Testimony of

Robert H. Herz, Chairman

Financial Accounting Standards Board

before the

U.S. House of Representatives Financial Services Subcommittee
On Capital Markets, Insurance, and Government Sponsored Entities

Accounting & Auditing Standards: Pending Proposals & Emerging Issues

May 21, 2010

Introduction

Chairman Kanjorksi, Ranking Minority Member Garrett, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). Thank you for inviting me to participate in today's 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.

My testimony this morning includes a brief overview of the FASB and its parent organization, the Financial Accounting Foundation ("FAF"), with an emphasis on both the FASB's role within the U.S. financial system and how we remain accountable to our constituents in performing that role. My testimony then reports on what the FASB has done over the past year, as well as on our planned activities during the coming year. Finally, it includes some information on matters on which I have been asked to comment.

The FASB and the FAF

The FASB is an independent private-sector organization, which operates under the oversight of the FAF, a not-for-profit organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Since 1973, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both businesses (public and private) and not-for-profit organizations. Those standards are recognized as authoritative generally accepted accounting principles ("GAAP") by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for public companies and by the American Institute of Certified Public Accountants ("AICPA") for other nongovernmental entities. GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make resource allocation decisions.

An independent standard-setting process is the best means of ensuring high-quality accounting standards, since it relies on the collective judgment of experts, informed by the input of all interested parties through a thorough, open, deliberative process. Although the FASB's mission is to set standards through an independent process, the FASB does not operate in a vacuum. The FASB is accountable in two important ways: (1) by engaging in robust due process in setting standards, including wide consultation with stakeholders, and (2) by being subject to oversight conducted in the public interest.

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and objective. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure, set by the Board within the parameters of the FAF's bylaws, require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views. We meet regularly on both a formal and an informal basis with our counterparts at various levels at the SEC and the Public Company Accounting Oversight Board ("PCAOB"), and SEC and PCAOB staff members serve as observers on our advisory groups and often participate in our working groups. We also have observer status on the PCAOB's principal advisory group. Because bank regulators have a keen interest in GAAP financial statements as a starting point in the assessment of the safety and soundness of financial institutions, we meet with them on a quarterly basis and otherwise as appropriate. We also understand Congress's great interest and regularly brief Members and their staffs on developments. Indeed, a number of FAF trustees and FASB members will be meeting with Members of Congress next week.

The Board makes final decisions on standards only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. The Board is also focused on making technical, rather than policy or legal, judgments. In making those technical judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

Due process procedures are intended to ensure that all stakeholders have an adequate opportunity and time to make their views known before changes in accounting standards are made. Wide consultation helps the Board to assess whether the benefits to users of contemplated changes outweigh the costs of the changes to preparers and others. Wide consultation also promotes excellence, neutrality, the identification of unintended consequences, and, ultimately, broad acceptance of the legitimacy of the standards that are adopted.

Accountability also derives from oversight of the Board, at two levels. First, the Board is monitored by the independent Board of Trustees of the FAF with regard to its standard-setting process for public companies, private companies, and not-for-profit organizations. Second, the Board is also subject to oversight by the SEC with respect to standard setting for public companies.

In addition to the important and ongoing role of the FAF trustees in appointing FASB members, evaluating the FASB chair, and otherwise ensuring that the FASB has adequate and appropriate human and financial resources to accomplish its mission, the FAF recently initiated a couple of new processes aimed at strengthening its oversight of the FASB. First, it has established a post-implementation review process for assessing whether the FASB followed its rigorous due process procedures in issuing key standards and whether those standards are having the intended effect. Second, the FAF has undertaken its own regular outreach efforts to hear directly from stakeholders, beginning with a "listening tour" last summer.

As I indicated earlier, the FASB and the FAF are also overseen by the SEC, which has the authority and responsibility under the U.S. federal securities laws to set accounting standards for public companies, but has historically looked to private-sector standard-setting bodies to set and improve standards and has deferred to their judgment. In 2003, the SEC studied the FASB and the FAF and determined that they met the criteria prescribed by Section 108 of the Sarbanes-Oxley Act of 2002 so that the FASB's standards may be recognized as "generally accepted" for purposes of the U.S. federal securities laws.[1] The SEC monitors the FASB and the FAF on an ongoing basis to ensure they continue to meet the statutory criteria and other SEC expectations.

Additional information about the FASB and the FAF can be found in the 2009 Annual Report of the FAF the complete text of the Annual Report is available electronically at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB/Document_C/DocumentPage&cid=1176156817431.

FASB Activities

Addressing Financial-Crisis-Related Issues

Over the past year, the FASB has issued a number of standards addressing reporting issues emanating from or highlighted by the Financial Crisis.[2] Most notably, these have included certain standards for two important financial reporting areas: (1) fair value and impairments and (2) securitizations and other involvements with special-purpose entities (SPEs):

1. Fair Value and Impairments

[1] See SEC Release No. 33-8221, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 23, 2003).
[2] A complete list of all standards issued by the FASB since January 1, 2009, is attached to this testimony.

- FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (April 2009)

- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (April 2009)

- FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 2009).

2. <u>Securitizations and Other Involvements with SPEs:</u>

- Statement 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (June 2009)

- Statement 167, *Amendments to FASB Interpretation No. 46(R)* (June 2009).

In issuing the FSPs on fair value and impairments, the FASB provided important timely guidance in the midst of the Financial Crisis, while still engaging in extensive due process, following the Subcommittee's hearing at which I appeared in March 2009:

- FSP FAS 157-4 provided important clarifying guidance on the intent of Statement 157,[3] reminding preparers and auditors to use judgment and all appropriate valuation techniques and inputs in measuring the fair value of assets in inactive markets, rather than simply defaulting to stale market data in such circumstances. The FSP also included helpful indicators for when a market may be considered inactive and/or an asset sale forced rather than orderly.

- FSP FAS 107-1 and APB 28-1 helped foster more timely information to help "red flag" potential losses in financial instruments carried at amortized cost (such as loans held for investment and debt securities held to maturity) by requiring public companies to disclose fair value information for such instruments in the notes to their financial statements on a quarterly, rather than an annual, basis.

[3] Statement 157, *Fair Value Measurements* (September 2006).

- FSP FAS 115-2 and 124-2 amended the other-than-temporary impairment guidance for debt securities held outside an entity's trading portfolio, most importantly to allow the non-credit-related portion of such impairment (for example, declines in fair value stemming from market illiquidity) to be reported in other comprehensive income instead of earnings.

