American Accounting Association's Financial Accounting Standards Committee

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Response to the FASB Preliminary Views: Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value

INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (hereafter the Committee) is charged with responding to requests for input from standard setters on financial-reporting issues. The Committee is pleased to respond to the invitation to comment on the FASB Preliminary Views document “Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value” (hereafter the Document). The opinions in this letter reflect the views of the individuals on the committee and not those of the American Accounting Association. Our comments are organized to address the specific issues raised in the Document and follow the same numbering scheme.

ISSUE 1: WHAT SHOULD BE REPORTED AT FAIR VALUE?

As it has indicated previously,¹ the Committee generally supports the FASB position that financial instruments be reported in the financial statements at fair value when the associated conceptual and measurement issues are resolved. Thus, the question at hand seems to be one of scope—which financial statement items should be reported at fair value (or equivalently, how should we define financial instruments)? We believe that the research that we summarize next sheds some light on this question.

A large body of research assesses whether fair value disclosures for financial instruments are “value-relevant” to investors.² To do this, researchers regress stock prices

¹ See AAA FASC (1998).
² For example see Barth (1994), Barth et al. (1996), Eccher et al. (1996), Nelson (1996), and Venkatachalam (1996).

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on recognized assets and liabilities, earnings, and the fair value of the financial instruments of interest, principally investment and derivative securities (for which market prices are usually available). These studies typically find that fair-value disclosures for investment and derivative securities are value-relevant to investors; i.e., the coefficients on the financial instrument fair-value variables are statistically significant and have the expected signs (positive for assets and negative for liabilities). Some interpret these results as implying that fair-value disclosures are used by investors to set share prices, although it may simply be that the information used by investors to set share prices is correlated with the fair value of financial instruments. Thus, this research does not tell us about the marginal information content of the fair-value disclosures, that is, whether investors obtain fair-value information from the financial statements or from sources outside of the financial statements.

A second caveat is that, as is true of most capital-markets-based accounting research, these studies assume that securities markets are efficient enough to process the information sufficiently well that value relevance can be assessed. Thus, although we know that the fair-value information is correlated with price, we cannot know whether investors have processed this information "correctly," absent some independent valuation benchmark. Concerns such as these have led some to argue that value-relevance studies should not be used to inform or guide the formation of accounting standards. Our position is not as strong. We believe that when (1) researchers have clear and economically sound predictions about the signs and magnitudes of regression coefficients, and (2) those predictions are borne out in the data, these studies can provide useful information, especially on the issue of reliability to which we turn next.

An important concern with the extension of fair-value reporting to all financial instruments is whether measured fair values are sufficiently reliable to be recognized in the financial statements, especially for those assets and liabilities that do not trade on liquid secondary markets for which market values are not readily available. For these items managerial judgment must be used to measure fair value, allowing the possibility that the reported numbers are subject to manipulation by management, adding noise or bias to reported fair values.

There is some research to support the idea that fair values that are not taken directly from market values are measured less reliably. Petroni and Wahlen (1995) investigate the value-relevance of fair-value disclosures by property-casualty insurers for various asset categories. While these authors find that fair-value disclosures for investments in equity and U.S. Treasury securities (for which market values are readily available) are value-relevant, they also find that fair-value disclosures for investments in corporate and municipal bonds and other debt securities (for which market prices are

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3 For recognized financial instruments, researchers include the difference between carrying values and fair values, while fair values are included separately for off-balance-sheet instruments.

4 This point has been discussed by Holthausen and Palepu (1994) and Skinner (1996), among others.

5 For example, if we simply assume that $1 of fair value of an investment security should translate into $1 of equity value for the firm, then we should see coefficient of 1 in these regressions. However, we sometimes see coefficients that are significantly less than 1 in these studies, making it difficult to interpret the results (such results could be interpreted to mean that the market is inefficient, or that the fair-value numbers are unreliable, or that there are econometric problems with the regression model specification, or some combination of these).

6 For a comprehensive critique of the value-relevance literature and its implications (or lack thereof) for standard setting, see Holthausen and Watts (2000).
more difficult to obtain) are not. This suggests that the differential reliability of fair-value estimates for different types of securities affects the value-relevance of these fair values.

