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Response to Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

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INTRODUCTION

The Financial Reporting Policy Committee (the Committee) of the Financial Accounting and Reporting Section of the American Accounting Association is charged with responding to discussion memoranda and exposure drafts on financial accounting and reporting issues.¹ The Committee is pleased to respond to the Financial Accounting Standards Board's (FASB's) Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (hereafter, "Proposed Standard"). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association or the Financial Accounting and Reporting Section of the American Accounting Association.

The Proposed Standard addresses many aspects of financial instrument accounting, including initial measurement, classification, impairment, and hedge accounting. The Proposed Standard is broadly applicable and applies to financial liabilities as well as financial assets.

¹ The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

Financial instruments specifically excluded from the scope of previous fair value recognition standards would be subject to the new rule. These include held to maturity securities, loan portfolios not held for sale, most long-term debt, and certain deposit liabilities.

Under the Proposed Standard, the default classification will be to recognize financial instruments at fair value, with fair value changes recognized in net income (FVNI). Certain financial instruments may be recognized at fair value with fair value changes recognized in other comprehensive income (FVOCI). FVOCI treatment is reserved for classes of instruments for which the firm's business strategy is to collect or pay the contractual cash flows associated with the instrument over its term. The "business strategy" criterion differs from the "held to maturity" notion relevant in current GAAP because it is applied at a business unit level rather than the instrument level. Certain financial instruments may continue to be recognized at amortized cost. These include instruments without reasonably determinable fair values, short-term instruments, including demand deposits, and instruments that are "linked" to other assets or liabilities not recognized at fair value.

The Proposed Standard includes arguments supporting fair value and amortized cost as alternative bases of measurement for financial instruments, and proposes presentation of both amortized cost and fair value on an entity's statement of financial position for most financial instruments not held for sale or trading. The proposed standard overlaps with other current standard-setting projects, including the financial statement presentation project and the conceptual framework project. The Proposed Standard solicits comments on measurement and presentation issues, as well as scope.

Various committees of the American Accounting Association have written numerous letters commenting on reducing complexity in reporting financial instruments, fair value measurement,

and various proposed approaches and issues related to financial instrument accounting, many of which overlap with the approaches described in the Proposed Standard (Financial Accounting Standards Committee [FASC] 1993, 1999, 2001, 2004; Financial Reporting Policy Committee [FRPC] 2008, 2009). Other working groups within the Committee are currently charged with responding to the financial statement presentation project and the conceptual framework project, each of which overlap in certain areas with the Proposed Standard. For this reason, the present letter primarily focuses on four areas that are either new in scope, or that present overarching issues to which we can contribute non-redundant, research-informed comments. These areas are:

1. Does the measurement of financial liabilities at fair value provide decision-relevant information?
2. Is the measurement of core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate appropriate?
3. Is fair value an appropriate measurement basis for financial instruments held primarily for the collection of income?
4. Should fair value be the default measurement attribute for financial instruments?

RESPONSES TO ENUMERATED QUESTIONS

***Question 1.** Does the measurement of financial liabilities at fair value provide decision-useful information?*

Opponents of fair value accounting for liabilities argue that holding gains and losses on debt are irrelevant for equity valuation if the debt is expected to be paid at maturity. However, we propose that debt fair values are relevant for equity valuation because debt fair values aggregate important information about debt that is not disclosed elsewhere in the financial statements. For

example, two firms with the same book value of debt may have very different risk profiles. Two issues of debt with the same book value may have high or low interest rates, or short or long payback terms. One debt issue may allow prepayment, while the other may be callable by the creditor. One issue may be collateralized, while another is unsecured.