In issuing Statements 166 and 167, the FASB provided necessary improvements to the accounting and reporting of securitizations and other involvements with SPEs, effective in January 2010. These improvements should result in more assets involved in such transactions staying on the books of sponsoring institutions, by significantly reducing their ability to give off-balance-sheet treatment to securitizations and similar arrangements for which they retain significant risk. These improvements were taken into account by the U.S. banking regulators in their 2009 "stress tests" of the nation's largest financial institutions, and those regulators have been providing guidance on the regulatory effects of the new FASB standards. Statements 166 and 167 were preceded by interim improvements made to the disclosures requirements in this area through an FSP issued in December 2008.[4]

Also addressing deficiencies in financial reporting involving matters highlighted by the Financial Crisis were three pronouncements that the FASB issued in 2008 which became effective in 2009. Together, these improved the disclosure standards for derivatives, including credit derivatives such as credit default swaps, and the accounting and disclosure standards for financial guarantee insurance contracts:

- Statement 161, *Disclosures about Derivative Instruments and Hedging Activities* (March 2008)

- Statement 163, *Accounting for Financial Guarantee Insurance Contracts* (May 2008)

[4] FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities.*

- FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees* (September 2008).

In the coming year, the FASB expects to complete two other key projects aimed at improving accounting for financial instruments: Disclosures about Credit Quality and the Allowance for Credit Losses (the "Credit Loss Disclosures" project), and Accounting for Financial Instruments. The Credit Loss Disclosures project, to be completed soon, is aimed at improving the disclosures by financial institutions and other creditors of financing receivables (loans, finance leases, and trade receivables with terms that exceed one year) about the allowance for credit losses and the credit risks inherent in their portfolio of financing receivables.

The Accounting for Financial Instruments project represents a comprehensive reexamination of the standards for financial instruments, including classification and measurement, impairment, and hedge accounting. It is aimed at improving and simplifying the accounting and reporting of such instruments and, to the extent possible, achieving convergence of U.S. GAAP and International Financial Reporting Standards ("IFRS"). (This and other projects covered by our Memorandum of Understanding with the International Accounting Standards Board ["IASB"], aimed at improvement and convergence, are discussed further below.) Later this month we expect to issue an Exposure Draft on financial instruments for public comment, with the goal of finalizing the standard in early 2011, with a subsequent effective date to be determined.

In the Board's deliberations of those two projects, we have given careful consideration to nonpublic entities, including credit unions and many community banks. In the final credit loss disclosures standard, we will provide a one-year deferral of the effective date for all nonpublic entities, so that the standard's requirements will take effect for their 2011 calendar-year-end financial statements. In addition, the expected Exposure Draft on financial instruments will propose a four-year deferral of the effective date for all nonpublic entities with less than $1 billion in assets. This proposed deferral will allow extra time for those nonpublic entities to adopt the new requirements that would likely necessitate the greatest changes in their financial information systems. It is important to note that approximately 90 percent of all U.S. financial institutions, which together represent about 10 percent of the assets in the system, would be eligible for this four-year deferral.

Reducing Complexity in the U.S. Financial Reporting System

In issuing the standards that I just described, as well as other standards it has issued in recent years, the FASB has aimed to make its standards more understandable through a focus on clear objectives and principles (generally set forth in boldface paragraphs), supported by a sufficient level of implementation guidance.

In addition to its standard-setting activities, the FASB has taken other significant steps during the past year to reduce complexity in the U.S. financial reporting system.

On July 1, 2009, following an 18-month "verification" trial period by the public, we officially launched the *FASB Accounting Standards Codification*™ (the "Codification") as the source of authoritative nongovernmental U.S. GAAP. This was a milestone event for the FASB and the U.S. financial reporting system, ushering in a new era of modern accounting research to accounting and financial reporting professionals, as well as to analysts and investors. The Codification's launch culminated a multi-year effort to make the U.S. GAAP literature more accessible and user-friendly. Instead of GAAP standards scattered among many pronouncements issued by various standard setters over the years, the Codification provides constituents with one topically organized, easily accessible online research system.

We expect that the new system will significantly reduce the amount of time and effort required to research accounting issues, mitigate the risk of noncompliance with standards through improved usability of the literature, provide accurate information with real-time updates as new standards are released, and assist the FASB with the research efforts and literature amendments required during the standard-setting process.

With the launch of the Codification, the FASB is no longer adding numbered Statements, Interpretations, and FSPs to GAAP but, rather, is issuing Accounting Standards Updates (ASUs) that amend the relevant sections of the Codification.

The Codification's launch was further enhanced by the inclusion of XBRL (eXtensible Business Reporting Language) functionality, making it easier for users of the Codification to access information about the U.S. GAAP financial reporting taxonomy elements that link to the Codification. To ensure continued coordination of GAAP standards and the XBRL taxonomy, the FAF recently assumed responsibility for the ongoing maintenance of the U.S. GAAP financial reporting taxonomy, including updates for changes in U.S. GAAP, reviews of best practices, and technological enhancements.

International Convergence

During the past year, the FASB has also made much progress, intensifying our efforts, on our joint projects with the IASB that are aimed at improving both U.S. GAAP and IFRS and achieving convergence in a number of key areas:

- Consolidations
- Derecognition
- Fair Value Measurement
- Financial Instruments
- Financial Instruments with Characteristics of Equity
- Financial Statement Presentation
- Insurance
- Leases
- Revenue Recognition.

These projects are discussed in the attached March 2010 Quarterly Progress Report.

The FASB's commitment to international convergence of accounting standards is a longstanding one. In 2002, the FASB and the IASB laid the groundwork for convergence projects through an agreement (the "Norwalk Agreement") in which they "acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" and pledged to use their best efforts to achieve such compatibility. In the first few years after signing the Norwalk Agreement, the Boards harmonized their standards in a number of areas, such as employee stock compensation and segment reporting. The current projects became a significant part of both Boards' agendas as the result of a Memorandum of Understanding (MOU) that they entered into in 2006, reflecting the decision by the Boards, with concurrence of the SEC and the European Commission, that their resources should best be focused on developing converged and improved standards in those areas in U.S. GAAP and IFRS that were most in need of improvement. The Boards completed the first such major improvement and convergence project, on Business Combinations, at the end of 2007,[5] and updated the MOU in 2008. The updated MOU targeted 2011 for completion of the various projects.

For many of our constituents, the recent Financial Crisis underscored the need for expeditious progress on these projects, especially those projects that are most relevant to financial institutions (Financial Instruments, Fair Value Measurement, and Consolidations/ Derecognition). At their September 2009 summit in Pittsburgh, the leaders of the G-20 nations called for the Boards to "redouble" their efforts to achieve convergence in these areas by the 2011 target date.[6] In their February 24, 2010 statement,[7] the SEC indicated that along with the execution of an SEC staff work plan, "completion of the convergence projects of the FASB and the IASB according to their current work plan...will position the Commission in 2011 to make a determination regarding incorporating IFRS into the financial reporting system for U.S. issuers."

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[5] FASB Statements 141 (revised 2007), *Business Combinations*, and 160, *Noncontrolling Interests in Consolidated Financial Statements* (both, December 2007), and IFRS 3, *Business Combinations* (January 2008).

[6] *Leaders' Statement: The Pittsburgh Summit*, September 24-25, 2009.