Eccher et al. (1996) report, consistent with other studies, that SFAS No. 107 disclosures of the fair value of investment securities are value-relevant, consistent with the idea that banks do not earn "rents" from investment securities (so that value-in-use closely approximates exit values, which is another way of saying that market values are readily determinable). However, they find mixed evidence when they consider the value-relevance of other financial instruments—a weaker correlation between stock prices and fair values for net loans and off-balance-sheet instruments, and no correlation for the fair value of deposits. They interpret the latter finding as being due to the exclusion of core-deposit intangibles from the fair value of deposits under SFAS No. 107. Nelson (1996) reports similar evidence in her study of SFAS No. 107 disclosures; she finds that the fair value of investment securities is positively related to equity values, but that the fair values of loans, deposits, long-term debt, and net off-balance-sheet financial instruments are not. Barth et al. (1996) also examine the value-relevance of fair-value disclosures under SFAS No. 107 and find that loan fair values are value-relevant, but only when other loan-related variables (such as the level of nonperforming loans) are included in the regression.

To summarize, the evidence in these papers indicates that fair values are correlated with security prices for those financial instruments for which fair values can be reliably measured, meaning that readily determinable market values are available. There is also some evidence that the lack of value-relevance for other financial instruments (such as deposit liabilities and loans) may be due to the lack of disclosures about economically important characteristics of these less-marketable instruments, such as information about core-deposit intangibles and the level of nonperforming loans.

We next discuss how the exercise of judgment by managers affects the reliability of fair-value disclosures. Bernard et al. (1995) shed some light on this question by analyzing Danish banks, which are required to use market-value accounting for regulatory purposes. Although these authors find some evidence that loan-loss provisions (over which managers have a good deal of discretion) are managed in such a way as to delay the reporting of credit risks (similar to what happens in U.S. banks), they do not find overall that manipulation is a serious issue for these banks and, in fact, find some evidence that the Danish market-value numbers are more reliable than U.S. historic-cost numbers.

There are also several papers that specifically assess how managers exercise their judgment over loan-loss provisions, an area where managers would continue to have discretion given that market values of bank loans (especially commercial loans, whose characteristics are more idiosyncratic) are not readily available. These papers document that these provisions are largely discretionary, which increases concerns that fair-value numbers for bank loans would not be reliably measured. However, these papers document that, despite the discretion, loan-loss provisions provide information to market participants and, holding news about the default risk of banks' loan portfolios constant, increases in loan-loss provisions tend to convey good news to the market. This result is interesting because it indicates that even when managers do have discretion, it does not necessarily reduce the information content of the related financial statement numbers to investors.

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Finally, recent papers by Beaver and Venkatachalam (1999) and Nissim (1999) assess the value-relevance of loan fair values, distinguishing among loan components over which managers exercise different levels of judgment. The results are consistent with economic intuition; when managers have little scope to exercise judgment, loan fair values are "priced" by investors, while loan components over which managers exercise relatively more judgment are not.

To summarize, a number of papers assess the "value-relevance" of fair-value disclosures for financial instruments. While these studies find consistent evidence that the fair values of investment securities are correlated with equity values (and are thus "value-relevant"), evidence on the value-relevance of the fair values of other financial instruments is more mixed. This perhaps reflects the fact that these other instruments have associated intangible components (e.g., core-deposit intangibles) whose value is difficult for managers to credibly communicate to outsiders. This suggests that attempting to value the entire package of financial-instrument components is likely to result in a number that is more highly correlated with stock prices (assuming that valuation is reasonably reliable) than trying to estimate the values of individual components of financial instruments. In addition, research findings support the idea that investors distinguish between fair-value numbers that are more and less reliably measured (e.g., because they reflect differential levels of managerial estimates and judgments) and price the associated financial instruments accordingly. This supports the notion that fair values should be reported for financial instruments, even when some managerial discretion is involved in forming these numbers. Finally, given the inherent limitations of the "value-relevance" approach, none of this research can speak to whether fair-value disclosures have marginal information content for investors (i.e., do they provide new information) and/or whether fair-value information should be provided in the financial statements as opposed to being obtained from other sources.

We next make some more specific comments on the Document (sections cited appear in parentheses). We believe that the Document's current approach is ad hoc. The Document indicates at the outset that its scope is based on the definition of a financial instrument "with certain exceptions" (para. 14). Some items that would otherwise be included under paragraph 14 are specifically excluded (such as investments in other entities that are accounted for using the equity method or are consolidated), while certain items that would otherwise be excluded are specifically included (such as financial asset servicing rights [para. 43]). The Document rationalizes these choices for what appear to be pragmatic reasons (e.g., they are being considered as part of other Board projects). It is not clear from a conceptual standpoint how these various inclusions and exclusions are determined. Specific examples follow.

