Thank you Chairman Reed, Ranking Member Allard, and committee members for the opportunity to be here today to testify on the topic of accounting for off-balance-sheet entities and activities, a very important issue to investors.

I am an analyst with the Capital Group Companies, an organization which, through affiliates, manages the American Funds Family as well as institutional, endowment and private client accounts. Capital Research Global Investors, Capital World Investors and Capital Guardian Trust Company are long-term investors in equities and fixed income securities globally. We are one of the largest active investment managers with over $1 trillion of assets under management representing over 55 million accounts primarily for individuals and institutions. We employ over 9,000 people globally. We conduct extensive, fundamental, on-the-ground company research and we rely heavily on financial statements prepared by public companies. For more information about The Capital Group Companies, please see our website www.capgroup.com.

Additionally, I am a member of the Financial Accounting Standard Board’s (FASB) Investor Task Force and the Investors Technical Advisory Committee (ITAC), the FASB and the International Accounting Standards Board’s (IASB) Joint Advisory Committee for the Financial Statement Presentation Project (JIG), and am a former member of FASB’s Advisory Council (FASAC).

At the Capital Group Companies, we feel that it is critical that the views of investors be considered in the formulation of accounting standards. So, thank you, again, for the opportunity to be here.

The key points I wish to emphasize are as follows:

1. The current rules are inadequate and allow institutions to have too much involvement and risk exposures with entities off the balance sheet.

2. While the FASB rule proposals have just been released and I have not fully studied them, my preliminary view is that together they represent a good response and significant improvement over what we have today. Reforms in this area should be adopted on a timely basis.

1 For more information about ITAC, FASAC, ITF and JIG, see FASB.org and IASB.org.
3. The SEC should enforce the new rules as enacted and not weaken them or permit management or auditors to weaken them through interpretation as it did with the current rules. The inadequate accounting as well as the weak enforcement of the current rules equally contributed to the recent well-documented transparency problems.

4. The Congress should be supportive of FASB’s efforts and not undermine them. In the oversight capacity with respect to the SEC, Congress should monitor and encourage enforcement of the new rules. Congress does not need to legislate in this area.

5. The FASB rule proposals are better than the current international standards and we are waiting to see improvements to IASB’s draft proposal. The US should not adopt the International Financial Reporting Standards (IFRS) rules if they are not substantially equivalent to FASB’s rules. We must be sure this fix is not undone if IFRS rules are adopted in the U.S. U.S. and International standard setters should converge to the highest-quality accounting and disclosure requirements.

6. Investors are an important constituent without a sufficient voice at the table in accounting standard setting. The FASB and IASB should expand investor representation on their boards.

First I will give you my view of why the issue of off-balance-sheet accounting is extremely important to investors. Then I will address what I consider to be some of the important elements of an accounting solution to this issue.

It is well accepted that the lack of transparency in financial reporting creates unwarranted confusion and unnecessarily produces higher cost of capital, misallocates capital across industries and distorts securities valuations. In particular, the accounting for securitizations\(^2\) and special-purpose entities (SPEs) lacks sufficient transparency for efficient capital markets, and has been a contributing cause to the current financial crisis. In this decade, investors have suffered substantial losses over this accounting issue, twice: once after Enron and again in the current mortgage crisis. The present problems in the financial markets are directly linked to insufficient reporting of exposures on the balance sheet and confusion between what is exposure and what is not.

Many of the losses incurred over the last year stemmed in part from companies’ ability to easily transfer loans and other assets to off-balance-sheet entities - entities for which investors often have limited information, with inadequate accounting for, or disclosure of, the risks retained by such companies. As of March 2008, the International Monetary Fund (IMF)

\(^2\) Securitization is defined by Investopedia as “The process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors.” at http://www.investopedia.com/terms/s/securitization.asp. Securitization is the sale or transfer of assets in exchange for cash; the assets are typically transferred to a special-purpose entity (SPE), which raises cash by issuing securities, i.e. the repackaged instruments.
forecasted $720 billion\(^1\) of potential losses primarily on asset-backed securities, which are complex securities typically collateralized by loans and receivables transferred off balance sheets. Often the economics of these transactions were structured financings, yet those assets and liabilities did not appear on the balance sheets, and when the assets declined in value, the accompanying risks and losses were also not apparent to investors or regulators.