[7] SEC Release Nos. 33-9109 and 34-61578, *Commission Statement in Support of Convergence and Global Accounting Standards.*

Many of these projects are nearing their Exposure Draft stage. Achieving both improvement to U.S. GAAP and convergence with IFRS on the MOU projects, while making necessary improvements to U.S. GAAP on other projects such as those described in the preceding sections of this testimony, remains a significant challenge for the FASB. In some of the MOU projects, the Boards are on track to both make the desired improvements to U.S. GAAP and IFRS and achieve convergence. In other MOU projects, achieving convergence is proving to be quite challenging.

Section 108 of the Sarbanes-Oxley Act and the SEC's 2003 Policy Statement (discussed on page 3 above) require us, in serving as a recognized authoritative standard setter, to "consider, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and the protection of investors." Along these lines, while we are committed to, and are making every effort to, foster convergence between U.S. GAAP and IFRS through the MOU projects, we must ensure that, first and foremost, the resulting standards represent improvements that are in the best interest of U.S. investors and other users of GAAP information.

Activities Related to Private Companies and Not-for-Profit Organizations

While a significant portion of the FASB's attention has been, and continues to be, focused on international convergence of standards and other matters that affect U.S. public companies, privately-held companies and not-for-profit organizations remain very important to the FASB's and the FAF's mission. We extensively outreach to these sectors during our due process and carefully consider their differential needs, with the result often being a deferral of effective dates of new pronouncements and sometimes a reduction in disclosure requirements for those sectors versus public companies. For example, we deferred the effective date of Interpretation 48, *Accounting for Uncertainty in Income Taxes*, for nonpublic entities by two years and we exempted them from some of the quantitative disclosure requirements. And, as noted above, we will be proposing to defer by several years, for many nonpublic entities, some of the significant requirements in our upcoming proposed ASU on Accounting for Financial Instruments.

In our outreach to privately-held companies and not-for-profit organizations, we benefit from the input received from important advisory groups. For private business enterprises, the FASB regularly consults with both its Small Business Advisory Committee (whose members also represent small public companies) and its Private Company Financial Reporting Committee ("PCFRC"), on specific areas in proposed or existing standards where differences for private companies might be appropriate based on user needs or cost-benefit considerations.

Beyond these routine consultations, however, there are a number of forces in play that have challenged the approach that the U.S. has traditionally had, of one set of standards for both public and private companies (with exceptions as appropriate) rather than the type of parallel system of "Big GAAP/Little GAAP" that is present in certain other countries. These include the potential move to IFRS for public companies (and the uncertainty that has created for private companies), the available use of IFRS for Small and Medium-Sized Entities by U.S. private companies, recent developments in other countries that have adopted IFRS for their public companies but not for their private companies, and continuing concerns expressed by some constituents over the relevance and cost/benefit to private companies of certain U.S. GAAP requirements. In response to hearing these concerns from private company constituents during the Trustees' listening tour last summer, as well as receiving input from the PCFRC, in December 2009 the FAF created the "Blue-Ribbon Panel" on Standard-Setting for Private Companies (the "Panel"), sponsored jointly by the AICPA and the National Association of State Boards of Accountancy. The Panel, which includes a cross-section of private company financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors, will examine these matters and issue its report with recommendations to the Trustees in early 2011.

As I indicated earlier, standard-setting for not-for-profit organizations is also important to the FASB's and FAF's mission. In October 2009, the FASB established a Not-for-Profit

Advisory Committee ("NAC"). The FASB has just appointed the initial members of the NAC, which will hold its first meeting in September. The NAC will provide us with input on reporting issues in that sector, including issues that may arise if and when U.S. public companies move to IFRS, because IFRS does not explicitly cover not-for-profit entities.

Other Matters

I have been asked to comment on financial arrangements that companies may employ to manage their financial position near the end of a reporting period—presumably including arrangements such as the so-called Repo 105 and Repo 108 transactions engaged in by Lehman Brothers. I would respectfully refer the Subcommittee members to the attached letter that I sent to Committee Chairman Frank and Ranking Minority Member Bachus in connection with the Committee's April 20, 2010 hearing, "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." As noted in the letter, the FASB does not have any regulatory or enforcement powers, but we do work closely with the SEC whenever there are reports of any significant accounting or reporting issues such as the ones highlighted in that examiner's report. We stand ready to take any additional standard-setting actions that may be warranted as the result of our ongoing discussions with the SEC staff as they evaluate that report and any information they obtain concerning practices of other financial institutions in the area of repurchase agreements and consolidation of SPEs.

Conclusion

The demands on accounting standard setters that have stemmed from the Financial Crisis, together with the goal of continuing to improve U.S. GAAP and of achieving convergence of GAAP and IFRS, have made this past year one of the most challenging in the FASB's 37-year history. The coming year will likely be equally if not more challenging as we work towards completion of the various MOU projects. I and others at the FASB very much look forward to the challenge.

Thank you, Mr. Chairman, for the opportunity to appear here today. I would be pleased to answer any questions.

Attachments:

1. List of Standards Issued by the FASB since January 1, 2009
2. IASB and FASB Commitment to Memorandum of Understanding: Quarterly Progress Report, 31 March 2010
3. Letter from Robert H. Herz to House Financial Services Committee Chairman Barney Frank and Ranking Minority Member Spencer T. Bacchus III, dated April 19, 2010

Standards Issued by the FASB since January 1, 2009

Prior to the *FASB Accounting Standards Codification*™:

FASB Staff Position EITF 99-20-1, **Amendments to the Impairment Guidance of EITF Issue No. 99-20** (January 2009)

FASB Staff Position FAS 141(R)-1, ***Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*** (April 2009)

FASB Staff Position FAS 157-4, ***Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*** (April 2009)

FASB Staff Position FAS 107-1 and APB 28-1, ***Interim Disclosures about Fair Value of Financial Instruments*** (April 2009)

FASB Staff Position FAS 115-2 and FAS 124-2, **Recognition and Presentation of Other-Than-Temporary Impairments** (April 2009)

FASB Statement No. 164, ***Not-for-Profit Entities: Mergers and Acquisitions—including an amendment of FASB Statement No. 142*** (May 2009)

FASB Statement No. 165, ***Subsequent Events*** (May 2009)

EITF Issue No. 09-1, ***Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance*** (June 2009)

FASB Statement No. 166, ***Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*** (June 2009)

FASB Statement No. 167, ***Amendments to FASB Interpretation No. 46(R)*** (June 2009)

FASB Statement No. 168, ***The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*** (June 2009)

Accounting Standards Updates amending the *FASB Accounting Standards Codification*™ [1]:

Accounting Standards Update No. 2009-01, ***Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles*** (June 2009)

[1] Excludes Accounting Standards Updates by the SEC staff that amend the SEC-maintained sections of the Codification.

