Appendix A

RELEVANCE OF FAIR VALUE INFORMATION FOR FINANCIAL INSTRUMENTS

150. The following is a reprint of an article by Diana W. Willis, an FASB staff member, that appeared in a FASB Viewpoints in 1998. It illustrates why fair value is the most relevant attribute for financial instruments, based on two relatively simple examples.

FINANCIAL ASSETS AND LIABILITIES—FAIR VALUE OR HISTORICAL COST?

The FASB has said that its long-term goal is to have all financial assets and liabilities recognized in statements of financial position at their fair values rather than at amounts based on their historical cost. There are two important reasons to work toward a financial reporting system based on fair values of financial assets and liabilities:

?? Fair values provide information about financial assets and liabilities that is more relevant than amounts based on their historical cost, and

?? Today’s mixed-attribute measurement model in which some financial assets are measured at fair value while others, along with most financial liabilities, are measured at historical-cost-based amounts cannot cope with today’s complex financial instruments and risk management strategies. It is time for a better model.

This article discusses the main reasons for the first of those conclusions. It also briefly summarizes the reasons for the second conclusion.

Measure Which Assets and Liabilities at Fair Value?

The FASB, as well as the joint Steering Committee on Financial Instruments of the International Accounting Standards Committee and the Canadian Institute of Chartered
Accountants, has concluded that measuring financial instruments at fair value is an idea whose time has come. An international Joint Working Group consisting of the FASB and its counterpart standard setters from various other countries, including Canada, the United Kingdom, Australia, Germany, and Japan, are cooperating to develop a workable accounting system in which financial assets and liabilities are measured at fair value. It is important to note that the work is limited to financial assets and liabilities. None of the standard setters are considering changing the measurement basis for nonfinancial assets and liabilities to fair value.

Changes in the economic environment during the last two decades or so have made the issue of how to measure financial instruments critical. Those changes include the increased volatility of prices such as interest rates and foreign exchange rates, and the introduction of derivatives and other complex instruments.

**Why We Would Expect Fair Values to Be Relevant**

The objectives of financial reporting are based on a conclusion that investors and creditors are primarily interested in assessing the amounts, timing, and uncertainty of future net cash inflows to the entity, and eventually to them. Information is relevant if it has the capacity to make a difference to that assessment.

Financial instruments (other than cash or evidences of ownership interests in another entity) are contracts that require one party either to transfer cash or another financial instrument to another party who has a contractual right to receive it or to exchange financial instruments with another party. The essence of such a contract is an eventual cash receipt, cash payment, or both. A bond, a bank loan, and an interest rate swap all are financial instruments. (An
example of an interest rate swap is a contract in which one party agrees to pay periodic amounts based on a floating interest rate, such as LIBOR, to a counterparty who in exchange agrees to pay to the first party a specified fixed interest rate.)

While descriptive and quantitative information about the nature and risks of a financial asset or liability is important, a measure of its amount clearly is needed if the asset or liability is to be included in financial statements. But which measure?

The fair value of a financial instrument represents the amount at which the instrument could be bought or sold in a current transaction between willing parties. Fair value is measured based on a quoted price in an active market, if one is available. If a market price is not available, fair value is measured based on the information and techniques that provide the best available estimate of a current market price. A market price of a financial instrument reflects the market’s assessment of the present value of the future cash flows embodied in it, based on current interest rates and the market’s assessment of the risk that the amount or timing of the cash flows will differ from expectations.

No one questions the relevance of information based on market prices—the controversy about fair values versus historical-cost-based measures involves only the date of the market prices on which accounting measures are based. Historical cost information is based on market prices at which assets were acquired and liabilities incurred. Fair values, in contrast, are based on current market prices.

It seems logical that information based on prices that reflect the market’s assessment, under current conditions, of the present values of the future cash flows embodied in an entity’s financial instruments would be more relevant for investors’ and creditors’ decisions than
information based on old market prices. Those older market prices reflect both an old interest rate and an outdated assessment of the amounts, timing, and uncertainty of future cash flows.