Book values reflect historical transaction prices, but do not reflect the effects of changes in market conditions on the value of the debt. In contrast, debt fair value aggregate relevant attributes of outstanding liabilities into price so that more meaningful comparisons may be made across firms and across debt issues. Academic research suggests that reported asset and liability fair values are sufficiently relevant and reliable to be useful for equity valuation. See Landsman (2007) for a comprehensive discussion of this research, most of which focuses on the financial services industries.²

Although reported asset and liability fair values are relevant for equity valuation, critics of fair value accounting for liabilities assert that recording changes in debt fair values will distort income measurement. In particular, when a company is performing well (poorly) and experiences a decrease (increase) in credit risk, any increase (decrease) in debt value will be charged (credited) to comprehensive income. Critics claim that recording charges to income during periods of good performance (or credits to income during periods of poor performance) is “counterintuitive”.

However, we propose that recognizing debt at fair value is counterintuitive only when the forward-looking nature of fair values is ignored. The difference between the book value and market value of debt reflects a real opportunity cost or benefit to the firm that will be realized in the future through relatively higher or lower interest payments. Specifically, a firm reports an unrealized loss on its own debt when the contractual rate on the firm’s debt exceeds the current

² Also see Simko (1996) for a study linking debt fair values to share prices for industrial firms.

market rate of interest for debt with similar term characteristics and credit risk. Because the existence of prepayment options is included in the determination of debt fair value, a larger unrealized loss will be reported when the firm is unable to prepay the debt.

This has consequences for future cash flows: other things equal, firms with large unrealized losses (gains) on outstanding debt will have higher (lower) future interest expense. For a firm experiencing a decline in credit risk, being locked into above-market future interest payments is certainly “bad news.” Conversely, for a firm experiencing an increase in credit risk, having below-market future interest payments is certainly “good news”. When changes in debt fair value are viewed as a measure of the opportunity cost or benefit arising from prior debt contracting, the effects of recording fair value changes in income are not at all counterintuitive.

A comparison of Altria Group to Abbott Laboratories at December 31, 2009 illustrates these effects. Figure 1 shows selected financial information for both companies, including total liabilities and the book value of long term debt presented on the balance sheet. Fair values are obtained from note disclosures, and interest expense is obtained from the income statement.

Figure 1

	<u>Altria</u>	<u>Abbott</u>
Total Liabilities 12/31/2009	32,573	29,518
Book Value of Long-term Debt 12/31/2009	11,185	11,266
Fair Value of Long-term debt 12/31/2009	13,615	12,089
Unrealized Gain/(Loss) on Long-term Debt 12/31/2009	(2,430)	(823)
First Quarter 2010 Interest Expense	287	126
Average interest rate on Long-term Debt	9.1%	5.3%
S & P Debt Rating 12/31/2009	BBB	AA

As of December 31, 2009 the book value of Altria’s long-term debt is slightly smaller than the book value of Abbott’s long-term debt (\$11.2 billion compared to \$11.3 billion).

However, fair value disclosures indicate that subsequent to issuance, Atria experienced an

unrecorded loss on its long-term debt of \$2.4 billion, while Abbott experienced a significantly smaller unrecorded loss of \$823 million. A review of Altria's notes indicate that Altria's debt matures between 2011 and 2039, with half maturing in 2018 or after and one fourth maturing in 2038 or after. Similarly, Abbott's footnotes indicate that Abbott's debt matures between 2011 and 2039, with half maturing in 2017 or after and one fourth maturing in 2036 or after. Because the duration of Altria and Abbott's debt is similar, the significantly larger unrealized loss on Altria's debt is most consistent with Altria borrowing at a higher interest rate and experiencing a greater decline in market rates, relative to Abbott.

Altria's greater unrealized loss existing at December 31, 2009 is associated with higher future interest cost: in the first quarter of 2010, Altria recognized \$287 million of interest expense compared to Abbott's recognized interest expense of \$126 million.³ This example shows that unrealized gains and losses on debt are realized through the subsequent payment of above or below market rates of interest. More generally, Evans et al. (2010) shows that unrealized gains and losses on financial instruments are associated with higher or lower future net interest income. Barth et al. (2008) shows that these opportunity costs arising from increases and decreases in credit risk are associated with economic gains and losses to equity holders. Overall, we conclude that fair value provides decision-useful information for liabilities.