Accounting Standards Update No. 2009-02, ***Omnibus Update—Amendments to Various Topics for Technical Corrections*** (June 2009)

Accounting Standards Update No. 2009-05, ***Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value*** (August 2009)

Accounting Standards Update No. 2009-06, ***Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*** (September 2009)

Accounting Standards Update No. 2009-12, ***Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*** (September 2009)

Accounting Standards Update No. 2009-13, ***Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-14, ***Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-15, ***Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*** (October 2009)

Accounting Standards Update No. 2009-16, ***Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*** (December 2009)

Accounting Standards Update No. 2009-17, ***Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*** (December 2009)

Accounting Standards Update No. 2010-01, ***Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*** (January 2010)

Accounting Standards Update No. 2010-02, ***Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*** (January 2010)

Accounting Standards Update No. 2010-03, ***Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*** (January 2010)

Accounting Standards Update No. 2010-06, ***Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*** (January 2010)

Accounting Standards Update No. 2010-07, ***Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*** (January 2010)

Accounting Standards Update No. 2010-08, ***Technical Corrections to Various Topics*** (February 2010)

Accounting Standards Update No. 2010-09, ***Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*** (February 2010)

Accounting Standards Update No. 2010-10, ***Consolidation (Topic 810): Amendments for Certain Investment Funds*** (February 2010)

Accounting Standards Update No. 2010-11, ***Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*** (March 2010)

Accounting Standards Update No. 2010-13, ***Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*** (April 2010)

Accounting Standards Update No. 2010-15, ***Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*** (April 2010)

Accounting Standards Update No. 2010-16, ***Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*** (April 2010)

Accounting Standards Update No. 2010-17, ***Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*** (April 2010)

Accounting Standards Update No. 2010-18, ***Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*** (April 2010)

IASB and FASB Commitment to Memorandum of Understanding

Quarterly Progress Report

31 March 2010

Introduction

In November 2009, we, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), released a joint statement in which we:

- reaffirmed our commitment to improving International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) and achieving their convergence.
- agreed to intensify our efforts to complete the major joint projects described in the 2006 Memorandum of Understanding (MoU), as updated in 2008.
- described our plans for completing those major projects, including milestone targets for each project.
- Committed to providing transparency and accountability regarding those milestones by reporting quarterly on our progress and making those reports available on our websites.

This is the joint progress report for the quarter ended 31 March 2010. The chairmen of the FASB and IASB discussed a draft of this report with the joint working group of their respective oversight bodies at a meeting on 29 March.

As of 31 March 2010, we had achieved substantially all of the milestone targets for the first quarter of 2010. As we explain more fully in a later section of this report:

- for five of the major MoU projects, we are on track to publish, by mid-2010, exposure drafts that would improve and achieve substantial convergence of US GAAP and IFRSs in those areas.
- on two major projects, financial instruments and insurance contracts, we have reached different conclusions on some important technical issues. Addressing those differences in ways that foster convergence could affect the project timetables described in this report.
- the boards also agreed in late March to explore an alternative approach to lessor accounting. That decision could affect the project timetables described herein.

The exposure drafts scheduled for publication in the second quarter of 2010 are significant both in nature and number (eleven for the FASB (eight on major projects) and eleven for the IASB (seven on major projects)). We will provide comment periods commensurate with the degree of change and complexity of each exposure draft. However, we recognise the effort that will be required by stakeholders to consider carefully and respond thoughtfully to these many different proposals. We are developing outreach programmes to provide potential respondents with enhanced opportunities to engage with the boards to help them consider the proposals.

That outreach will also provide the boards with more opportunities to hear and absorb that input and thoughtfully complete their redeliberations.

The boards are also aware of the significant challenges that will arise from implementing the many major MoU standards targeted for completion in mid-2011. The boards will publish a separate discussion paper to seek views on ways to implement these improvements so as to minimise the disruption and cost to the financial reporting system.

This remainder of this report is presented in three parts:

- The first part describes changes the boards have made to their work methods to foster completion of their joint projects by the June 2011 target.
- The second part describes progress made on each project since the November 2009 report and updated milestone targets.
- The third part is a complete list of all documents the FASB and IASB expect to publish in connection with the completion of the MoU and the expected publication timing.

Part 1: Work method improvements

We changed our work methods to enhance the likelihood that we will complete the major MoU projects in the time frame outlined in the MoU and that the resulting standards will both improve IFRSs and US GAAP and reduce the differences between them.

- **Intensification of work programme:** We fulfilled our November 2009 commitment to meet jointly at least every month. The boards had full-day meetings on three consecutive days in each of November, December, January and February. In March, the boards met jointly for three consecutive afternoons by video, followed the next week by a three-day, face-to-face joint meeting in London.
- **Willingness to schedule special meetings to address key issues:** To address issues requiring their joint attention, the boards called seven further special sessions during this period.
- **Continuing work:** The boards have meetings scheduled for 8 April, 20-22 April, 4 May, 17-19 May, 1 June and 15-17 June.
- **Enhanced stakeholder outreach on projects:** We are developing extensive outreach programmes to ensure broad stakeholder participation in the standard-setting due process (we will post those programmes on our websites). Those programmes will include public educational outreach sessions in Asia-Oceania, North America and Europe. We have already scheduled such sessions for August in Tokyo, Norwalk in early September (hosted by the FASB) and London in mid-September (hosted by the IASB).

Part 2: Updates on convergence projects

Financial instruments

Our goal is to issue comprehensive improvements to this complex and contentious area that will foster international comparability of financial information about financial instruments.

As we noted in our November statement, each board has faced different imperatives that pushed our development timetables out of alignment. In particular, the IASB has been replacing its financial instrument requirements in a phased approach, whereas the FASB has been developing a comprehensive proposal. Those differing development timetables and other factors have contributed to the boards reaching differing conclusions on a number of important technical issues (a summary description of those differences is available on our websites).

Our strategy for addressing those differences calls for each board to publish its proposals and that of the other board, as a way of giving interested parties the opportunity to compare and assess the relative merits of both boards' proposals. Additionally, we established an *expert advisory panel* to help the boards identify and resolve operational aspects of their respective credit impairment models.

Our strategy also calls for us to consider together the comment letters and other feedback we receive in an effort to reconcile our differences in ways that foster convergence. We expect to begin those joint discussions in the third quarter of 2010. Although our recent experiences with joint meetings show that we have been able to resolve differences on several projects, there is no guarantee we will be able to resolve all, or any, of our differences on this project.

First quarter 2010 milestone targets achieved

The following first quarter milestones were achieved in accordance with the timetable published in November.

- The IASB issued new requirements for the classification and measurement of financial assets in early November 2009.
- On 5 November 2009 the IASB published for public comment an exposure draft on the amortised cost measurement and impairment of financial instruments, with comments due by 30 June 2010.