**Does Management’s Intent Determine the Relevance of Fair Value?**

In today’s mixed-attribute model, some financial assets and liabilities are measured at fair value, but many others—especially liabilities—are measured at amounts based on historical cost or proceeds. Many argue that historical cost or proceeds sometimes is the appropriate attribute while fair value is appropriate in other situations because the most relevant measure of a financial instrument is the one that reflects management’s intent for the item.

Most people agree that fair values are the most relevant measure for assets and liabilities that an entity actively trades. Some also acknowledge the relevance of the fair values of assets held for (or available for) sale, although they often question the significance for evaluating an entity’s performance of changes in the values of assets and liabilities that the entity does not intend to trade. But if management intends to hold an asset or to owe a liability until its maturity, or just has no present plans to sell or settle it before maturity, advocates of today’s measurement model contend that the most relevant measure is one based on the amount initially paid or received.

Supporters of that measure say that historical-cost-based information is more relevant because it focuses on the decisions and resulting actions to buy or sell assets and to incur or settle liabilities. They say that fair value information, with its focus on current market prices, is less relevant because it reflects the effects of transactions and events in which the entity did not directly participate. They contend that, except for assets or liabilities in which an entity intends
to actively trade, timely information about the effects of interim decisions to continue to hold an asset or to owe a liability is not relevant to an assessment of enterprise financial performance. Rather, they say that the effects of those decisions should become apparent to the reader of financial statements only over time, as the entity reports earnings that reflect higher or lower yields than the current market rates.

Fair value advocates, on the other hand, note that in today’s highly fluid economic environment, significant changes often occur in extremely short periods of time. A change may, for example, call into question whether an asset acquired with the intent to hold it to maturity should instead be sold and the proceeds invested elsewhere. In their view, decisions to hold assets or to continue to owe liabilities are vitally important in such an environment. The effects of those decisions, whether made actively or indirectly through inattention, are an important aspect of entity performance. Investors and creditors need information that will help them evaluate the effects of an entity’s decision to hold or sell an asset or continue to owe or settle a liability.

**Why Decisions to Continue to Hold or to Owe Are Important**

Let’s look more closely at the effects of decisions to continue to hold assets using a simple example. Assume that on December 31, 2000, a publicly held enterprise—Company A—purchases at par $1,000,000 of IssuerCo’s 10-year bonds with a 10 percent coupon rate. Two years later, interest rates have risen, and the fair value of the bonds is $899,000,\(^1\) reflecting

\(^1\)Amounts throughout the examples generally are rounded to the nearest $1,000.
the current yield to maturity of 12 percent.\(^2\) Company A expects to hold its bonds until they mature.

\(^2\)To focus the discussion, we assume that interest rates for the years 2003–2010 are the same for all maturities (that the yield curve is flat), that the entire decline in value occurred at the end of 2002, and that there are no further changes in interest rates during the remaining 8 years of the term of the bonds.
“But It’s Only an Opportunity Loss”

Company A’s bonds decreased in value by $101,000 ($1,000,000 – $899,000) by the end of 2002. If Company A had sold the bonds at that date, the loss would be considered "realized" and few would question its relevance. But supporters of the mixed-attribute model often dismiss the decline in value of Company A’s bonds during 2002 as “only an opportunity loss.” They say that Company A merely lost the opportunity to purchase the bonds for $101,000 less than it actually paid for them, which in their view is not a “real” loss that is pertinent in considering Company A’s financial performance. Moreover, that opportunity loss "reverses" over the remaining life of the bonds because Company A will collect the amount it originally invested, $1,000,000, when the bonds mature.

Unrealized gains and losses on financial assets and liabilities can, of course, be described as related to lost opportunities—opportunities either to sell or settle at a relatively high price or to acquire or incur at a relatively low price. But are lost opportunities on existing assets and liabilities really irrelevant in evaluating an entity’s financial position and performance? Let’s extend the example to examine that question further.

