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Response to the FASB's Exposure Draft – “Fair Value Measurements and Disclosures”

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INTRODUCTION

The Financial Accounting and Reporting Section of the American Accounting Association has charged the Financial Reporting Policy Committee (the Committee) with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the Financial Accounting Standards Board (FASB) Exposure Draft, *Fair Value Measurements and Disclosures* (hereafter the ED) issued in June 2010. The opinions in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The ED proposes to make changes to the existing guidance for fair value measurement, which includes changes that would result in a common measurement standard in U.S. GAAP and IFRS. There are five significant changes proposed including (1) highest and best use and valuation premise; (2) measuring the fair value of an instrument classified in shareholders' equity; (3) measuring the fair value of financial instruments that are managed within a portfolio; (4) application of blockage factors and other premiums and discounts in a fair value measurement; and (5) additional disclosures about fair value measurement.

OVERALL EVALUATION

The Committee supports the move to a converged set of guidance for fair value measurement. We believe that a single measurement guidance for fair value guidance would improve the efficiency of the international capital markets by reducing frictions that might arise when investors and other users are required to understand and employ multiple sets of standards in order to make full use of information provided by financial reports. Furthermore, a single means of measuring fair value both within and across sets of standards should reduce preparer and regulators costs, relative to application of two sets of guidance. Furthermore, the committee believes that the idea of disclosures about uncertainty within fair value measurement is a worthwhile objective. We do, however, have some reservations about the current proposals that we will outline below.

RESEARCH ON FAIR VALUE ESTIMATES

There is a considerable body of research on the relevance and reliability of fair value estimates. Rather than review this extensive body of research here, we refer you to our Committee's comment letter on the original exposure draft for fair value measurement issued in June 2004 by the AAA Financial Accounting Standards Committee. Our discussion below refers only to the more recent research on fair value and on current requirements for fair value measurement in Topic 820.

Much of the recent research in this area suggests that information provided wherein the assets are sorted into Levels 1, 2 and 3 (as required by FAS 157) provides incremental explanatory power (in explaining firm stock prices), as expected there appears to be a "pecking order" in the process. Investors discount Level 2 and Level 3 estimates, relative to Level 1

estimates (e.g., Goh et al 2009 and Kolev 2009). As further evidence of the informativeness of these estimates, Song et al (2010) document that variation in corporate governance characteristics is associated with investors' assessments of disclosed Levels 1 and 2 versus Level 3.

Fair values are also shown to be associated with different types of risk. Blankespoor et al (2010) examine whether financial statements using fair values for financial instruments better describe banks' credit risk than less fair value-based financial statements. The authors find that adjusting bank leverage to incorporate the disclosed fair value of its financial instruments explains significantly more variation in credit risk than unadjusted leverage measures, suggesting a role for fair values in credit risk assessment. Hodder et al (2006) find that in comparing a full-fair-value model to net income or comprehensive income models, the full-fair-value model is (1) more volatile, (2) more closely correlated with measures of interest risk, and (3) relates more closely to the capital-market pricing of that risk than the other models.

Academic research raises two potential concerns with the Level 1, 2, and 3 fair value disclosures, however. First, Koonce et al (2009) consider and document that investors' perceptions of the fair values are contingent on whether the item in question is an asset or a liability, change is a gain or a loss, and management intent. Furthermore the paper finds that attempts to debias individuals' judgments were sensitive to the instrument used. Second, Fiechter and Meyer (2009) document an association between reported Level 3 fair values and banks' operating performance, consistent with firms using the discretion in estimating Level 3 reported values to manage earnings during the subprime crisis in order to report higher earnings in the subsequent periods. These studies highlight concerns with implementation of the current measurement guidance.