Updated milestone targets

Milestone targets for financial instruments	
Q2 2010	The IASB has been developing improved financial reporting requirements for financial instruments in phases, in response to requests to accelerate particular parts of the project. In the next phase the IASB will publish in April proposals for the classification and measurement of financial liabilities, rather than by March as previously planned. (The IASB published proposals for the classification and measurement of financial liabilities in July 2009 but decided not to include financial liabilities within the scope of the first phase of the financial instruments project). The FASB expects to publish its comprehensive proposal covering classification and measurement, impairment and hedging during the first week of May 2010 rather than March as previously planned. As part of that proposal, the FASB will solicit views on the IASB's proposals for recognition and measurement (of both assets and liabilities) and impairment. The IASB also will publish a request for views on the FASB's comprehensive exposure draft. Since November, the IASB has decided to include non-financial hedges in the phase of the project addressing hedge accounting. As a consequence, the IASB will publish its initial proposals on hedge accounting in mid-2010 (rather

	than by March as previously planned). The IASB will review the application of its requirements for classification and measurement of financial assets by those entities adopting the requirements early.
Q3 2010	The boards will begin to consider together the comment letters and other feedback received on each of the boards' various proposals.
Q4 2010 / Q1 2011	The boards will complete their joint consideration of feedback received and expect to finalise and issue new requirements.

Consolidations

The agendas of both boards include projects on consolidation. In 2008 the IASB published an exposure draft of a comprehensive replacement of its consolidation requirements, and in 2009 the FASB finalised one aspect of that project that amended and improved US GAAP relating to consolidation of variable interest entities and related disclosures.

The boards concluded last November that, ideally, their standards for consolidation would include objectives and principles for assessing control that would be applied consistently for all types of entities and produce globally comparable results. Consistently with that conclusion:

- the IASB agreed in November 2009 to amend its timetable to give the boards the opportunity to jointly deliberate the consolidation requirements.
- the FASB set a goal of publishing an exposure draft in the second quarter of 2010.
- the IASB agreed to make available a staff draft of its proposed standard and publish a request for views on the FASB's proposal.
- the two boards agreed to jointly deliberate the issues with the expectation they would produce improved and common final standards by the third quarter of 2010.

The IASB proposal, originally published in 2008, included enhanced disclosures about unconsolidated entities. The IASB decided in February 2010 to accelerate its work plan and issue in the second quarter of 2010 final disclosure requirements for securitisation and investment vehicles (such as special purpose entities and structured investment vehicles) that an entity has sponsored or with which it has a special relationship, but does not control.

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Milestone targets for consolidations	
Q2 2010	The IASB expects to finalise and publish required disclosures about securitisation and investment vehicles that any entity does not control but has sponsored or with which it has a special relationship (which the IASB had previously planned for publication in Q4 2010). The FASB expects to publish a comprehensive exposure draft on consolidations that is not expected to significantly affect consolidation of variable interest entities (previously expected in Q1 2010). The IASB will make available a staff draft of its proposed standard and will also publish a request for views on the FASB's proposals.
Q4 2010 or Q1 2011	The IASB and FASB aim to issue common standards on consolidation covering all entity types.

Derecognition

In late 2009 the FASB finalised a project to amend and improve its requirements in relating to the derecognition of some financial assets and liabilities.

The IASB is also undertaking a project to improve the derecognition requirements for financial assets and to provide users with better information about an entity's exposure to the risks of transferred financial assets. The current requirements are perceived as complex and difficult to understand and apply in practice. The IASB published proposals in 2009 and the responses showed stronger support for the alternative model proposed. The IASB has completed development of that alternative and in April the FASB will consider that model.

In their next quarterly update the boards expect to provide further details on their plans to improve and develop common standards for derecognition of financial assets and liabilities

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Milestone targets for derecognition	
Q2 2010	The IASB staff will present to the FASB a proposed model for derecognition of financial assets and liabilities. The boards will develop and provide further details regarding their plans and milestone targets for this project.

Fair value measurement

The FASB issued Statement 157 *Fair Value Measurements* in 2006 and those requirements have been in effect since November 2007. In May 2009 the IASB published an exposure draft of an IFRS on fair value measurement. The exposure draft is largely consistent with the FASB requirements.

In November, the boards reached agreement on the following:

- Their objective is to ensure that fair value has the same meaning in US GAAP and IFRSs, by making US GAAP and IFRS fair value measurement requirements the same other than minor necessary differences in wording or style.
- The boards agreed to consider together the comments received on the IASB's exposure draft. The FASB agreed to propose amendments to US GAAP fair value measurement requirements, if necessary.
- The boards also agreed that if they become aware of perceptions that the FASB and IFRS fair value measurement requirements are different they will work together to address those perceptions.

First quarter 2010 milestone targets achieved

The IASB held public round-table meetings in Asia, Europe, and North America in conjunction with the FASB.

Updated milestone targets

Milestone targets for fair value measurement	
Q2 2010	The FASB expects to issue an exposure draft of proposed amendments to its fair value measurement requirements that would improve them and achieve convergence with the proposed IFRS (previously expected to be issued in Q1 2010).
Q3 2010	The FASB expects to hold a public round-table meeting to discuss its proposal.
Q4 2010	After the close of the public comment period for the FASB exposure draft, the boards will deliberate issues jointly, with a goal of issuing common standards in the fourth quarter.

Revenue Recognition

The boards are working together to provide a single revenue recognition model that can be applied to a wide range of industries and transaction types. US GAAP currently has many industry-specific requirements that are not always consistent with each other. IFRSs are perceived as lacking necessary application guidance. The new model will eliminate weaknesses and inconsistencies in the existing standards.

The boards published a joint discussion paper in December 2008 that proposed a single revenue recognition model built on the principle that an entity should recognise revenue when it satisfies its performance obligations in a contract by transferring goods and services to a customer. That principle is similar to many existing requirements. However, the boards think that clarifying that principle and applying it consistently to all contracts with customers will improve the comparability and understandability of revenue for users of financial statements.

The boards have been considering the comments received on their discussion paper as well as feedback from their outreach programmes.

First quarter 2010 milestone targets achieved

The boards conducted a series of workshops to learn how various types of entities would apply the proposed requirements. The feedback received was positive and provided additional comfort that the proposals are operational.

Updated milestone targets

Milestone targets for revenue recognition	
Q2 2010	The IASB and FASB expect to publish an exposure draft that would improve their respective requirements and achieve convergence.
Q2 2011	The IASB and FASB aim to issue improved and common standards.

Leases

The IASB and FASB are developing together a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognised in the statement of financial position. The project is addressing the accounting from the perspective of both the lessor and lessee.

The boards continued to deliberate technical issues during the first quarter of 2010.

First quarter 2010 milestone targets achieved

There were no first quarter 2010 milestone targets for this project.

Updated milestone targets

Although the boards have retained their second quarter 2010 milestone target for publishing exposure drafts, their decision in March to explore an alternative approach to the accounting by a lessor may affect that milestone target.

Milestone targets for leasing	
Q2 2010	The IASB and FASB will publish exposure drafts proposing the accounting for leases, from the perspective of the lessor and the lessee.
Q2 2011	The IASB and FASB aim to issue improved and common standards.