On December 31, 2000, when Company A purchased its bonds, Company B, one of Company A’s publicly held competitors, also had $1,000,000 to invest. But Company B chose to invest its money in 2-year, 9 percent notes. On December 31, 2002, when the notes mature, Company B uses the proceeds to purchase in the open market some of the same issue of IssuerCo’s bonds that Company A holds. At the current 12 percent yield-to-maturity, the
quoted bond price is $89.90. Company B’s $1,000,000 thus purchases bonds with a face amount of $1,112,000 ($1,000,000/$89.90 per $100 of face amount).

Table 1 summarizes the two companies’ investment results for the year ending December 31, 2002.

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest income</strong></td>
<td>$100,000</td>
<td>$90,000</td>
</tr>
<tr>
<td><strong>Bond investment</strong></td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Fair value of bonds held</strong></td>
<td>$899,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Loss in fair value</strong></td>
<td>$(101,000)</td>
<td>0</td>
</tr>
</tbody>
</table>

Ms. Investor is reviewing the two companies’ financial statements at December 31, 2002, to help decide whether to invest in Company A or in Company B. Advocates of measuring the bonds at historical cost claim that the *most* relevant information the financial statements can provide for Ms. Investor’s decision *excludes* the information in the last two lines of Table 1. Without that information, Company A’s performance looks better than Company B’s. Historical cost advocates say that the decline in value of Company A’s bonds is not relevant in assessing the company’s financial performance for 2002. Ms. Investor should, they say, evaluate Company A’s performance for 2002 without considering that loss because it will “reverse” by the time the bonds mature.

Just how valid is the claim that Company A’s “opportunity loss” will “reverse” over the remaining term of the bonds? Let’s examine that question by extending the comparison between Company A’s and Company B’s economic positions *vis-à-vis* their bond investments to consider what Company A’s loss represents in present value terms.
Company B and Company A each paid $1,000,000 to acquire their bonds, but Company B’s $1,000,000 bought more bonds. Company B thus will receive higher interest payments during the remaining eight years of the bonds’ term. Company B also will collect more money than Company A does upon maturity of the bonds. Table 2 summarizes those differences in cash receipts and their present values at December 31, 2002, computed at the current interest rate of 12 percent compounded semiannually.

### Table 2

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
<th>Difference</th>
<th>Present Value of Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Semiannual interest income</strong></td>
<td>$50,000</td>
<td>$55,600</td>
<td>$5,600 per period for 16 periods</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total semiannual interest receipts</strong></td>
<td>$800,000</td>
<td>$890,000</td>
<td>$90,000</td>
<td>$57,000</td>
</tr>
<tr>
<td><strong>Cash receipt at maturity</strong></td>
<td>$1,000,000</td>
<td>$1,112,000</td>
<td>$112,000</td>
<td>$44,000</td>
</tr>
<tr>
<td><strong>Total cash receipts</strong></td>
<td>$1,800,000</td>
<td>$2,002,000</td>
<td>$202,000</td>
<td>$101,000</td>
</tr>
</tbody>
</table>

The present value at 12 percent of the differences in the 2 companies’ cash receipts from their bond investments—$101,000—is the same as, or rather it is, the loss in the fair value of Company A’s bonds when the interest rate changed at the end of 2002. Company A thus "realizes" its "opportunity loss" over the remaining life of the bonds. Company A’s "opportunity loss" is both real and permanent. It collects in interest and at maturity only the amount that it would have collected had it purchased the bonds for $899,000 at the end of 2002, which would have saved Company A $101,000 to invest elsewhere.
The assertion that the most relevant information Company A’s financial statements for the year ending December 31, 2002, can provide for Ms. Investor’s use excludes the fair value of and related loss on the bonds is less than convincing. Moreover, failure to recognize that loss when it occurs impairs the usefulness of Company A’s financial statements not only in 2002 but throughout the remaining 8 years of the bonds’ term.