Two recent academic papers discuss research on the reasons why loan securitizations result in poor loan origination and screening practices and higher default rates, particularly in the subprime debacle. Research by A. Mian and A. Suffi with The University of Chicago in January 2008 concluded:

"We directly link the disintermediation process [i.e., the process in which organizations sell mortgages in the secondary market shortly after origination] to credit expansion, house price appreciation, and ultimate defaults by showing that these changes take place in precisely those zip codes that experienced the greatest increase in disintermediation."\(^4\)

Also, research by B. Keys et al. in January 2008 found:

"Conditional on being securitized, the portfolio that is more likely to be securitized defaults by around 20% more than a similar risk profile group with a lower probability of securitization."\(^5\)

In the recent past, during a period of easy credit availability and without transparent accounting that accurately reflects risks, financial institutions appeared especially profitable and attracted capital to the sector. They also added many jobs. In summary, employment, industry practices, corporate profits, capital allocation, executive compensation, risk management and prudential regulation may be adversely impacted by poor reporting of structured financings. Investors have been surprised that accounting in this area has not been made more transparent since Enron. It is clearly time to set forth transparent, high quality accounting and disclosure requirements and to enhance the way the standards are implemented and enforced by auditors and the Securities and Exchange Commission (SEC).

In its letter to FASB dated February 15, 2008, the ITAC wrote:

"The general consensus of the ITAC: the reporting of securitization transactions currently provided to investors has significant deficiencies, and has contributed to uncertainty and volatility in the capital markets. Accordingly, we applaud and support\(^6\)


risks in many of their off-balance-sheet entities, while providing at best only limited disclosures to investors regarding their off-balance-sheet risks. Financial reporting should result in the substance of transactions, rather than their oblique "engineered legal forms" being reported to investors. Financial engineering should not result in companies being able to report financial results and conditions that misrepresent the underlying economics of their businesses, and to report balance sheets that omit millions or billions of dollars of liabilities, or fail to disclose significant risks. When a public company effectively controls or has power over the assets and liabilities of other entities, those entities along with their assets and liabilities should be consolidated by the company on the face of its balance sheet. There may not be any legal obligation for sponsoring institutions to financially support their off-balance-sheet entities, but sponsors have demonstrated willingness to lend to their off-balance-sheet entities and take losses for them, and therefore have significant moral or substantive recourse and other strings attached that need to be considered in the accounting.\(^7\)

Now, I will move on to discuss some important elements of a transparent, high-quality accounting solution.

**First, put a stop to financial-engineering opportunities that allow inaccurate reporting of risk and reward profiles.** We now know that a number of companies have retained substantial risks in many of their off-balance-sheet entities, while providing at best only limited disclosures to investors regarding their off-balance-sheet risks. Financial reporting should result in the substance of transactions, rather than their oblique "engineered legal forms" being reported to investors. Financial engineering should not result in companies being able to report financial results and conditions that misrepresent the underlying economics of their businesses, and to report balance sheets that omit millions or billions of dollars of liabilities, or fail to disclose significant risks. When a public company effectively controls or has power over the assets and liabilities of other entities, those entities along with their assets and liabilities should be consolidated by the company on the face of its balance sheet. There may not be any legal obligation for sponsoring institutions to financially support their off-balance-sheet entities, but sponsors have demonstrated willingness to lend to their off-balance-sheet entities and take losses for them, and therefore have significant moral or substantive recourse and other strings attached that need to be considered in the accounting.\(^7\)

In its letter to FASB dated February 15, 2008, the ITAC expressed similar views:

> “Short-term repairs to Statement [of Financial Accounting Standards No.] 140 [Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities] will do nothing to address the issue of structured investment vehicles (SIVs) and other similar asset-backed securitization transactions that are not effected through a QSPE [Qualifying Special Purpose Entity] (e.g., many ABCP [Asset-Backed Commercial Paper] transactions), most of which did not exist on the balance sheets of companies that have originated them and have benefited from their borrowing activities. We believe investors have not been provided with meaningful information about potential risks associated with such activities – partly attributable to the insufficient balance-sheet accounting for them despite the application of Interpretation 46R, and partly attributable to the lack of full-throated disclosures. Such vehicles have been the cause of much market tumult over the last six months, and there appears to be a substantial lack of transparency surrounding them.”\(^8\)

Moreover, in its letter to FASB dated July 31, 2003, the Corporate Disclosure Policy Committee (CDPC, formerly the Financial Accounting Policy Committee) of the CFA Institute wrote the following:


\(^7\) FASB has incorporated the notion of substantive obligations into accounting for other commitments, for example Statements 87 and 106 addressing accounting for pensions and post-retirement obligations.

\(^8\) Letter from Investors Technical Advisory Committee, supra, footnote 6.
"The [CDPC] has expressed its concern on several occasions with companies' continued ability under current accounting standards to hide assets and obligations by removing them from the financial statements. Statements that understate assets or liabilities and other risks of a company severely impair the usefulness of the information to investors and other users. The needs of investors for complete, reliable, relevant and timely financial information should supersede all other interests."\(^9\)

What is on-balance sheet for accounting purposes is about conveying to investors information and judgments made by management and agreed to by its auditors. The objective of financial reporting is not to achieve appropriate regulatory capital; that is a different matter between the banks and banking regulators. If the Federal Reserve believes it appropriate for prudential regulation to have temporary regulatory forbearance on capital and reserve requirements that is fine, but in my opinion bank regulators should not manage the financial reporting to investors. That is, if regulators think transparency in financial reporting results in asset sales and therefore excessive losses, then regulators could prevent forced deleveraging by easing up on capital requirements. If the economics are such that banks regulators think holding more or less capital would be prudent then that should be required despite the accounting.

Accounts reported on the face of the financial statements are most critical and relevant to investors. The accounts represent the starting point to financial analysis, which must be complemented by high-quality footnote disclosures. Numerous academic studies\(^10\) reinforce this notion and suggest that data in financial statement footnote disclosures are lower quality and taken far less seriously by companies, auditors, and investors, than what is reported on the face of the financial statements. It is common knowledge in the accounting field that disclosures are an inadequate substitute for good accounting; rather good disclosures must go hand in hand with good accounting.

Second, the accounting solution should be accompanied with useful disclosures. It is important that companies provide additional information that augments and explains items on the face of financial statements so users may understand financial risks and benefits facing companies, and forecast future cash flows. A few examples, and there are many more, of information that should be included in disclosures to investors are as follows:

\(^9\) Letter from Financial Accounting Policy Committee (FAPC), CFA Institute, to Suzanne Bielstein, FASB (July 31, 2003). ("The FAPC has expressed its concern on several occasions with companies' continued ability under current accounting standards to hide assets and obligations by removing them from the financial statements. Statements that understate assets or liabilities and other risks of a company severely impair the usefulness of the information to investors and other users. The needs of investors for complete, reliable, relevant and timely financial information should supersede all other interests.") available at http://www.cfainstitute.org/centre/topics/comment/2003/03fas_proposal.html.

Third, a high-quality, workable and effective accounting solution should be in place without further delay from the timing in the current FASB proposal. Regulators worldwide have expressed concern about the market impact of poor financial reporting of off-balance-sheet exposures, and have urged accounting standard setters to act. For instance:

- In its report to Congress in June 2005, SEC Staff identified off-balance-sheet financial reporting as an area needing improved transparency in reporting.
- The Financial Stability Forum (FSF) highlighted in its report issued to the G7 group of Finance Ministers and Central Bank Governors that “a lack of adequate and consistent disclosure of risk exposures and valuations continues to have a corrosive effect on confidence,” and recommended that “Standard setters take urgent action to improve and converge financial reporting standards for off-balance-sheet vehicles.”
- The European Commission has indicated concern about insufficient disclosures regarding securitization activity and exposures.
- The Senior Supervisors Group in its letter to the FSF expressed a similar view.