Financial instruments with the characteristics of equity

The FASB and IASB have been working together to improve and, as a consequence, simplify, the financial reporting requirements for financial instruments with characteristics of equity. The purpose of this project is to develop a better way to distinguish instruments that are equity from those that are assets or liabilities. Some aspects of the current IFRS and US GAAP requirements have been criticised for their complexity or inconsistency.

As of November 2009, the boards had agreed to assess the feasibility of an approach that would classify as equity particular share-settled instruments. The boards noted they were unable to establish a timetable until they completed that assessment.

First quarter 2010 milestone targets achieved

- The boards completed their assessment and decided to propose for public comment an approach that would classify as equity particular share-settled instruments.
- The boards agreed on milestone targets for this project.

Updated milestone targets

Milestone targets for liabilities and equity	
Q2 2010	The FASB and IASB expect to publish exposure drafts of proposed requirements for identifying financial instruments that should be classified as equity and those that should be classified as an asset or as a liability. The exposure drafts will have a 120-day comment period.
Q2 2011	The boards expect to issue improved and common standards.

Financial statement presentation

The FASB and IASB are working together to establish a common standard that would improve how information is organised and presented in the financial statements. The IASB has already implemented the decisions reached in the first phase of this project into its existing IFRS for the presentation of information in financial statements. Accordingly, the FASB's proposals will include improvements related to that phase as well as the matters the boards are currently discussing together.

In 2008 the boards published a discussion paper in which they set out the principles for presenting financial statements in a manner that portrays a cohesive financial picture of an entity's activities, disaggregates information so that it is useful in predicting an entity's future cash flows and helps users to assess an entity's liquidity and financial flexibility.

As of November, the Boards had decided to accelerate aspects of this project relating to the presentation of other comprehensive income and discontinued operations. In particular:

- the boards agreed to publish together a proposal that would make it easier to compare income statements prepared in accordance with IFRSs or US GAAP. The proposals are designed to improve how items of other comprehensive income are presented in the financial statements.

- the boards agreed to explore a definition of discontinued operations based on existing IFRSs and to work together to improve related note disclosures.

First quarter 2010 milestone targets achieved

- The boards agreed to base the definition of discontinued operations on existing IFRSs and agreed on improvements to related note disclosures.

Updated milestone targets

Milestone targets for financial statement presentation	
Q2 2010	The IASB and FASB expect to publish in April exposure drafts proposing improvements to how items of other comprehensive income items are presented in the financial statements (the previous report called for an ED in March). The FASB and IASB expect to publish in April exposure drafts that would bring together their requirements for defining discontinued operations and improve related disclosure requirements (the previous report called for an ED in March). The IASB and FASB both expect to publish an ED on *Financial Statement Presentation* with a five-month comment period.
Q4 2010	The IASB and FASB aim to finalise amendments to their requirements for reporting discontinued operations.
Q1 2011	The IASB and FASB aim to finalise improvements to how items of other comprehensive income are presented in the financial statements.
Q2 2011	The IASB and FASB aim to issue improved and common standards on *Financial Statement Presentation*.

Other MoU projects

The IASB has been developing proposals to improve the accounting for **joint ventures**, and remove differences between IFRSs and US GAAP. The IASB plans to finalise its new requirements in June 2010, which includes removing the ability to use proportionate consolidation for joint ventures, thereby providing a more representative portrayal of the assets the reporting entity controls.

In response to calls from preparers and users of financial statements, the IASB is conducting a project that will result in significant improvements to the accounting for **post-employment benefits.** Having reviewed comments received on a discussion paper published in March 2008, the IASB focused on improvements to the recognition and presentation of changes in defined benefit obligations and plan assets. The resulting proposals, which include eliminating the corridor approach and revised disclosure requirements, will be published in April.

Other joint projects

The boards are also working together on other projects that are not part of the MoU. They have been developing together a new **Conceptual Framework**. The first two chapters of the Framework, which address the *objectives* and *qualitative characteristics* of financial reporting, will be published in the second quarter of 2010 (rather than towards the end of 2009, as indicated in the previous report). As indicated in the previous report, in the first quarter of 2010 the boards published together an exposure draft for a chapter addressing the *reporting entity.*

Both boards understand the importance of **emissions trading schemes** as a mechanism to help manage $C0_2$ emissions. The financial reporting consequences of the many different allocation and trading systems will become increasingly important. The boards have been working together on this project and expect to publish an exposure draft together in 2010 with the aim of issuing common standards in 2011.

The IASB published in 2007 a discussion paper ***Preliminary Views on Insurance Contracts*** and has been developing proposals on the basis of that discussion paper, in the light of comments received. In 2007, the FASB issued an Invitation to Comment containing the IASB's discussion paper to solicit input on whether it should undertake a comparable project jointly with the IASB. In October 2008 the FASB added a project on insurance to its agenda and the boards agreed to undertake it jointly. They began discussing the project together in 2009 and, to date, have reached different conclusions on several important technical issues (a summary of those differences is available on our websites). While the boards have a milestone target of publishing together exposure drafts in Q2 2010 (with a view to finalising a high quality common standard by mid-2011), the nature and timing of the milestone targets may change depending on the outcome of our efforts to reconcile our differences

Part 3: Publications expected in the second quarter of 2010

A clear sign of continued progress towards completing the improvements to IFRSs and US GAAP identified in our November statement is the forthcoming publication of proposals on the topics listed below.

IASB

- Consolidation: Disclosures about unconsolidated SPEs/structured entities (IFRS)
- Financial Instruments - Classification and Measurement: Financial Liabilities (exposure draft)
- Financial Instruments – Hedge Accounting (exposure draft)
- Joint Arrangements (IFRS)
- Post-employment Benefits – Defined Benefit Plans (exposure draft)
- Derecognition (exposure draft)

FASB

- Financial Instruments (exposure draft)
- Consolidation (exposure draft)
- Fair Value Measurement (exposure draft)

IASB and FASB

- Financial Statement Presentation – organisation and presentation of information in the financial statements (exposure draft)
- Financial Statement Presentation – Presentation of Items of Other Comprehensive Income (exposure draft)
- Financial Statement Presentation – Discontinued Operations (exposure draft)
- Financial Instruments with Characteristics of Equity (exposure draft)
- Revenue Recognition (exposure draft)
- Leases (exposure draft)
- Insurance Contracts (exposure draft)

Appendix A to this quarterly update includes a comprehensive a schedule of all publications relating to joint and MoU standards projects.