The recent subprime crisis has generated research that considers the relation between fair value measurement and economic stability. While theoretical papers have identified means by which fair value accounting might be pro-cyclical, leading to contagion (e.g. Allen and Carletti 2008; Sole et al 2010), the empirical evidence fails to support these models. For example, Ryan (2008), Laux and Leuz (2009), and Barth and Landsman (2010) suggest that fair value accounting might have actually helped limit the extent of the crisis by forcing firms to recognize losses in a more timely manner than historical cost accounting. Badertscher et al (2010), who directly assess the effect of fair value losses on bank holding companies regulatory capital, find that the effect of impairments on regulatory capital stemming from fair value losses were small and fail to find evidence of increased loss selling, or even general selling, of securities during the crisis.

In sum, research that examines FAS 157 Level 1, 2, and 3 reported values suggests that the values provide decision-useful, relevant information to investors. Level 3 estimates appear to be associated with managerial discretion and are discounted by investors, relative to Level 1 and 2 estimates, consistent with increased uncertainty in Level 3 estimates.

RESPONSES TO SPECIFIC ISSUES

The FASB invited comment on all matters related to the ED, but specifically requested comments on 12 specific questions/issues. The Committee's comments are limited to those issues for which empirical research provides some insights, or those sections of the ED that are conceptually inconsistent or unclear.

Question 1: Improve the understandability of fair value measurement

We believe having common requirements for measuring and disclosing fair value across

US GAAP and IFRS will be beneficial. The summary of prior research above clearly establishes the case for disclosures improving the quality of accounting, and if one subscribes to the notion that convergence of US GAAP and IFRS is beneficial, the findings documented in prior research ought to extend to other markets. One difference between the two standards suggested by the ED – where US GAAP will refer to US Treasury securities and IFRS would refer to governmental securities – might require additional clarification. Given the role of these terms/references in measurement, e.g., “determines the appropriate risk free interest rate” (paragraph 820-10-55-5), we do not think they can be used interchangeably.

Question 4: Exception for measurement when a group of assets and liabilities managed on the basis of an entity’s net exposure to a market risk.

The ED defines the unit of account as the individual share but allows an exception when legal right of offset exists. We agree with this exception. It would be misleading to investors not to know the fair value measurement for the entire portfolio, i.e., in effect the legal agreement changes the unit of account.

Question 5 and 6: Premiums and discounts to be taken into account when measuring fair value

The ED refers to the application of “blockage factors and other premiums and discounts” in the measurement of fair value and considers (explicitly) two potential sources: blockage factors and control premiums or noncontrolling interest discounts. The ED explicitly prohibits the use of a blockage factor, due to measurement being based on the unit of account of an individual financial instrument.¹ Blockage factor can only be considered when multiple financial instruments of the same type, e.g., share for an entity, are being considered. It is appropriate to

¹ 820-10-35-18L states “When using the exception in paragraph 820-10-35-18I to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, the reporting entity shall include the effect of the reporting entity’s net exposure to the credit risk of that counterparty in the fair value measurement when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (for example, because the reporting entity has entered into a master netting agreement with that counterparty).”

exclude a blockage factor as long as the unit of accounting is the individual financial instrument.

The ED also refers to the existence of control premiums or noncontrolling interest discounts that might be reflected in measurement, “when market participants would take into account those premiums or discounts when pricing an asset or a liability consistent with the unit of account for that asset or liability.” If the unit of account continues to be defined as an individual share, a controlling interest premium could only be applied to the individual financial instrument that gains control, e.g., when the number of shares exceeds 50 percent by one share. Is it inconsistent to have a controlling interest premium with a unit of account defined as an individual financial instrument, i.e., isn’t a controlling interest premium similar in concept to a blockage factor in the sense that a group of financial instruments must be considered? The explicit elimination of blockage factors from measurement along with a continued concern for premiums for controlling interest appears inconsistent.