Question 2. *Is the measurement of core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate appropriate?*

We propose that measuring deposit liabilities at *fair value* is appropriate because providing users with information on fair values allows them to make better informed judgments. Fair value information is useful in assessing a financial institution's investment and financing strategies as

³ "Interest expense" for this comparison includes capitalized interest.

well as their success in managing interest rate risk, credit risk, and liquidity risk. However, to be most useful for these purposes, fair values should be reported for all financial instruments. For example, Hodder, Hopkins and Wahlen (HHW, 2006) show that the volatility of “full fair value income” (FFVI) is much more highly correlated with bank-level interest rate risk than net income (which excludes the effect of unrealized fair value changes) or comprehensive income (which includes only the effects of changes in unrealized investment security fair values). For their measure of full fair value income, HHW collect reported fair values for loans and long-term debt, and estimate core deposit fair values. HHW conclude that more comprehensive measurement of assets and liabilities at fair value results in greater risk-relevance of income. Therefore, we agree that deposit liabilities should be included in the scope of the fair value standard.

Consistent with these academic results, comment letters from bankers on various fair value measurement standards consistently indicate that recognizing assets at fair value will be misleading if liabilities, including core deposit liabilities, are not also recognized at fair value (Hirst et al., 2008). We concur that fair values will be more useful, and reported income will more meaningfully reflect actual risk realizations if liabilities are also measured at fair value.

Although we propose that measuring core deposit liabilities at fair value will be useful, we do not believe that measuring core deposits at the present value of the average core deposit amount discounted as the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits is appropriate, because this amount may differ materially from fair value. Current GAAP defines fair value as the “exit value” in a hypothetical market exchange. The basis of measurement included in the Proposed Standard is an “alternative cost” based on firm-specific servicing cost and firm-specific alternative cost of

debt. We propose that more comprehensively measuring assets and liabilities at fair value will be most useful if a consistent definition of fair value is used for both assets and liabilities.

Although present value may be a reasonable proxy for fair value in certain cases, we are unsure whether this is the case for core deposit liabilities. Moreover, we do not see the need to introduce an alternative basis of measurement for financial instruments, or pools of financial instruments for which there exist observable market prices and established valuation models. Core deposits have a market: they are routinely assumed by third parties, at the branch-level or bank level, and assumption-transaction prices are observable. Moreover, in the absence of separate transaction data, assumed liabilities are frequently appraised at fair value by qualified independent appraisers. The routine nature of such appraisal practices are reflected in surveys of bankers who indicate that that the significant market advantages associated with the ability to generate core deposits at low-or-no interest cost are readily estimable.⁴

Question 3. Is Fair Value an Appropriate Measurement Basis for Financial Instruments Held Primarily for the Collection of Income?

We propose that fair value is an appropriate measurement basis for financial instruments even when those instruments are held primarily for the collection of income because fair values provide more timely feedback than cash flows about the relative success of managements' investment and risk-management strategies. Specifically, measuring certain financial assets and liabilities at historical transaction amounts tends to delay recognition of changes in value arising from shifts in economic conditions and expectations. The failure of existing GAAP to timely

⁴ Tschirhart (2007) presents one such survey. Note that we diverge from current banking practice in that we do not consider the ability to generate low-cost funds an asset. We view difference between the market rate and the contractual rate on deposit borrowings as most similar to a bond discount. If the assumption of deposit liabilities also includes the purchase of a customer list (i.e. an acquired customer base does not overlap with the acquirer's), then this asset is separately valued in the acquisition and may be adjusted from observable transaction prices. Consistent with current GAAP, firms would not recognize internally-generated customer lists when recording their own core deposits at fair value.

recognize relevant losses on assets held for the collection of income was identified in the early 1990s as one cause of the Savings and Loan crisis. For example, in an analysis of the causes of Savings and Loan debacle and rise of bank failures, the General Accounting Office (GAO) concluded that GAAP made it too easy for bankers and regulators to overlook or ignore losses on bad loans:

“Regulators need more timely and reliable data on the financial condition of depository institutions to more effectively work with management to restore the health of troubled institutions and to minimize losses to the insurance fund. There is a concern that financial data prepared in accordance with generally accepted accounting principles are inadequate for this purpose. Generally accepted accounting principles call for a writedown from cost to market value and recognition of a loss when an asset value has been diminished. The “probable” requirement unduly delays the writedown of problem assets to fair market value and thus defers recognizing the loss in the financial statements...Based on our ongoing study of these issues our preliminary view is that market value based accounting or, in the alternative, comprehensive market value disclosure, is preferable to present accounting and disclosure standards for financial institutions.” (GAO, 1990)

According to the GAO report to Congress, delayed recognition of inherent losses in bank loan books resulted in many “surprise” bank and thrift failures and huge underestimates of losses to be incurred during resolution. Although these factors reflected negatively on the government’s ability to budget for and control the crisis, GAAP deficiencies also likely increased the scale of the crisis and increased realized losses. This happened because problem institutions that were essentially insolvent on a fair value basis were allowed to expand by using insured deposits to acquire increasingly risky loans and real estate assets. When these institutions eventually failed, the loss to the insurance fund was larger than it would have been had the problems been identified sooner.

The deficiencies of existing GAAP for timely recognition of losses in the bank book are still relevant today. For example, Vyas (2009) examines the timeliness of write-downs taken by

U.S. financial institutions during the current financial crisis. Results show that accounting loss recognition is less timely than the fair value devaluations implied by credit indices applied to bank holdings. Notably, the association between bank equity returns and implied but unrecognized losses suggests that indices used in fair value measures for items recognized at fair value provide a reliable indicator of loss even during period of market illiquidity.

Beatty and Liao (2010) demonstrate the importance of timeliness. They find that delayed recognition of losses allowed under current GAAP for loans held for the production of income is associated with reduced lending. Specifically, relative to banks with more forward-looking loss provisioning, banks with less timely provisions reduce lending more during recessionary periods. This suggests that recognizing expected losses inherent in fair value estimates would not only provide a better representation of the asset value at the balance sheet date, but would be more countercyclical than recognizing losses as they are actually incurred as called for by current GAAP.

Bleck and Liu (2007) show that fair value accounting provides market participants an “early warning mechanism” while historical cost reporting allows management to hide what may be the true economic results of operations. Importantly, their model shows that historical cost accounting can increase market volatility and may lead to more frequent and severe market disruptions than fair value accounting. These results run counter to charges that fair value accounting increases systematic risk and exacerbates the business cycle.

Proponents of amortized cost accounting for assets held for the production of income assert that the effects of management’s decisions to hold certain assets will become apparent over time as the entity reports realized earnings that are higher or lower than the current market. Although transaction-based accounting may provide information that is useful for assessing

performance, we propose that fair values and changes in fair values should be given at least equal prominence in the financial statements as cost-based measures because fair values provide a more timely and transparent measure of performance.

Question 4. Should fair value be the default measurement attribute for financial instruments?

We propose that the default measurement attribute for financial instruments should be fair value and that amortized costs should be disclosed. Our reasoning is based on three premises. First, fair values are useful. Second, fair values are more difficult to measure and verify than amortized costs. Third, recognized amounts are estimated with more precision than disclosed amounts. Taken together, this suggests that 1) fair value measurement technology will improve if fair values are recognized, and 2) the combined precision of recognized and disclosed amounts will increase if less verifiable fair values are recognized and more verifiable amortized costs are disclosed.⁵ From a professional viewpoint, we propose that recognition of fair values will encourage the evolution and refinement of valuable, relevant, accounting technology. Simultaneous disclosure of amortized cost will retain this measure for those who find it relevant.

Accounting research supports the premise that fair values are useful. This point has been documented in a subset of the comment letters cited previously in this letter. Landsman (2007) provides a comprehensive overview of the accounting literature on fair value relevance and reliability. Importantly, the value-relevance of fair value information appears to be increasing over time as measurement technology improves and as users become more familiar with fair value measurement techniques (Khurana and Kim, 2003).