Appendix A

TIMETABLE FOR DOCUMENT PUBLICATION—APRIL 2010 to DECEMBER 2011

	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 H2
Financial instruments:						
IASB proposal: liability classification and measurement	ED (May)		IFRS			
IASB proposal: hedging	ED (June)		IFRS			
FASB: comprehensive proposal (including request for comment on the IASB proposal)	ED (May)			Final		
IASB: request for views on FASB proposal	DP (April)					
Consolidations:						
IASB: Disclosures about securitisation and investment vehicles	IFRS (June)					
FASB: Exposure draft of a comprehensive standard on consolidation that is not expected to significantly affect the consolidation of variable interest entities.	ED (May)		Final			
IASB: staff draft of proposed standard and request for views on FASB proposal	May		IFRS			
Derecognition						
IASB proposal: timing to be determined						
FASB proposal: timing to be determined						
Fair value measurement						
FASB proposal: changes to improve requirements and converge with IASB proposed standard IASB: final IFRS	ED (May)		Final IFRS			
Revenue recognition						
IASB proposal: comprehensive standard	ED (May)				IFRS	
FASB proposal: comprehensive standard	ED (May)				Final	
Leasing						

Appendix A

TIMETABLE FOR DOCUMENT PUBLICATION—APRIL 2010 to DECEMBER 2011

	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 H2
IASB proposal: comprehensive standard	ED (June)				IFRS	
FASB proposal: comprehensive standard	ED (June)				Final	
Financial Instruments with characteristics of equity						
IASB proposal: comprehensive standard	ED (June)				IFRS	
FASB proposal: comprehensive standard	ED (June)				Final	
Financial Statement Presentation						
IASB: reporting comprehensive income	ED (April)			IFRS		
IASB: disclosures about discontinued operations	ED (April)		IFRS			
IASB: main standard, replacement of IAS 1 and IAS 7	ED (May)				IFRS	
FASB: reporting comprehensive income	ED (April)			Final		
FASB: disclosures about discontinued operations	ED (April)					
FASB: comprehensive standard	ED (May)				Final	
Other MoU Projects						
Joint ventures: IASB only		IFRS (June)				
Pension accounting: IASB only	ED (April)			IFRS		
Other Joint Projects						
Emissions trading – both FASB and IASB, timing to be determined						
Insurance – both FASB and IASB	ED (June)				Final	

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ROBERT H. HERZ
Chairman

April 19, 2010

The Honorable Barney Frank, Chairman
The Honorable Spencer T. Bachus III, Ranking Minority Member
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Re: Discussion of Selected Accounting Guidance Relevant to Lehman Accounting Practices

Dear Chairman Frank and Ranking Minority Member Bachus:

Thank you for the opportunity to submit an explanation of the accounting standards and relevant guidance relating to repurchase agreements for your April 20, 2010 hearing "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." In order to focus my response on the most relevant financial accounting guidance, I have referred to certain matters discussed in the report of the Lehman Bankruptcy Examiner.[1] Additionally, I have also provided a brief discussion of the relevant accounting guidance relating to consolidation of special-purpose entities, which I believe may be helpful to the Members of the Committee as they deliberate the public policy issues relating to Lehman's bankruptcy.

The FASB does not have regulatory or enforcement powers. However, whenever there are reports of significant accounting or financial reporting issues, we monitor developments closely to assess whether standard-setting actions by us may be needed. In some cases, a misreporting is due to outright fraud and/or violation of our standards, in which case accounting standard-setting action is not necessarily the remedy. Other cases reveal weaknesses in current standards or inappropriate structuring to circumvent the standards, in which case revision of the standards may be appropriate. In some cases, there are elements of both.

At this point in time, while we have read the report of the Lehman Bankruptcy Examiner, press accounts, and other reports, we do not have sufficient information to assess whether Lehman complied with or violated particular standards relating to accounting for repurchase agreements or consolidation of special-purpose entities. Furthermore, we do not know whether other major financial institutions may have engaged in accounting and reporting practices similar to those apparently employed by Lehman.

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[1] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010.

In that regard, we work closely with the SEC. We understand that the SEC staff is in the process of obtaining information directly from a number of financial institutions relating to their practices in these areas. As they obtain and evaluate that information, we will continue to work closely with them to discuss and consider whether any standard-setting actions by us may be warranted.

However, in the meantime, this letter and its attachments summarize the current accounting and reporting standards relating to repurchase agreements and consolidation of special-purpose entities, including some of the recent changes the FASB has put in place.

Accounting and Reporting Standards for Repurchase Agreements

In a typical repurchase (repo) transaction, a bank transfers securities to a counterparty in exchange for cash with a simultaneous agreement for the counterparty to return the same or equivalent securities for a fixed price at a later date, usually a few days or weeks. Accounting standards prescribe when a company can and cannot recognize a sale of a financial asset based on whether it has surrendered control over the asset. In this context, two of the criteria key in determining whether a sale has occurred are:

(a) The transferred financial assets must be *legally isolated* from the company that transferred the assets. In other words, Lehman or its creditors would not be able to reclaim the transferred securities during the term of the repo, even in the event of Lehman's bankruptcy.[2]
(b) The company that transferred the assets does not maintain *effective control* over those assets. Specific tests relate to whether the company has maintained effective control, which are described below.

If both of these criteria are met (among other criteria), the repo would be accounted for as a sale. If either of these criteria is not met, the repo would be accounted for as a secured borrowing. As a general matter, most standard repo transactions fail one or both of these criteria and, therefore, are accounted for as financings.

In the case of repos, one of the relevant tests for assessing effective control relates to the amount of cash collateral that has been provided, relative to the value of the securities transferred. The rationale behind this condition is that the counterparty has promised to return the securities, but even if it defaults, the arrangement provides for sufficient cash collateral at all times, so that the company could buy replacement securities in the market.

My understanding of Lehman's Repo 105 and 108 transactions is based on what I have read in the Examiner's report, press accounts, and other reports. Lehman apparently engaged in structured transactions, known within Lehman as "Repo 105" and "Repo 108" transactions,

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[2] The Audit Issues Task Force Working Group of the AICPA issued an Auditing Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 140," to assist auditors in their analysis. I have separately provided a copy to the Committee staff.

to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days. Lehman reported its Repo 105 and Repo 108 transfers as sales rather than secured borrowings. The cash received in the transfers was used to pay down liabilities.

Lehman reported its Repo 105 and Repo 108 transactions as sales rather than secured borrowings, apparently by attempting to structure the transactions so as to try to support the following conclusions:

(a) That the transferred securities had been legally isolated from Lehman (based on a true sale opinion from a U.K. law firm), and
(b) That the collateralization in the transactions did not provide Lehman with effective control over the transferred securities.

Based on the Examiner's report, Lehman's Repo 105 and Repo 108 transactions were structurally similar to ordinary repo transactions. The transactions were conducted with the same collateral and with substantially the same counterparties.[3]

Additionally, the following two points may be relevant to the analysis of Lehman's accounting for Repo 105 and Repo 108 transactions.

First, the assessment of legal isolation may have only considered whether the securities were isolated from a U.K. subsidiary, as opposed to the consolidated U.S. entity. We understand that, at least in some cases, the securities were first transferred from a U.S.-based entity to a U.K. subsidiary, and were then repoed with a counterparty in the U.K. Attorneys have told us that there are significant legal differences in how repo transactions are viewed in the event of the insolvency of a repo seller under U.S. and English laws. In the United States, case law related to repurchase transactions has been varied enough that most attorneys generally would not provide a true sale opinion. In England, there is apparently significantly less uncertainty about how a transfer related to a repo would be viewed by a court of law in the event of the insolvency of the repo seller (transferor). Under English law, a transfer in which the documents clearly demonstrate a seller intends to transfer outright to the buyer his entire proprietary interest in an asset apparently would be considered a true sale.