The Document indicates that identifying a financial instrument may require analyzing a chain of contractual obligations to see whether it results in an exchange of cash or an ownership interest. Contractual obligations that result in the exchange of goods or services are excluded from the definition of financial instruments. This distinction seems artificial. Ultimately, it seems that all assets (liabilities) are rights (obligations) that will eventually result in exchanges of cash. Consider warranty obligations. As indicated specifically in Table 1 of the Document, warranty contracts that settle in cash qualify as financial instruments, while those that provide for repair or replacement of

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8 See also papers by Graham et al. (1999) and Simko (1999), as discussed in AAA FASC (1999).
the warranted items do not. It is hard to see an important economic distinction here, since the entity with the obligation can choose either to make the repairs itself or pay a third party to perform the repairs.

Consider also a bond that involves the promise to deliver to its holder a certain amount of a commodity at a specified future time. This bond would not be considered to be a financial instrument under the current definition (para. 31). However, since commodities are traded on liquid secondary markets and have readily determinable market values, the holder is likely to be indifferent between receiving the commodity or its equivalent market value in cash, so the distinction between rights and obligations that result in an exchange of cash and those that result in an exchange of goods and services seems artificial. It seems to the Committee that all instruments that result in the delivery of goods and services whose market values are readily determinable should be considered to be financial instruments.

Another inconsistency relates to the requirement that rights and obligations be contractual. The Document indicates that financial instruments must involve contractual obligations (para. 19) “whether they arise from written, oral, or implied contracts.” While we understand and agree with this view, we do not then understand why items such as taxes receivable or payable are not considered to be financial instruments since these rights and obligations are established under the law. If taxes receivable and payable are rights and obligations that are enforceable under the law, then how are they different from other contractual rights and obligations? The Committee believes that all legally enforceable rights and obligations should be included as financial instruments.

At times the document is unclear on the question of whether executory contracts are considered to be financial instruments (see especially paras. 29–33). We were especially unsure about what point paragraph 30 conveys (or is intended to convey) since the first and last sentences seem to contradict one another.

Certain of these problems seem rooted in the original definition in paragraph 14. It seems here that, once we go beyond cash and investments in the equity of other entities (paras. 14a and 14b), there is no good “primitive” definition of a financial instrument—paragraphs 14c and 14d both define financial instruments in terms of financial instruments. In addition, paragraphs 14c and 14d would seem to include executory contracts within the definition of financial instruments, an outcome we are not sure is intended.

Thus, the Committee sees the current scope of the Document as being too restrictive, and would prefer to see fair-value reporting for all financial instruments, including firm commitments such as take-or-pay contracts and operating leases.

It may be that, for pragmatic reasons, this broader approach cannot be implemented. If this is the case, an alternative approach is to start with two criteria that seem, implicitly, to underlie the current approach: (1) ease of measurement, and (2) measuring the combined value of items (such as demand deposits and credit cards) that tend to be traded as bundles rather than as separate components. For example, under this definition credit cards, demand deposits, and investments in equity securities currently accounted for using the equity method would be included as financial instruments, while pension and other-post-employment-benefit (OPEB) obligations would be excluded. This approach is consistent with research findings discussed above that imply that financial

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9 Credit cards, demand deposits, and equity investments over which the entity can exercise a significant influence are all examples of financial instruments with several components, while pension and OPEB obligations are instruments for which measurement issues preclude treatment as a financial instrument.
instruments with the most reliable fair values are those with readily determinable fair values even when those instruments include components that are not themselves financial instruments (e.g., core-deposit intangibles). This would avoid some of the conceptual issues that arise with the current approach such as those related to trying to separate the values of financial-instrument components (e.g., how does one separate the value of a control premium from the value of the underlying shares when one has a controlling or even substantial interest).

**ISSUE 2: WHAT DOES FAIR VALUE MEAN?**

As noted in paragraph 3 of the Document, the major conceptual advantage of fair value as a measurement system is that “because it is a market-based notion, it is unaffected by: (a) The history of the asset or liability...(b) The specific entity that holds the asset or owes the liability...(c) The future of the asset or liability....” Thus, the principal advantage of the use of fair values seems to be neutrality. While this is certainly a laudable goal, perhaps the most important economic reason to prefer a current-value accounting system is that current values are more relevant to financial statement users for decision-making purposes than historical-cost numbers.