To illustrate, assume that Company A’s old management team departs and a new one enters the scene in January 2003. The new management decides to hold onto the bonds. Ms. Investor remains interested in comparing the financial performance of Company A and Company B over the next several years. She is especially interested in assessing the apparent effect of Company A’s new management team on its performance. If the financial statements report the bonds at historical cost, the new team starts off at a disadvantage because it will report that it earns a lower return each year on its bonds than Company B earns on its bonds. But Company A’s old management team decided in 2000 to invest in long-term bonds yielding 10 percent. The new team decided, in effect, to reinvest the bonds’ fair value of $899,000 in January 2003 at the current 12 percent yield to maturity. Company A’s new management will likely feel that its economic decision results in the same return—12 percent—that Company B earns on its bonds. Again, how credible is the claim that the most relevant information Company A’s financial statements can provide during the years 2003 through 2010 excludes the current fair value of and yield on its bonds?

What about Liabilities?
Most acknowledge the problems with today’s mixed-attribute system in which many financial assets but few financial liabilities are measured at fair value. Banks and other financial entities often “match” their financial asset and liability positions to limit their potential net loss from unpredictable changes in interest rates. Reporting the change in fair value of only one side of a matched position misrepresents the effects of management’s asset-liability strategy. Even if financial asset and liability positions are not directly “matched,” reporting the fair value of only financial assets misrepresents the financial position of an entity that also has significant financial liabilities.

Some people suggest that relevant information about an asset-liability matching strategy would result from recognizing the fair values of both financial liabilities and financial assets. But others would prefer to achieve consistent measurement bases for financial assets and liabilities by not recognizing the fair values of either assets or liabilities. Many people question the relevance of information about the fair value of a financial liability that management does not intend, and may not even be able, to settle before its maturity. An exploration of why the fair values of financial liabilities are relevant even for liabilities that are not settled before maturity is in order.

**Company Y and Company Z and Their Outstanding Bonds**

Company Y and Company Z are competitors, they both are publicly held, and both have bonds outstanding. On December 31, 2002, Company Y owes $1,000,000 due in 8 years that carries a fixed interest rate of 10 percent. Company Z also owes $1,000,000 due in 8 years, but Company Z issued its bonds in a less favorable interest-rate environment. Its debt carries
an interest rate of 14 percent. The two companies have equivalent credit ratings. The prevailing market interest rate for both companies changes to 12 percent on December 31, 2002.

Under historical-price-based GAAP, each company will report $1,000,000 of outstanding debt in its statement of financial position dated December 31, 2002. But the fair value of Company Y’s debt at that date is $899,000, while the fair value of Company’s Z’s debt is $1,101,000—both fair values computed at the current yield-to-maturity of 12 percent.

Table 3 summarizes pertinent amounts from the two companies’ financial statements under historical-price-based accounting, as well as their economic positions at December 31, 2002.

<table>
<thead>
<tr>
<th></th>
<th>Company Y</th>
<th>Company Z</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reported amount of bonds outstanding at 12/31/02</strong></td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Reported interest expense (at 10% and 14%)</strong></td>
<td>$100,000</td>
<td>$140,000</td>
</tr>
<tr>
<td><strong>Fair value of bonds</strong></td>
<td>$899,000</td>
<td>$1,101,000</td>
</tr>
<tr>
<td><strong>Economic gain (loss)</strong></td>
<td>$101,000</td>
<td>$(101,000)</td>
</tr>
</tbody>
</table>

Mr. Investor (a colleague of Ms. Investor) is reviewing the financial statements of Companies Y and Z to help decide whether to invest in Company Y or Company Z. Again, advocates of the present measurement model for financial assets and liabilities contend that the most relevant information about the two companies is based solely on the amounts in the first two rows of Table 3. Mr. Investor does not, they say, need to know that Company Y has enjoyed an economic gain as a result of changes in market interest rates since issuing its bonds, while Company Z has sustained a loss of the same amount. And, his evaluation of the financial positions of the 2 companies at December 31, 2002 should be based on information that shows
that both companies’ debt imposes an economic burden of $1,000,000. Again, the validity of those assertions seems questionable at best.

