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**News  
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**THE PROPER ROLE OF FINANCIAL REPORTING:  
MARKET BASED ACCOUNTING**

**REMARKS OF**

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## THE PROPER ROLE OF FINANCIAL REPORTING: MARKET BASED ACCOUNTING

One major area of current Commission concern is the valuation of financial instruments held by financial institutions. Under current practice, GAAP for banks and thrifts are based principally on a historical cost framework. These institutions are permitted to carry assets on their books at amortized cost, even in instances where the current value of the assets has eroded substantially, and where a market-based standard would provide a far more accurate measure of the institution's financial health.

As we enter the decade of the 1990s, we should consider a fundamental shift in the goal we set for the accounting standards for financial institutions. Financial institutions are in the business of buying and selling financial instruments, all of which have a value measured in terms of current market conditions. Determining the current value of an institution's assets, not recording their original cost, should increasingly be the goal toward which we must work.

The bedrock for current general-purpose financial reporting for almost all industries is the "historical" cost model. 1/ In most cases,

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1/ Under the historical cost model, most assets are recorded at their acquisition price, which is presumed to be more objective. Departing from the historical cost rule (*i.e.*, using the lower of cost or market, or "LOCOM") is generally done only when the future utility (or revenue-producing  
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historical cost produces reliable information because it is based on verifiable recorded amounts for transactions. However, as many observers have noted, the cost system has been subject to abuses and can lose its relevance in a changing economic environment, such as that experienced by the thrift and banking industries in the 1980s. As observed by Professor Edward J. Kane of Ohio State University, historical cost accounting for financial institutions undervalues an institution's best portfolio decisions and overvalues its worst ones. Perhaps even worse, by not modifying carrying values to reflect subsequent market developments, irrefutable and often readily observed evidence is neglected.

The nation's experience with the crisis in the savings and loan industry, as well as many of the largest bank failures, demonstrates the inherent and substantial dangers of a reporting system for financial institutions that is premised on historical cost accounting principles. Market-based information can permit regulators and investors alike to make a much more meaningful assessment of the

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ability) of an asset is less than its cost. Such differences should be recorded in the period in which they occur. (See, e.g., Financial Accounting Standards Board Statement of Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," (December 1984), paragraphs 67-69; Accounting Principles Board, "Accounting Research Bulletin No. 43," Chapter 4, paragraphs 8 and 9.)

real economic value and risk exposures of a financial institution. Knowing current market value also allows regulators to take appropriate actions before a situation deteriorates irretrievably.

When a financial institution becomes insolvent, the loss to the insurance fund, and ultimately to the taxpayers, is measurable based solely on the market values of its assets and liabilities -- historical costs are irrelevant. The risk exposure to the insurance system should therefore be calculated on the same basis that its ultimate obligation will be calculated. Although market values for some types of illiquid assets such as LDC loans or one-of-a-kind term loans cannot be measured with the same degree of precision as historical costs, a good estimate of a relevant fact like current value is better than a precise measure of data that is irrelevant to everyone other than historical novelists.

While some in the banking industry have argued that mark-to-market accounting would produce unacceptable volatility in operating results and other problems, market-based accounting has long been required of broker-dealers and investment companies. Thus, firms like Salomon Brothers, Merrill Lynch and others with huge securities positions routinely use daily mark-to-market accounting without such problems. So too, mutual funds with hundreds of billions in securities must utilize mark-to-market accounting. It is therefore hard

to believe that this method of reporting by banks and thrifts would produce problems nearly as great as have been suggested. This is especially true with respect to holdings of securities irrespective of "trading" or "investment" intent.

The Commission recognizes that transforming the accounting standards of banks and thrifts from a cost to a market-based standard is a complex undertaking, and we realize that studies are currently under way concerning these issues. 2/ However, it is our strongly held view that the objective of these efforts should be to achieve financial reporting that uses appropriate market-based measures of valuation at the earliest possible date.

Presently, banks and thrifts report debt securities classified as trading assets at market prices. Securities classified as investments are carried at cost (less provisions for credit losses), or at the lower

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2/ Several studies are currently underway concerning these issues. The FASB has a significant project addressing the accounting for financial instruments, which encompasses the issue of market-based measures. The FASB currently is focusing on disclosure of value information. In addition, the International Accounting Standards Committee and the Canadian Institute of Chartered Accountants have a similar joint project which is in the early stages. Both projects involve consideration of value-based accounting and disclosure. As part of the study of the Federal deposit insurance system required by section 1001 of FIRREA, the Department of the Treasury, in consultation with the federal banking agencies and others, is to evaluate several topics, including the feasibility of market value accounting. See FIRREA, Section 1001(b)(4).

of cost or market if the institution does not have either the intent or the ability to hold the securities. 3/

Under current GAAP, recording investment securities at cost generally requires that an institution have the ability and intent to hold the securities to maturity. 4/ The rationale for this treatment is that, if the security is held to maturity, it will be redeemed at its face amount. Therefore, temporary fluctuations in market value due to interest rates changes are considered irrelevant since they do not affect ultimate realization at maturity, -- which of course may not occur for decades. 5/ This justification is irrelevant, however, to the value of the investment, and to the true value of rate of return in an

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3/ In most other major countries, trading accounts are generally carried at market; however, Germany and Japan generally use LOCOM. For non-trading debt investments, the accounting is generally at cost or LOCOM -- Japan and Germany use LOCOM, Canada uses principally cost, while certain other countries (e.g., the United Kingdom and France) distinguish among cost, LOCOM, or market based on the purpose of the investment.