Broadly speaking, there are two types of situations that might give rise to price effects of block trades: a change in the under-lying value of the stock (information effect) or to a temporary deviation of prices (distribution effect) (see Kraus and Stoll (1972) for a detailed discussion of this issue). It might be useful to consider whether discounts or premiums that are allowed/disallowed by the ED might be categorized into these two types of situations. How does an investor consider a controlling (non-controlling) interest without considering a block of shares? Doesn’t the investor always have to deviate from the unit of account of the individual financial instrument to make this determination? The Committee questions the ability to implement a process that allows for the consistent identification of the appropriate unit of account for measurement in situations beyond explicit contractual arrangements. We recommend explicit guidance for anything other than contractual arrangements.

Question 7: Disclosure of measurement uncertainty analysis for assets and liabilities categorized within Level 3.

The majority of the Committee supports the concept of disclosing information to inform investors about the uncertainty in the fair value measurement. Outside of actively traded markets, the fair value of an asset or a liability will be measured with some uncertainty. Precision of information is an important dimension to decision making and disclosures about measurement uncertainty have the potential to assist investors in their decision-making. How and what specific information is disclosed, however, is key to investors' understanding.

Currently, the ED would require firms to disclose an uncertainty analysis for fair value measurements categorized within Level 3, with a focus on the unobservable inputs used in the analysis. The ED requires that when a different input could have been reasonably used to obtain a higher or lower fair value measurement, the reporting entity shall disclose the effect of using those different amounts and how it calculated that effect. Furthermore, the "entity shall take into account the effect of correlation between unobservable inputs if that correlation is relevant when estimating the effect on the fair value measurement of using those different amounts." The Committee has several concerns with issues raised (or not raised) in the ED that are detailed below.

1. The ED states that reporting entities must provide a measurement uncertainty analysis and to take into account the effect of correlation between unobservable inputs (820-10-55-78) and provides a table illustrating these disclosures. It is unclear, however, from the ED whether the disclosures are related to values selected from the *distribution of a single unobservable input* or values selected from *two different unobservable inputs*.

If the required disclosures are related to two unobservable inputs, is the measurement uncertainty analysis disclosure required the actual correlation between these two unobservable inputs? Based on illustration included in the ED, the information disclosed appears to be values drawn from the distributions of inputs, which might reflect a correlation between them. However, the example does not provide a correlation coefficient or information to estimate one. Thus, one issue raised by members of the Committee is what precisely is meant by “the effect of correlation”?

2. The ED requires that the effect of correlation between the unobservable inputs be considered. If the input is unobservable, however, the correlation between it and the observable inputs will also be unobservable. Thus, the Committee questions why information regarding the effect of correlation between unobservable and observable inputs is excluded from the measurement uncertainty analysis.
3. Hodder et al (2000) discuss judgment and decision-making research in order to identify and analyze the behavioral implications of risk disclosures (FRR No. 48) and document several findings relevant to the current ED. In particular, their discussion surrounding the disclosures of “insufficient quantitative information” (pp. 61-63) should be considered in the current context. Though the subject matter of their paper is different, the broad conclusions remain the same.² The authors highlight research suggesting mistakes that might arise from inappropriate disclosures and means for reducing those mistakes. For example, prior research suggests that disclosing a point estimate drawn from an uncertain distribution might lead to over-confidence in that value (e.g., Slovic et al. 1980; Kahneman and Tversky 1979b) and cause individuals to consider that outcome to be

² Hodder et al (2000) are commenting on the SEC’s requirement for forward-looking information about risk. The disclosure in this ED is about current measurement uncertainty. Both situations, however, consider investors’ understanding of information about an underlying distribution of a variable.

more likely than it is. However, Kuhn and Sniezek (1996) demonstrate that describing different points on the outcome distribution reduces this effect. Hodder et al (2000) conclude that a failure to disclose sufficient quantitative information may result in inappropriate assessments of risk. The disclosure should be designed with these concerns in mind so that investors have appropriate information upon which to estimate the underlying distribution.