Few are likely to disagree with including Company Y’s gain and Company Z’s loss in the reported measure of their financial performance for 2002 if the gain is "realized" by repaying the bondholders. Let’s assume that both companies repurchase their outstanding bonds on December 31, 2002.3 In that situation, the two companies’ financial statements at December 31, 2002 will report the following amounts.

| Table 4 |
|-----------------|-----------------|
| **Bonds outstanding at 12/31/02** | Company Y | Company Z |
| $0 | $0 |
| **Interest expense for 2002**<br>(at 10% and 14%) | $100,000 | $140,000 |
| **Realized gain (loss) on early settlement of debt** | $101,000 | $(101,000) |

Company Y’s income statement thus reports its economic gain from the increase in interest rates, while Company Z’s reports its loss. But for Company Y to recognize its gain, it had to repay debt that carried a favorable interest rate. A company with below-market financing is in an economically advantageous position relative to one with financing at the current rate or higher. If Company Y had not used $899,999 to repay the debt, it could have invested that amount in its own operations and perhaps earned a higher return. Moreover, if Company

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3To keep the amounts used throughout the examples consistent, we assume that Companies Y and Z repurchase all of their bonds. In practice, of course, an issuer is not likely to be able to repurchase on the open market all of an outstanding bond issue—certainly not on a single day. But the principles discussed in the example would be the same if the 2 companies had repurchased only, say, 2 percent of their outstanding bonds, which might be possible.
Y continues to need financing, it will have to refinance at the higher current interest rate.

Repurchasing its bonds may not have been the best way for Company Y to invest its money.

Company Z, on the other hand, reported a loss because it repaid debt that carried an above-market interest rate. That might have been the best use of Company Z’s money.
Company Z’s choice was limited to leaving its bonds outstanding and realizing its loss through paying above-market rates during the remaining 8 years of their term or repaying the bonds and realizing the loss now. Depending on the available alternative uses of its money, repaying the bonds and relieving future operations of the burden of above-market interest payments may have been a reasonable choice, but Company Z could have avoided a reported loss by not repaying its debt.

Something is wrong with a measurement model that reports gains and losses only when an entity takes an action that may place it in a less economically advantageous position than it was in before, while refusing to acknowledge the same gains and losses when they arise. Company Y’s gain and Company Z’s loss were caused by changes in interest rates—not by a decision to repay debt. Today’s measurement model for financial instruments not only fails to provide the most relevant information for investors’ and creditors’ decisions, it also sometimes provides an incentive for uneconomic actions.

**Which Measure Is the Liquidation Basis?**

Some people say that the result of measuring financial assets and liabilities based on current prices is a "liquidation" measurement basis rather than a "going-concern" measurement basis. For liabilities at least, the accuracy of that assertion seems questionable.

For example, Company Y’s bondholders have a contractual claim against the enterprise of $1,000,000 on December 31, 2002 (assuming that the bonds are not callable at some other amount on that date). If Company Y’s stockholders decide to liquidate the company on that date by selling all of its assets and settling all of its liabilities, the bondholders have the right to
collect the full contractual amount of their claim, provided that the company’s assets are sufficient to cover that amount after paying all senior claims.

If Company Y continues to operate, however, it may well be able to "realize" the reported gain that would result from acknowledging in the financial statements the decline in value of the bonds. As illustrated with Company A’s bonds held, unrealized gains and losses are realized in one sense through operations over the remaining term of the bonds. But Company Y might realize its gain immediately with an interest rate swap—a risk-management tool once used only by large and sophisticated companies but now often available to smaller companies as well.

For example, Company Y might enter into a custom-tailored “in-the-money” interest rate swap to effectively convert its gain to cash. It might agree to receive fixed interest payments at 10 percent on $1,000,000 for the remaining term of the bonds while paying a floating rate for the same term. Ignoring transaction costs, Company Y would receive the amount of its gain as its price of entering into that interest rate swap. It thus realizes its gain without creating any more interest rate risk than if it had repaid the bonds by refinancing them with floating-rate debt. (The interest rate swap does, however, result in a new credit risk for Company Y.)

Company Y may not wish to be exposed to the risk of interest expense volatility from future interest rate changes that comes with floating-rate debt. If not, it could enter into a second, "plain-vanilla," interest rate swap to pay fixed interest payments at the current rate of 12 percent and receive floating-rate payments. That would leave it in the same interest-rate-risk position as if it had repaid the bonds by refinancing them with new fixed-rate debt.