It is noncontroversial that when the market for a good is perfectly competitive, fair values are both relevant for investor decision making and well defined using market prices. Thus, for certain financial instruments for which there are well-established and liquid secondary markets, fair-value accounting is easy to implement since market values can be unambiguously determined. The issue becomes difficult when instruments trade on less-liquid markets or not at all. These are the cases when entry, exit, and value-in-use numbers are different. This occurs when the value of the instrument depends on idiosyncratic or “intangible” features whose values are difficult for managers to communicate in a credible way to outsiders. For example, it is hard for the originating lender to communicate to outsiders the value of commercial loans because this value depends on variables such as the lenders’ experience and relationship with that particular borrower, along with borrower-specific terms and conditions of the loan. This explains why certain instruments trade in relatively liquid markets while others do not.

In situations where the market for an instrument is not perfect and complete, it becomes less obvious that exit values provide the most useful information to investors. In paragraph 48, the Document argues that since exit prices represent the market’s estimate of the present value of future cash flows, these numbers are useful to investors in forecasting those cash flows. Yet it is not clear how investors could derive information about the pattern and amount of future cash flows from a single present-value number. In this situation, because investors are likely to be interested in valuing the entity as a going concern, it is arguable that value-in-use is a more relevant measurement attribute than exit value. Moreover, when market prices are not available the Document requires present-value calculations, which in turn require estimates of future cash flows. These future cash-flow estimates depend in turn on managers’ assumptions and judgments about how the instrument will be used. Thus, absent market prices, there seems to be an almost inevitable shift into a value-in-use calculation of fair value.

In paragraphs 68–70, the Document indicates that the fair value of equity investments should exclude the value of control premiums and blockage factors since these are “not

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10 For a good summary of these issues, see Barth and Landsman (1995).
included in the market price." The logic for this is hard to understand since it seems clear that the economic value of a controlling or dominant equity position in another entity is larger than simply the sum of the value of the shares traded individually. As indicated earlier, it is conceptually more sound to fair value the entire bundle, even if some managerial judgment is involved.\(^1\)

To the extent that managerial estimates and assumptions are necessary to arrive at financial-instrument fair values, we support the disclosure of the estimates and assumptions necessary to arrive at these fair values. Ideally, such disclosures would include both details of prior-period assumptions and estimates, as well as some indications of the sensitivity of the estimated fair values to those assumptions and estimates.

In the absence of market prices, the Document advocates the use of present-value concepts to determine fair values. It also indicates that these calculations should be made in a manner consistent with the recently issued Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, it is not clear that this methodology is consistent with the approach advocated in other FASB pronouncements. For example, while the Concepts Statement advocates an expected-cash-flow approach in present-value calculations, SFAS No. 121 advocates using a “best estimate” cash-flow approach.

**ISSUE 3: HOW SHOULD CHANGES IN FAIR VALUE BE REPORTED?**

Although the Document does not resolve the issue of whether financial instrument fair values should be recognized in the financial statements or disclosed in the footnotes, the Committee believes that financial instrument fair values should be recognized and that the associated gains and losses should be included as part of a single statement of financial performance.\(^2\) Moreover, the Committee believes that, to achieve consistency with the fair-value model, interest revenues and expenses should be calculated consistent with fair-value accounting (i.e., beginning fair value x market interest rate) rather than on the amortized cost basis currently required in SFAS No. 115.

**OTHER ISSUES**

Items 4, 5, and 6 in the Document relate to implementation and unresolved issues, such as how credit cards and demand deposits (and their components) should be treated. We have addressed certain of these issues in a general way—we believe that these issues would be easier to resolve if a clearer and more consistent conceptual approach to the definition of financial instruments was adopted. For example, both of these items would be included as financial instruments and measured at fair value if we applied the approach that considered: (1) ease of measurement, and (2) measuring the combined value of items. Absent a clearer conceptual approach, it will be difficult to resolve some of these issues except in an *ad hoc* manner. For example, the Committee believes that demand deposits likely meet the ease-of-measurement test and so should be included as financial instruments. This follows because these instruments are traded among banks and there are fairly well-established techniques available to value these instruments.

\(^{11}\) We realize that the Document reflects the logic of Concepts Statement No. 7, which rejects entity-specific measurements (paras. 24–38). Our point is that an exit-value approach is, by construction, both difficult to implement and less relevant to investors in the presence of entity-specific “intangibles.”

\(^{12}\) Please refer to AAA FASC (2000).
REFERENCES
———. 1999. Letter to Diana Willis, Senior Project Manager, 15 June.