4. The ED refers to “reasonable” when discussing the range of estimates and several additional aspects of fair value measurement. It is unclear how to implement this term in this setting.
5. The ED refers to measurement uncertainty surrounding disclosure around a significant unobservable input, but does not consider disclosures when there are multiple significant unobservable inputs. While reporting entities would reasonably be required to provide the disclosures for the multiple significant unobservable inputs, there are additional measurement uncertainty disclosures beyond the stated correlations (like cross-correlations) that might be informative to users that are not addressed in the ED.
6. Is it correct to sum the increases and the decreases? What happens if there is correlation across unobservable inputs, e.g. prepayment speed and probability of default?

Question 8: Alternate disclosures to the measurement uncertainty analysis

The ED requires expanded disclosures including disclosure of measurement uncertainty analysis for Level 3 fair values. It is unclear why uncertainty analyses related to (1) all levels of fair value (especially level 2 fair values) and (2) correlations between observable and unobservable inputs are not included in the current ED. While measurement uncertainty is a significant concern in Level 3 fair values, it is also a concern in Level 2 fair values. Furthermore,

the magnitude of Level 2 values frequently exceeds the magnitude of Level 3 values, which increases the potential importance of investor understanding of the uncertainty surrounding the Level 2 values. Table 1 documents the differences in magnitude across reported Level 1, 2, and 3 assets during 2008 and 2009 for all firms included in Compustat and for bank holding companies only. The table below displays the mean percentage of Level 1, 2, and 3 fair value assets (scaled by total assets) for all Compustat firms (bank holding companies) with reported fair value assets.

Table 1						
Assets Classified within Level 1, 2, or 3						
Mean Values						
<u>Reporting year</u>	<u># of Firms</u>	<u>Proportion of Total Assets Reported at</u>			<u>Fair Value</u>	
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>		
<i>All Compustat Firms:</i>						
2008	3360	0.09	0.08	0.02	0.19	
2009	3900	0.09	0.08	0.02	0.18	
<i>Bank Holding Companies (SIC 6020):</i>						
2008	552	0.01	0.15	0.01	0.16	
2009	580	0.01	0.16	0.00	0.17	

While some firms early adopted FAS 157 in 2007 (47 firms), the standard became effective for fiscal year 2008 for the remaining firms and resulted in 19 (18) percent of the total assets being classified within Level 1, 2, and 3 fair values. Across all firms/industries the majority of reported assets are classified as either Level 1 or Level 2 (9 and 8 percent, respectively). Only 2 percent of total asset value is classified within Level 3 fair values. If we limit our view to bank holding companies (SIC 6020), the proportion of assets classified as Level 1 is drastically reduced, with a shift of reported assets into Level 2. Ultimately, however, the proportion of assets classified as Level 3 fair values is minimal. Thus, the FASB might consider extending the uncertainty analysis to Level 2 disclosures. While the measurement uncertainty inherent in Level 2 fair values is expected to be lower than in Level 3 fair values, the increased magnitude of the assets classified as Level 2 increase the relevance of the additional disclosures.

An additional concern raised by some members of the Committee is the potential informativeness of disclosures related to the correlation between observable and unobservable inputs. While the Committee believes disclosures related to the effect of correlation between unobservable inputs to be informative, it is unclear why disclosures that detail the correlations between observable and unobservable inputs are not also considered in the ED.

CONCLUSION

The Committee supports the formulation of a single converged standard for the measurement of fair value. In particular, it believes that providing converged guidance for fair value measurement has the potential to reduce frictions that might arise when investors and other users are required to understand and employ multiple sets of standards to make full use of information provided in financial reports. Furthermore, preparer and regulator costs should be reduced if they are required to employ a single means of measuring fair value both within and across sets of standards rather than two sets of guidance. We do have several significant concerns, however, most notably about the uncertainty disclosure. A revised version of this proposal would benefit from a careful consideration of the extant research on how individuals estimate distributions and additional clarification of various terms and concepts included in the ED.

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