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12 SEC Office of the Chief Accountant, Office of Economic Analysis and Division of Corporate Finance, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, submission to the President of the United States, the Committee on Banking, Housing, and Urban Affairs of the United States Senate and the Committee on Financial Services of the United States House of Representatives, June 15, 2005. (Staff wrote that it “believes that investors—and the market as a whole—are best served by financial information that is presented fully and clearly...What presents difficulties for investors, as well as the market as a whole, is a lack of information about potential positive and negative cash flows.”), at http://www.sec.gov/news/studies/soxoffbalancerept.pdf.
The President’s Working Group on Financial Markets recommended that “Authorities should encourage FASB to evaluate the role of accounting standards in the current market turmoil. ... include[ing] an assessment of the need for further modifications to accounting standards related to consolidation and securitization…”16

Moreover, since 1999, CFA Institute members have repeatedly expressed their need for better information through their responses to its surveys on corporate reporting and disclosures. In three surveys conducted, respondents consistently ranked information about off-balance-sheet items as being the most important of the corporate disclosures listed in the survey questionnaire. In addition, respondents consistently ranked the quality of off-balance-sheet disclosure near the bottom, resulting in the largest informational gap for those disclosures listed in the survey.17

Investors should not have to wait any longer for progress to be made in financial reporting of off-balance-sheet activities. The numerous attempted accounting improvements over the years18 have not worked. Indeed, for many years, standard setters have thoroughly studied the accounting for off-balance-sheet entities, and they have researched it particularly intensively over the last couple of years. The IASB and FASB understand that both IFRS and US GAAP derecognition standards need improvement. In the Information for Observers handout distributed in advance of the joint IASB/FASB meeting on April 21, 2008, it highlighted that “Statement 140 was then [in 2006] deemed to be irretrievably broken, and still is despite ongoing repair and maintenance work. IAS 39 was then, and still is, viewed by many as internally inconsistent, and anecdotal evidence indicates that it is inconsistently applied in practice.”19 Accordingly, both the FASB and IASB should achieve a standard that results in the substance of these transactions being reflected in the balance sheets and income statements of public companies.

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15 Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence, March 6, 2008. Transmittal letter from William L. Rudledge, Chairman, to FSF Chairman Mario Draghi. “[W]e will support efforts in the appropriate forums to address issues that may benefit from discussion among market participants, supervisors, and other key players (such as accountants). One such issue relates to the quality and timeliness of public disclosures made by financial services firms and the question whether improving disclosure practices would reduce uncertainty about the scale of potential losses associated with problematic exposures. Another may be to discuss the appropriate accounting and disclosure treatments of exposures to off-balance-sheet vehicles.”), at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.


18 See e.g. AICPA Statement of Position (SOP) 74–6, Financial Accounting Standard No. (FAS) 77, FAS 125, FAS 140; Emerging Issues Task Force Consensus 90-15 (1990), FASB Interpretation No. (FIN) 46, FIN 46R; FASB Staff Position (FSP) papers, and Q&A Implementation Guidance.

Fourth, the U.S. and International standard setters should converge to the highest-quality accounting and disclosure requirements. Our experience is that both IFRS and US GAAP accounting did not sufficiently capture important off-balance-sheet exposures over the last year, and the disclosures were poor. We noted that in a number of issued annual and interim balance sheets, income statements and footnote disclosures, investors were not advised that off-balance-sheet risk of loss existed. The FSF has recommended that the IASB improve the accounting and disclosure requirements for off-balance-sheet entities and activities. Recent research by PriceWaterhouseCoopers found meaningful deficiencies and incomparability in financial reporting of structured finance activities and entities under IFRS.

