Commission on accounting and auditing matters. The views I express today, however, are my personal views and my testimony has not been reviewed or approved by the Commission.

As the Subcommittee has requested, my testimony addresses my decision in December 2004 that certain accounting practices of the Federal National Mortgage Association ("Fannie Mae") did not comply in material respects with specific provisions within generally accepted accounting principles ("GAAP").

Fannie Mae has disclosed that the Commission is investigating certain issues associated with Fannie Mae's accounting and disclosure practices. I and others at the Commission appreciate the Subcommittee's recognition of the non-public nature of the Commission's active investigation. In light of the Commission's ongoing investigation, I ask that the Subcommittee understand my reluctance to address at this time specific issues related to Fannie Mae's compliance with the federal securities laws. You may be assured that the Commission staff thoroughly is investigating any evidence of financial reporting improprieties. My statements today will be confined to the public record[1] and, because the Commission has not expressed any opinion or views on these matters, my statements should not be attributed to the Commission.

Fannie Mae's Filing Status

Fannie Mae is the largest non-bank financial services company in the world and the nation's largest source of financing for home mortgages.[2] Fannie Mae's common stock is listed on the New York Stock Exchange and, after discussions with the Commission staff, on March 31, 2003, Fannie Mae voluntarily registered its common stock with the Commission under section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act").[3]

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1 The information contained in this statement concerning Fannie Mae's accounting practices is based upon publicly available information.

2 *See, e.g.*, Fannie Mae News Release dated December 17, 2004.

3 *See* Letter from Ann M. Kappler, Fannie Mae, and response from Martin P. Dunn, Deputy Director, Division of Corporation Finance, U.S. Securities and Exchange Commission (publicly available July 12, 2002), for a discussion of the sections of the Exchange Act that apply to Fannie Mae and the application of other provisions of the securities laws to Fannie Mae.

Commission Staff Review

As the Subcommittee is aware, the Office of Federal Housing Enterprise Oversight ("OFHEO"), Fannie Mae's safety and soundness regulator, is in the process of reviewing several of Fannie Mae's accounting practices, focusing on the implications of those practices on the adequacy of Fannie Mae's regulatory capital, the quality of its management, and the overall safety and soundness of the enterprise. OFHEO issued a report of its preliminary findings on September 17, 2004,[4] and last October officials from both OFHEO and Fannie Mae testified before this Subcommittee on issues discussed in that report.

Following the issuance of OFHEO's report, Fannie Mae sought guidance from the Commission's accounting staff regarding Fannie Mae's compliance with Statement of Financial Accounting Standards No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" ("Statement No. 91"),[5] and Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("Statement No. 133").[6]

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4 Office of Compliance, OFHEO, "Report of Findings to Date: Special Examination of Fannie Mae" (September 17, 2004).

5 The Financial Accounting Standards Board ("FASB") issued Statement No. 91 in December 1986. This statement establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. The statement applies to all types of loans (including debt securities) and to all types of lenders.

6 The FASB issued Statement No. 133 in June 1998, and has amended it on several occasions. The statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as a hedge against (a) changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) the exposure to variable cash flows of a forecasted transaction, or (c) certain foreign currency exposures. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

Although the SEC accounting staff may choose not to provide such guidance while there are pending investigations by the Commission and other agencies, Fannie Mae requested our guidance because, in its view, these accounting issues received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty.

To facilitate our review, Fannie Mae and OFHEO voluntarily provided the Commission's accounting staff with information and with explanations of their views of the application of Statement Nos. 91 and 133. Fannie Mae did not ask the accounting staff to express any views regarding whether the information provided by Fannie Mae or OFHEO was accurate or complete or to develop additional facts and, in providing the requested accounting guidance, we did not do so. Accordingly, the accounting staff's guidance was based on the information voluntarily provided by Fannie Mae and OFHEO.[7] In addition, the SEC accounting staff did not consider the appropriateness of Fannie Mae's business decisions to use financial or derivative instruments or to hedge its risks, but limited its consideration to whether the accounting used to record those transactions complied with Statement Nos. 91 and 133.

In light of the public attention and uncertainties cited by Fannie Mae, on December 15, 2004, the Commission's accounting staff issued a press statement containing our views.[8] In that press release, the SEC accounting staff indicated that, based upon our review of the information provided by Fannie Mae and OFHEO, during

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7 As noted elsewhere is this testimony, the Commission's investigation into these matters is continuing.

8 Press Release No. 2004-172, "Office of the Chief Accountant Issues Statement on Fannie Mae Accounting" (December 15, 2004).

the period from 2001 to mid-2004 Fannie Mae's accounting practices did not comply in material respects with the accounting requirements in Statement Nos. 91 and 133.