We understand that the opinion prepared by the English law firm may have limited applicability and pertains only to the portion of the transaction executed by the U.K. subsidiary with the repo counterparty. It is not clear that claims could not be pressed in another jurisdiction such as the U.S., since the securities were registered in the U.S. and it is not clear whether the transfer from Lehman to its U.K. subsidiary would be deemed to be a true sale under U.S. law. It is also not clear that the transfers would have resulted in isolation (including in bankruptcy) of the transferred assets from the consolidated Lehman entity, not just the U.K. subsidiary, and thus any legal analysis would likely need to address all relevant jurisdictions including U.K. and U.S. law.

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[3] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010, v3, pg. 746.

Second, with respect to the level of collateralization in the arrangement, Lehman apparently took a discount on the face value of the transferred assets (known as a "haircut") offered to the counterparty. Instead of transferring approximately $100 worth of securities for every $100 of cash received, Lehman transferred $105 worth of debt securities or $108 of equity securities for every $100 in cash received (hence, the names Repo 105 and Repo 108). It appears that Lehman structured the transactions in an attempt to support a conclusion that there was inadequate cash collateral to ensure the repurchase of the securities in the event of a default by the counterparty, and, on that basis, Lehman determined that sale accounting was appropriate. Under sale accounting, Lehman

(a) Removed the transferred securities from its balance sheet,
(b) Recognized the cash received, and
(c) Recognized the difference ($105 or $108 securities derecognized less $100 cash received) as a forward purchase commitment.

When developing the guidance for determining whether a company maintains effective control over transferred assets, the FASB noted that repo transactions have attributes of both sales and secured borrowings. On one hand, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning the asset. On the other hand, the contemporaneous transfer and repurchase commitment entered into in a repo transaction raises questions about whether control actually has been relinquished. To differentiate between the two, the FASB developed criteria for determining whether a company maintains effective control over securities transferred in a repo transaction.

As noted above, one of those criteria requires a company to obtain adequate cash or collateral during the contract term to be able to purchase replacement securities from others if the counterparty defaults on its obligation to return the transferred securities ("collateral maintenance requirement"). The accounting guidance provides the following example of a collateral maintenance requirement that does maintain effective control:

> Arrangements to repurchase securities typically with as much as 98–102% collateralization, valued daily and adjusted up or down frequently for changes in market prices, and with clear powers to use that collateral quickly in the event of the counterparty's default, typically fall clearly within that guideline.

The accounting guidance emphasizes the need for understanding the terms of a repo agreement and applying judgment in other situations to determine whether a company maintains effective control over the transferred securities. That example was not intended to, nor does it, create a "bright-line" for making that determination. Rather, the example describes typical collateral arrangements in repurchase agreements involving marketable securities indicating that these typical arrangements clearly result in the transferor maintaining effective control over the transferred securities.

The accounting guidance for repos has been in place since 1997 and has not been changed significantly over the years.

When there are material structured or unusual transactions, disclosure is also very important. The Examiner's report indicates that Lehman's disclosure was incorrect and misleading. According to the Examiner's report, Lehman disclosed that it accounted for all repos as secured borrowings.

Accounting and Reporting Standards for Consolidation of Special-Purpose Entities

A recent press account indicates that Lehman used a small company run by former Lehman employees apparently to shift investments off its books.[4] Based on that press account, it is not possible to determine whether that company was an operating business or a special-purpose entity (SPE). Although the press account does not describe whether and how the presence of related parties may have affected Lehman's consolidation analysis, consolidation accounting standards require consideration of related parties and de-facto agents in the consolidation analysis. In addition, accounting standards require companies to disclose significant related party transactions and de-facto agent arrangements.

The financial crisis revealed that accounting standards governing which entity must recognize and report interests in SPEs were inadequate to protect against "surprise" risks to institutions that had treated these entities as "off balance sheet." Before the recent changes to the accounting standards on consolidation described below, certain entities were exempt from consolidation requirements. Those exemptions assumed that some SPEs (including mortgage trusts) could function on "autopilot," in which no entity was deemed to be in control of such SPEs. This assumption has not been borne out in the recent period of severe stress in the mortgage market. Consolidation requirements before the recent changes had a simple concept that a company should consolidate an SPE if it has the majority of risks and/or rewards of that entity. However, the implementation of this concept was effected through complex mathematical calculations that often excluded the effect of key risks such as liquidity risk. With the benefit of hindsight, it seems that judgments were made based on overly optimistic forecasts of returns and risk, enabling companies to avoid consolidating entities in which they retained significant continuing risks and obligations. While there were numerous required disclosures under generally accepted accounting principles and SEC rules, many financial companies failed to clearly disclose retained risks, obligations, and involvements with SPEs.

Also, with the benefit of hindsight, it appears that arrangements were structured to achieve the desired outcomes of removing financial assets and obligations from balance sheets and reporting lower ongoing risk and leverage. From an investor's viewpoint, this obfuscated important risks and obligations.

To address this, the FASB, at the request of the SEC, completed targeted projects that resulted in removing the exemption for certain entities from consolidation requirements (FAS 166 on transfer of financial assets) and in tightening the requirements governing when such entities should be consolidated (FAS 167 on consolidation of variable interest entities). In addition, the FASB enhanced disclosure requirements to improve disclosure of a company's

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[4] Article in New York Times on April 13, 2010, titled *Lehman Channeled Risks Through "Alter Ego" Firm.*

involvements with transferred financial assets and SPEs. FAS 166 and 167 were issued in June 2009 and became effective in January 2010.[5] The enhanced disclosure requirements became effective in December 2008.

Under FAS 167, entities with the power to control key decisions and the exposure to risks and rewards will more likely report the assets and liabilities on their financial statements. FAS 167 requires an entity to provide enhanced disclosures about its continuing involvement with an SPE, regardless of whether that SPE is on- or off-balance sheet. Along with disclosures about the judgments used in assessing control and evaluating ongoing returns and risk, the revised accounting will put investors in a better position to determine who will ultimately bear the losses and reap the rewards of SPEs.

We are currently working with the International Accounting Standards Board (IASB), which promulgates International Financial Reporting Standards that are used in a number of other jurisdictions, to develop a joint standard on derecognition of financial assets, and the accounting for repurchase agreements is being considered. We are also working with the IASB to develop a joint standard relating to consolidation policy that would apply to traditional operating entities as well as SPEs. We stand ready to consider any further standard-setting actions that may be necessary.

Thank you for the opportunity to provide information on these important issues. FASB members and members of our technical staff would be pleased to respond to further inquiries or to discuss these matters further with you and your staff.

Sincerely,

Robert H. Herz

Robert H. Herz
Chairman

[5] I have separately provided a copy to the Committee staff.