Whether it enters into such swaps or not, Company A is better off on a "going-concern" basis by having low-coupon, fixed-rate debt in an environment of higher interest rates. But if the
company were to liquidate at the end of 2002, it might never realize its economic gain. One might ask: Which is the "liquidation basis" and which the "going-concern" basis?

**Today’s Mixed-Attribute System Cannot Cope in Today’s Environment**

Company Y’s interest-rate swaps help illustrate the second important reason to move toward a fair-value-based measurement model for financial instruments. The present mixed-attribute model cannot cope with financial innovations like interest rate swaps and the many other complex instruments that now make it possible for an entity to change its risk positions, virtually at a moment’s notice with a single phone call.

Under a mixed-attribute measurement model for financial instruments in which derivatives are measured at fair value but underlying cash positions generally are not, many want special accounting requirements to accommodate strategies like Company Y’s. The need for special hedge accounting requirements may not have been a pressing problem two decades ago. Back then, only a few sophisticated entities used the limited risk-management strategies and instruments that were available. That is no longer true, as demonstrated vividly by the widespread interest both in the Board’s project on accounting for derivative financial instruments and for hedging activities and in the complex instruments and strategies that are dealt with in that project.

For example, another risk-management strategy that poses severe difficulties for a mixed-attribute model is macro or portfolio hedging in which an entity wishes to group dissimilar items for hedging purposes. Under hedge accounting based on deferral of gains and losses on a hedging instrument until the period that the offsetting gain or loss on the hedged item is
recognized, gains and losses on hedging instruments must be allocated to individual items or
groups of similar items. Otherwise, it is impossible to determine the period in which the
deferred gain or loss should be recognized in earnings. That allocation must be done every time
the portfolio changes—not a simple procedure!

If all financial instruments were measured at fair value with the related gains and losses
included in income when they arise, far fewer special requirements would be necessary for the
financial statements to depict the success or lack thereof of risk-management strategies, no
matter how complicated. If both the hedged item—whether a single item or a group of similar
or dissimilar items—and the hedging instrument are measured at fair value, the degree to which
the hedging strategy succeeded in mitigating the risk would be readily apparent.

What Did We Learn from the Examples?

The next table summarizes pertinent features of historical-cost-based and fair-value-based
measures of financial assets and liabilities as revealed by the simple examples of the bonds held
by Companies A and B and the bonds owed by Companies Y and Z.
<table>
<thead>
<tr>
<th></th>
<th><strong>Fair Value</strong></th>
<th><strong>Historical Cost</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Improves comparability</td>
<td>Improves comparability by making like things look alike and unlike things look</td>
<td>Impairs comparability by making like things look different and different things look</td>
</tr>
<tr>
<td></td>
<td>different.</td>
<td>alike.</td>
</tr>
<tr>
<td>Provides information</td>
<td>Provides information about benefits expected from assets and burdens imposed by</td>
<td>Provides information about benefits expected from assets and burdens imposed by</td>
</tr>
<tr>
<td>about benefits expected</td>
<td>liabilities under current economic conditions.</td>
<td>liabilities under the economic conditions when they were acquired or incurred.</td>
</tr>
<tr>
<td>from assets and burdens</td>
<td></td>
<td></td>
</tr>
<tr>
<td>under current economic</td>
<td></td>
<td></td>
</tr>
<tr>
<td>conditions.</td>
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</tr>
<tr>
<td>Reflects effect on</td>
<td>Reflects effect on entity performance of management’s decisions to continue to</td>
<td>Reflects effect on entity performance only of decisions to acquire or sell assets</td>
</tr>
<tr>
<td>entity performance of</td>
<td>hold assets or owe liabilities, as well as decisions to acquire or sell assets</td>
<td>or to incur or settle liabilities. Ignores effects of decisions to continue to</td>
</tr>
<tr>
<td>management’s decisions</td>
<td>and to incur or settle liabilities.</td>
<td>hold or to owe.</td>
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<tr>
<td>to continue to hold</td>
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<tr>
<td>assets or owe liabilities, as well as decisions to acquire or sell assets and to incur or settle liabilities.</td>
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<td></td>
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<tr>
<td>Reports gains and losses</td>
<td>Reports gains and losses from price changes only when they are realized by sale</td>
<td>Reports gains and losses from price changes only when they are realized by sale or</td>
</tr>
<tr>
<td>when they occur.</td>
<td>or settlement, even though sale or settlement is not the event that caused the</td>
<td>settlement, even though sale or settlement is not the event that caused the gain or</td>
</tr>
<tr>
<td></td>
<td>gain or loss.</td>
<td>loss.</td>
</tr>
<tr>
<td>Requires current market</td>
<td>Requires current market prices to determine reported amounts, which may require</td>
<td>Reported amounts can be computed based on internally available information about</td>
</tr>
<tr>
<td>prices to determine</td>
<td>reported amounts, which may require estimation and can lead to reliability</td>
<td>prices in past transactions, without reference to outside market data.</td>
</tr>
<tr>
<td>reported amounts, which</td>
<td>problems.</td>
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<tr>
<td>may require estimation</td>
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<td>and can lead to</td>
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<td>reliability problems.</td>
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<tr>
<td>Easily reflects the</td>
<td>Requires complex rules to attempt to reflect the effect of most risk-management</td>
<td></td>
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<tr>
<td>effects of most risk-</td>
<td>management strategies.</td>
<td>management strategies.</td>
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<td>management strategies.</td>
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</table>

