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Financial Accounting Standards Board
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Notes to the Financial Statements

Members of the Board and Trustees of the Foundation:

As an individual investor in public companies, I am commenting on the Board's Exposure Draft ("ED") proposing a new *Chapter 8: Notes to the Financial Statements* to its Conceptual Framework for Financial Reporting, issued March 4th for comment by July 14, 2014. Although the ED is a thoughtful document, it suffers from the failure of the Board to return to first principles in the conduct of its important work, in which the Foundation needs to assist the Board. The focus of this letter is a conceptual critique and corrective of that failure, illustrated by reference to the Board's tentative decisions on recognizing credit impairments of financial assets.

**Overview of the ED**

The ED proposes a decision process for use by the Board and its staff in determining what disclosures should be required in notes to financial statements, developing an approach introduced in the Board's July 2012 Discussion Paper ("DP"), *Disclosure Framework*. General types of information deemed appropriate to the notes include supplemental information about line items, relevant information about the reporting entity, and information about past events and current circumstances and conditions that will or may affect future cash flows but that have not affected a line item.

The Board and its staff would use the proposed guidance in making disclosure decisions for public and private businesses and not-for-profit entities, but not for employee benefit plans, whose financial statements and users are deemed sufficiently different to warrant separate consideration. The overriding objective of such disclosure decisions, and of financial reporting generally, is to provide decision-useful financial information about the reporting entity to "resource providers," including investors, lenders, and other creditors, as well as contributors to not-for-profit organizations (ED¶D5).

**Discussion & Analysis**

While the ED is often creditable as far as it goes, it does not delve deeply enough. More specifically, it does not distinguish between the measurement of performance and risk, with the consequence that it lacks a principled basis in accountancy for deciding what information should be presented on the face of the financial statements rather than disclosed in the notes versus the MD&A.

The ED delimits the information that general-purpose financial statements should provide on their face "by the definitions of assets, liabilities, equity, revenues and expenses, gains and losses, and the related recognition and measurement requirements" (ED¶D2). Compared to the DP, the ED has the twin virtues of explicitly recognizing at least some role for revenues and expenses as gatekeepers for presentation on the face of the financial statements, while in the same breath implicitly acknowledging the evisceration of that role by the recognition of unrealized gains and losses required by fair-value orthodoxy.[1]

*Fair-value orthodoxy* is the faith-based belief that fair value is the accounting cure-all for otherwise deficient financial information, and its handmaiden in the ED and elsewhere in the Board's work is *comprehensive audit*, the belief that as little information as possible should be beyond the reach of audit. Together, fair-value orthodoxy and comprehensive audit are the twin engines of *shadow supervision*, the use of risk recognition on the face of the financial statements and expansively

[1] *Compare* DP¶1.13: "The definitions of and recognition requirements for assets, liabilities, and equity establish a boundary around the information to be provided on the face of the financial statements." The introduction of the concept of *comprehensive income* in the Board's Conceptual Framework represents an attempt to re-establish the former primacy of the balance sheet, notwithstanding the Board's commitment to accounting for investors, who continue to focus on net income based on realized transactions. This is so because investors need accounting principles helpful in estimating the future earnings power of a going concern rather than the fair-value net worth of a firm in liquidation. Both the balance sheet and income statement are important, but in the geography of financial accounting and reporting, performance drives position, not vice versa. Thoughtful creditors value the perspective of the equity investor because – unlike agency credit ratings – equity research is a leading rather than lagging indicator of performance and position that is updated at least quarterly.

audited disclosures to impose the Board's vision of risk measurement and management on reporting entities.

Grounded in dogma rather than empiricism, fair-value orthodoxy has little to do with providing investors decision-useful information and much to do with the Board's sympathies with regulators who have repeatedly proved themselves to be as misguided as they are well-intentioned. Specifically, fair-value orthodoxy arose from the supervisory misdiagnosis of the U.S. thrift crisis of the 1980s, in the wake of which regulators blamed historical cost accounting rather than bad public policy and goodwill recognition for causing and prolonging that debacle.[2]

The Board responded by adopting Statement of Financial Accounting Standards No. 115 ("SFAS 115"), *Accounting for Certain Investments in Debt and Equity Securities* (May 1993).[3] Whereas previously investment securities had been accounted for by analogy to loans as held for investment at amortized cost or held for sale at the lower of cost or market, henceforth things would be different.[4] Under SFAS 115, debt securities would be carried at amortized cost only if held to maturity, rather than the more flexible holding period for loans held for investment. Debt and equity securities held for trading would be accounted for at fair value through the earnings statement, while securities not held for trading that were nevertheless available for sale would be carried at fair value outside earnings in a separate component of equity. Thus for no good reason did the Board radically

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[2] The proximate cause of the crisis was the congressional deregulation of deposit interest rates for an industry holding 30-year, fixed-rate home loans at a time when the FRB was combating inflation with historically high interest rates. The Congress then doubled down on its initial policy blunder by relaxing federal restrictions on investment powers to enable thrifts to earn a positive spread over their funding costs. An asset-quality tsunami followed the negative-spread tsunami, sweeping away much of the thrift industry. By 1984 goodwill and supervisory goodwill recognition, not historical cost accounting, largely enabled one-fifth of the thrift industry – with over one-third of its assets – to avoid reporting insolvency. *See* Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (Oxford U. Press, 1991), pp. 86-87, Table 5-10 in particular.