In my view the FASB’s proposal is superior to current IFRS, and the IASB Staff Working Draft ED, however that Draft appears fairly fluid and not yet approved by IASB board members. In the latest available Draft proposal prepared by IASB Staff, a financial institution could avoid putting a SIV on the balance sheet despite having significant involvement with the SIV, including participating in the SIV’s governing body and having sufficient voting rights to appoint directors, servicing and administering the SIV’s assets and liabilities, appointing its management personnel, dominating the major contracts and having meaningful reputation risk. Because of that risk, a financial institution could have the obligation to absorb losses, which could potentially be significant. IASB has not yet responded to investor concerns on this issue and should adopt FASB’s anticipated new approach and disclosures if it would be more useful than IASB’s current draft proposal and help make a better financial reporting system. It is important at this juncture that we have a coordinated global effort to improve the accounting and enforcement in order to ensure a level playing field and the highest quality compliance with the new rules.

Fifth, the SEC, external auditors, audit committees, and management should be held accountable if they fail to implement and enforce the standard for securitizations and special-purpose entities. Once we have a clear and high-quality accounting standard that makes sense, compliance can follow. If it does not, then Congress should support the SEC, auditors, and standard setters to properly enforce the accounting in the interest of investors. A high-quality accounting standard is of limited value to investors and other market participants if enterprises fail to comply with its requirements, including disclosures. Investors should be able to rely on financial statements and the accompanying disclosures to report the risks and substance of the economics of transactions, including those that are structured financings and not true sales, rather than be left in the dark as current accounting standards permit.

There has been poor compliance and enforcement of the existing accounting rules for securitizations and special-purpose entities put in place following the Enron debacle. FASB Chairman Mr. Bob Herz highlighted several compliance issues in his letter to Senator

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20 Financial Stability Forum, supra, footnote 13, p. 25.
22 FASB, supra, footnote 11.
Reed.

The SEC must responsibly enforce compliance with the new accounting and disclosure requirements concurrent with the new standard becoming effective, rather than wait until another crisis develops. *The SEC through its Division of Corporation Finance should engage in a targeted review of compliance through its comment letter process with the objective of reducing diversity in practice and improving comparability in application and implementation before any SEC enforcement would be needed.* Knowing that an SEC review of their implementation of the standard was coming, companies would then have a good incentive to have transparent financial reporting, and investors would benefit in the process.

If the accounting is transparent and complied with, then companies would have every incentive to pull together sufficient information to conduct proper internal risk management, regulators would have the data to enforce the rules and prudentially regulate, and investors would have the information for valuing the companies in which they invest and for holding managements and boards accountable.

Sixth, the FASB and IASB should have more investor members and better investor participation in the accounting standard setting process. We believe the boards of trustees, i.e. both the Financial Accounting Foundation (FAF) and International Accounting Standards Committee Foundation (IASCF), should actively seek out, and have as voting FASB and IASB members, several people from the investment community with significant experience using financial statements in the research process. We also believe the trustees of the FASB and IASB should include significant representation from among such investors. *Simply stated, investor participation is critical to developing high-quality, transparent, relevant, consistent and comparable accounting standards.*

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In conclusion, the current lack of transparency has real economic costs including unwarranted confusion and unnecessarily high cost of capital, misallocated capital across industries over the long term, discounted securities valuations through higher risk premiums and uncertainty penalties, and also costs employment practices, people’s savings and livelihoods. It is critical for U.S. and non-U.S. capital markets to receive the information necessary for market participants to analyze transactions, so that market disciplinary and capital allocation mechanisms can properly function. If high-quality, properly-enforced financial reporting and information is provided on a timely basis, then reasonable investors can quickly digest it and move forward. If not, market inefficiencies get created that can have unfortunate outcomes for investors, the capital markets and the economy. We must

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24 Letter from FASB Chairman Bob Herz to The Honorable Jack Reed, p. 13-14, March 31, 2008, “[W]e have questions about compliance with the existing standards and requirements in the following areas:

a. The use of QSPEs to securitize assets for which decisions were required that may have extended beyond those specified in legal documents.

b. The completeness and reasonableness of probability assessments used in estimating expected losses for determining the primary beneficiary of a securitization entity.

c. Whether all involvements with a securitization entity were considered in determining the primary beneficiary (including, for example, implied guarantees and support arrangements).

d. The adequacy of disclosures made pursuant to the requirements.”
have truth and accountability in financial reporting to help put the current credit and confidence crisis behind us.

Thank you. That concludes my remarks and I would be happy to answer any questions committee members might have.