Statement No. 91

Regarding Statement No. 91, during the period under the SEC staff's review, Fannie Mae failed to record timely adjustments to the recorded amount of its loans based on changes in the estimated speed with which those loans would be prepaid. Among other requirements, Statement No. 91 provides that when applying the method used by Fannie Mae an entity should use its best estimate of expected prepayment rates in calculating the carrying amount of its loans.[9] Fannie Mae already had concluded that its methodology for performing these calculations for interim balance sheet dates in the periods 2001 through 2002 was not consistent with Statement No. 91, and had stated that it has changed its accounting policies to, among other things, calculate the amounts based on quarter-end positions rather than projected year-end positions.[10]

It also appears that, contrary to Statement No. 91, Fannie Mae recognized adjustments to the carrying amount of its loans only if they exceeded a self-defined materiality limit, referred to as a "precision threshold." Fannie Mae has represented that

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9 Statement No. 91, ¶ 19.

10 *See* Federal National Mortgage Association, Form NT 10-Q, dated November 15, 2004, which states, in part: "… Fannie Mae recently determined that its methodology for performing calculations to measure the catch-up adjustment required by [Statement No.] 91 for balance sheet dates in the periods 2001 through 2002 was not consistent with GAAP. During those periods, Fannie Mae should have been calculating its catch-up adjustment with reference to its quarter-end position rather than its projected year-end position and recording amounts solely on the basis of those quarterly calculations…. The company will make adjustments to prior periods if and to the extent material…."

it has initiated additional changes to eliminate the "precision threshold" and is working with OFHEO to further amend its accounting practices under Statement No. 91.[11]

Statement No. 133

Regarding Statement No. 133, one of the principles underlying the statement is that derivative instruments are to be recorded at their fair value, with changes in fair value being reported in earnings. If certain detailed hedge criteria and procedures are satisfied, however, Statement No. 133 affords special accounting for the hedge relationship. If the detailed hedging requirements are not satisfied, then special hedge accounting is not available.[12]

Fannie Mae internally developed its own methodology to assess whether hedge accounting was appropriate. Fannie Mae's methodology, however, did not qualify for hedge accounting because of deficiencies in its application of Statement No. 133. Among other things, Fannie Mae's methodology of assessing, measuring, and documenting hedge ineffectiveness was not supported by Statement No. 133.[13]

SEC Accounting Staff's Determination

As a result of the staff's review, on December 15, 2004, the Commission's accounting staff advised Fannie Mae that, to be consistent with Statement Nos. 91 and 133 and to provide investors with appropriate information, Fannie Mae should:

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[11] *See, e.g.*, Testimony of Franklin D. Raines, Chairman and CEO, Fannie Mae, Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (October 6, 2004), which states, in part: "We have agreed with OFHEO to discontinue the use of a range in implementing [Statement No.] 91 beginning in the fourth quarter of 2004." The "range" refers to the "precision threshold."

[12] *See*, Statement No. 133, ¶ 18.

[13] *See, e.g.*, Statement No. 133, ¶¶ 20-41.

- Restate its financial statements filed with the Commission to eliminate the use of hedge accounting for periods beginning on January 1, 2001 through June 30, 2004.
- Evaluate the accounting under Statement No. 91 and restate its financial statements filed with the Commission if the amounts required for correction are material.
- Re-evaluate the information prepared under GAAP and non-GAAP information that Fannie Mae previously provided to investors, particularly in view of the decision that hedge accounting is not appropriate.

In a report on Form 8-K filed with the Commission on December 17, 2004, Fannie Mae stated, "As a result of the [Commission accounting staff's] findings, Fannie Mae will restate its financial results for the periods [from 2001 to mid-2004] to comply fully with [that] determination."[14] As of the date of this testimony, Fannie Mae has not yet filed revised financial statements with the Commission.

It is my understanding that investigations into these and related matters by Fannie Mae's special review committee, the Commission, and others are continuing. As I noted previously, in order not to compromise the Commission's ongoing investigation, my statement today is based only on the information voluntarily provided to the SEC accounting staff by Fannie Mae and OFHEO when Fannie Mae requested the accounting guidance provided in our December 15, 2004 press release.

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[14] Federal National Mortgage Association, Form 8-K, dated December 17, 2004. *See* Federal National Mortgage Association, Form NT 10-Q, dated November 15, 2004, for an additional discussion of the impact of the restatement.

Conclusion

Thank you for the opportunity to appear today. I am pleased to try to respond to any questions the Members of the Subcommittee may have.