[3] *See* SFAS 115 ¶ 2, for the Board's acknowledgment of the influence of regulators. A subsequent study by the research manager and a board member of the FASB documented that the SEC was the regulator most responsible for the FASB's adoption of SFAS 115. *See* L. Todd Johnson & Robert J. Swieringa, "Anatomy of an Agenda Decision: Statement No. 115," *Accounting Horizons*, vol. 10, no. 2 (Sarasota, June 1996), p. 145.

[4] The pre-SFAS 115 rationale for recognizing in earnings unrealized losses on loans and securities held for sale was twofold: the business model rendered such losses virtual (they would be realized imminently), and active markets provided reliable pricing. SFAS 115 and its progeny turned a blind eye to both aspects of this commonsensical rationale. More generally, the ascendancy of the contractual cash flow characteristics of financial instruments in the Board's thinking reflects a long-standing animus toward accounting based on intent and business models dating back to SFAS 115: "Current accounting for a debt security is based not on the characteristics of the asset but on management's plans for holding or disposing of the investment. Intent-based accounting impairs comparability" (SFAS 115 ¶ 27). Of course, good disclosure enables comparability.

sever the ineluctable linkage between earnings and equity in classical accounting thinking and literature.

The Board's joint project with the IASB on expected-loss reserving for credit impairments of financial assets provides a timely reminder of the Board's continuing solicitude of supervisors regardless of the facts on the ground or investor sentiment. Coming out of the recent financial crisis, supervisory opinion held that incurred-loss impairment models aggravated the crisis by not recognizing losses soon enough, not incorporating information forward-looking enough to encompass the lifetime of assets and complete economic cycles, and not providing a uniform approach to the impairment of similar assets.[5] Notwithstanding the fact that empirical analysis reveals the fundamental failure to have been underwriting rather than reserving, the Board responded to misguided supervisory prompting by attempting to develop a converged model for the recognition of expected rather than incurred credit losses on financial assets not fair valued through earnings, including loans held for investment and debt securities available for sale.[6]

The attempt at a converged standard has broken apart along a very telling fault line that confirms the Board's supervisory mindset. Briefly, the Board's characteristic focus on the balance sheet and its goal of immediately recognizing all (lifetime) expected credit losses on the face of the financial statements betrays a supervisory perspective on loss recognition: the more and the sooner, the better. By contrast, the IASB's model, with its focus on matching the recognition of interest income and credit expense in the income statement until credit deterioration becomes significant, reflects an accounting perspective closer to the business model. In short, the Board's model front-loads the recognition of credit risk, whereas the IASB's model recognizes credit deterioration as management expects it to develop.

[5] *See* Basel Committee on Banking Supervision, *Guiding principles for the replacement of IAS 39* (August 27, 2009), p. 3; *see also* SEC Office of Chief Accountant & Division of Corporate Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study of Mark-To-Market Accounting* (December 30, 2008), p. 6.

[6] Exposure Draft, *Financial Instruments–Credit Losses*, December 20, 2012. For the empirical analysis documenting that the fundamental failure in the recent financial crisis was underwriting rather than reserving or reserving methodology, as well as anecdotal evidence of institutional investor preference for incurred-loss reserving, *see* the author's "Credit Loss Reserving Investors Could Support," *Financial Debt Quarterly* (Sandler O'Neill, October 9, 2013), p. 1. For the best-performing quartile of U.S. banks, reserves remained adequate to cover nonperforming assets throughout the crisis. For the worst quartile, NPAs quickly and dramatically overwhelmed reserves. Needless to say, banks that failed performed much worse than the worst surviving banks. At an S&P Investor Roundtable on financial services accounting issues held October 3, 2013, of about a dozen large fixed-income institutional investors, not one supported the FASB impairment model, and only a couple supported the IASB model. As with the U.S. thrift crisis, the root causes of the recent financial crisis were bad public policy, including historically low interest rates engineered by the FRB and bipartisan promotion of the goal of almost universal American homeownership.

**Conclusion: Back to Basics**

The two-decade ascent of fair-value orthodoxy and the more recent advent of comprehensive audit reflect the unacknowledged mutation of accountancy into shadow supervision under the stewardship of the Board. As performance measurement and recognition are the essence of accountancy, so risk measurement and recognition are the essence of supervision. Concerning recognition, the more remote the business model renders exchange or settlement of an asset or liability, the more its recognition at fair value on the face of the financial statements measures risk rather than performance.

Mere disclosure of fair-value risk measurement in the notes or MD&A fails to satisfy the Board's supervisory imperative because it lacks the coercive effects on reporting entities of recognition on the face of the financial statements. Similarly, the metaphysical distinctions the ED attempts to draw between "future-oriented" and "forward-looking" information (ED¶¶D22 to D31) reflect the Board's more recent supervisory initiative of relocating as much information as possible from MD&A to the notes, subjecting it to audit.

Contrary to the ED, the true gatekeepers of financial accounting and reporting worthy of the name are assets and liabilities and revenues and expenses, and the necessary relationship of the income statement to the balance sheet is that performance drives position, not vice versa. Fair value has a rightful place in risk measurement and disclosure, but the Board needs to forswear its siren call on the face of the financial statements as an instrument of coercing reporting entities – financial firms in particular – to heel to the Board's supervisory vision of risk measurement and management and to attend, instead, to accounting for investors. Only a return to these core principles can provide the accounting bedrock the Board's legitimate agenda requires.

Sincerely,

Joseph Longino

Joseph Longino

cc: Paul A. Beswick, Chief Accountant
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