Accounting commentators argue that fair values are less accurate than more verifiable amortized costs (Watts, 2006). Sunder (2008) provides some structure for these arguments and

⁵ This assumes that income components are sufficiently disaggregated to allow users to assess their individual precision and significance.

presents a model of valuation based on different accounting inputs. Sunder argues that “current values” may contain less measurement error than “historical values” with respect to current economic conditions. However, “current values” may contain measurement error with respect to current price. Sunder posits that price errors arise from the need to estimate current prices in incomplete or imperfect markets. Such errors can also be intentional (Watts, 2006).

We acknowledge that fair value estimation presents challenges, both for estimators and auditors of such information. However, we view the need to estimate asset and liability prices in incomplete and imperfect markets as an integral and necessary role of modern professional accountancy. Many economic decisions require such information, and accounting research supports that such information is also useful for firm stakeholders. Fair values of illiquid assets are routinely required by the legal system. Examples include property disputes, eminent domain proceedings, domestic and other partnership dissolutions, and estimation of damages. In addition, fair values are necessary inputs to many systems of taxation. In general, current measurement technology is considered at least sufficiently reliable to support basing real economic transactions on these estimated values.

We argue that if measurement technology and audit technology is sufficiently reliable to support justice and commerce in our society, then it is sufficiently reliable to support financial statement recognition. Moreover, we believe that fair value measurement technology will improve if fair value estimates become more widely used for financial statement recognition. Our belief on this latter point is supported by research showing that that recognized amounts may be estimated with more precision than disclosed amounts.

Early research on recognition and disclosure established that recognized amounts tend to be more value-relevant than disclosed amounts (Ahmed et al., 2006; Davis-Friday et al., 1999).

Additional tests suggest that lower value-relevance is due to lower actual or perceived reliability of disclosed amounts (Barth, 1994, Davis-Friday et al., 2004).⁶ Libby et al. (2006) points toward the former explanation finding that auditors are more likely to require correction of recognized amounts than of disclosed amounts. The findings of Libby et al. (2006) suggest that auditors enforce a higher precision on recognized amounts than disclosed amounts. Thus, recognized amounts are likely to have less measurement error than disclosed amounts, holding the inherent “ability to estimate” constant.

Unlike amortized costs, which are unlikely to vary in precision whether recognized or disclosed, we propose that disclosed fair values are likely to reflect less measurement precision than recognized fair values. Therefore, recognition of fair values will increase the combined precision of recognized and disclosed financial amounts. For example, Tschirhart et al. (2007) document bank practices related to estimating fair values and note that for purposes of disclosure (e.g. SFAS 107), banks frequently do not formally estimate factors such as default and survival probabilities that would be relevant for valuation. More generally, banks indicate that “...valuation methodologies would have to be substantially improved if they were to be used for reporting in the primary financial statements under the fair value option” (Tschirhart et al. 2007, 10). We propose that fair value measurement technology *will improve* and measurement practices *will be better documented* if fair values are used for reporting in the primary financial statements. If amortized costs are useful for specific contracting purposes, then disclosure of amortized costs should allow users to assess firms’ performance relative to contracted standards.

⁶ See Schipper (2007) for an excellent summary of accounting research related to recognition and disclosure.

CONCLUSION

In this letter, the Committee chose to address issues that were not already addressed in prior research-focused comments letters written by the Committee (FRPC 2008, 2009) or the American Accounting Association's FASC (1993, 1999, 2001, 2004). Those letters generally support financial statement recognition of financial instruments at fair value. In this letter, the Committee concludes that (1) fair value measurement of financial liabilities provides incremental, decision-useful information; (2) fair value measurement of deposit liabilities is appropriate because providing users with information on fair values allows them to make better informed judgments; (3) fair value is an appropriate measurement basis for financial instruments, regardless of managements' intent with respect to the instrument holdings; and (4) overall financial statement precision and fair value measurement technology will significantly improve if accounting standards mandate reporting fair values of financial instruments in the primary financial statements.

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