4/ Under existing accounting rules, when the institution does not have the ability to hold the instruments to maturity, market losses must be recognized. Thus, the passage of FIRREA, which required thrifts to dispose of junk bonds and other risky investments, forced the recognition of significant market losses that had occurred as a result of a declining value of these speculative investments. If the thrift regulators had used market-based measures to assess the capital requirements of thrifts during the last decade, it would have been clear that some of these institutions did not have the ability to hold these investments to maturity.

5/ AICPA Industry Audit Guide, "Audits of Banks," 30 (2d ed. 1984),

institution's portfolio. Even if the principal of a debt security is ultimately paid 29 years in the future, this does not eliminate the relevance of a significant decline in the value of that security, and the real net worth of the institution, during the intervening years.

This accounting rule was developed in a vastly different economic environment than the one in which institutions must function today. Today financial institutions actively manage their interest earning asset and interest bearing liability portfolios to maximize net income and to manage interest rate risk. This "asset/liability" management often requires frequent buying and selling of investment securities to restructure asset and liability maturities. The continued use of the historical cost model in this environment is inappropriate because of the diminished relevance of the resulting financial information.

Further, the continued use of historical cost accounting for investment securities has enabled institutions to "manage" the timing of gains and losses. Some thrifts did trade out of their so-called investment portfolios, but only when doing so allowed recognition of a gain. "Gains trading", *i.e.*, selling profitable positions and holding losing positions, also referred to as "cherry picking," had the effect of inflating the thrift's apparent short-term profitability while inevitably leading to declines in future yields.

In the late 1980s, just before the passage of FIRREA, the FHLBB finally sought to curtail gains trading through the adoption of regulatory accounting guidance. 6/ However, the guidance was controversial and complex, and OTS subsequently deferred implementation of this guidance to permit the AICPA to clarify the principles and to develop guidance for banks as well as thrifts.

In the interim, the Commission's staff has acted to enhance the information provided in filings with the Commission. Financial institutions filing with the Commission must consider the need to furnish the amount of gross unrealized gain and loss in the investment portfolio, and are required to provide a description of the accounting policies followed in reporting its investment portfolio, and an analysis of any material effect on future earnings from unrealized portfolio losses and portfolio sales. In appropriate circumstances, failure to disclose such items will result in enforcement action by the Commission.

The Commission will carefully oversee the ongoing deliberations of the AICPA and FASB on the issue of bank and thrift accounting policies -- and especially the valuation of securities portfolios. Indeed, only yesterday the Commission's Chief Accountant wrote to

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6/ 12 C.F.R. 563c.102 (effectiveness delayed until April 1, 1990 by 55 Fed. Reg. 126 (1990)).

the AICPA committee considering this issue and stated: "We are familiar with the argument that market-based valuation will introduce additional volatility to reported earnings of banks and thrifts, but we find that argument unpersuasive. Any volatility is a product of the behavior of a financial institution's investment portfolio. Accounting standards ought not conceal the reality they are established to portray. Certainly, financial statements should not ignore the reliable valuation furnished by liquid markets." Because it is inherently difficult to distinguish portfolio categories based on intent and ability, particularly considering the dynamic market environment in which investment decisions are made, serious consideration must be given to reporting all investment securities at market value.

Steps currently being taken to clarify the accounting treatment for investment portfolios should be part of a broader move in the direction of mark-to-market accounting. The benefits of market-based accounting warrant consideration of a broader shift in this direction. I believe that it is time to recognize a presumption that market-based information is the most relevant financial data. In the future, it may be appropriate to utilize historical cost only where specifically justified by the circumstances.

The Commission recognizes that the move to a full-scale application of market-based accounting requires careful and

deliberate planning. The Commission is aware that strong views are held and valid concerns exist concerning a shift to market value accounting. In particular, great care must be taken to ensure that the costs of implementation and ongoing compliance do not exceed the expected benefits. With respect to reliability of market value information, additional work will be necessary to develop reasonable and cost-effective valuation techniques for those assets and liabilities that do not have a liquid market. We need to explore ways to reduce subjectivity of estimates to an acceptable level. However, valuations are used by well-managed institutions in making business decisions and are applied routinely in business combinations. Therefore, while we do not underestimate the significance or importance of these issues, the Commission believes that their resolution must be aggressively pursued.

The thrift crisis confirms that effective regulation of financial institutions requires adherence to sound accounting principles. It is essential, for the purposes of both general financial reporting and regulatory reporting, that financial institutions adhere to accounting standards that result in an accurate portrayal of the institution's financial position and results of operation.

The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to

make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose. This may also become the camouflage for improper and unsafe practices. Because of these dangers, all publicly-held companies, including financial institutions, should be required to adhere to a uniform set of accounting principles. The principles should be established through a standard-setting and review process, overseen by a single agency, that is immune to tampering by a failed industry or its regulators. The value of uniform standards will be enhanced if, wherever possible, they are based on market-based measures of valuation.

We must learn from our experience in the thrift crisis as we develop today's disclosure standards. Although accounting techniques were used to enhance the perception that thrift institutions were operating on a safe and sound basis, they did not -- and could not -- make any thrift institution more safe or sound in fact. Changes in accounting standards do not change the underlying business reality. They may, however, alter the way that we perceive and measure that reality. It is therefore critical that we seek to become aware of insolvency or financial crisis at the earliest possible time, not when it is already too late.