Standard setters must resolve various issues before it is feasible to require that all financial assets and liabilities be measured at fair value. Resolving them will not be easy and will require the cooperation of many people. But the time has come to get on with the move to fair value measurement. The old model with its historical-price-based measures provides less relevant information than today’s dynamic capital markets need, and it cannot cope with today’s complex financial instruments and risk-management strategies—much less tomorrow’s.
Appendix B

THE EFFECT OF THIS PRELIMINARY VIEWS ON FASB STATEMENTS NO. 5, ACCOUNTING FOR CONTINGENCIES, AND NO. 60, ACCOUNTING AND REPORTING BY INSURANCE ENTERPRISES

151. A number of authoritative pronouncements would change if financial instruments and other items within the scope of this Preliminary Views were required to be reported at fair value in the basic financial statements in accordance with this Preliminary Views. Two Statements that would be significantly affected by this Preliminary Views are FASB Statements No. 5, Accounting for Contingencies, and No. 60, Accounting and Reporting by Insurance Enterprises. This appendix describes the probable effect of the proposed requirements in this Preliminary Views on those two Statements.

FASB Statement No. 5, Accounting for Contingencies

152. The recognition and measurement criteria in Statement 5 focus on accrual of contingent losses. Some of those losses are due to impairment of assets, and others are due to incurrence of liabilities. If the proposed requirements in this Preliminary Views were adopted in the basic financial statements, Statement 5 would be amended to limit its scope to liabilities and impaired assets that are not financial instruments. Financial instruments would be reported at their fair values, and no additional valuation adjustments would be permitted or required.

153. Paragraph 4 of Statement 5 includes examples of loss contingencies. The following is an analysis of how each would be viewed under this Preliminary Views.
Collectibility of Receivables

154. Uncertainties about collectibility of receivables would affect the fair value of the receivables, which are financial instruments. A separate allowance for losses would not be recognized.

Obligations Related to Product Warranties and Product Defects

155. Obligations related to product warranties create a liability that is a financial instrument if the warrantor is obligated to pay cash. Obligations related to product defects that are not covered by warranties (for example, recalls) may be liabilities, but they are not financial instruments and thus not covered by this Preliminary Views. However, if the entity agrees to deliver cash or a financial instrument to fulfill its obligation, that would create a contractual obligation that is a financial instrument.

Risk of Loss or Damage of Enterprise Property by Fire, Explosion, or Other Hazards and Threat of Expropriation of Assets

156. Risks of future loss of, damage to, or expropriation of one’s own property are not liabilities, but they might affect the fair values of the entity’s assets. That is, physical assets subject to high risks might have impaired values. However, this Preliminary Views does not apply to physical property.

Pending or Threatened Litigation

157. A loss contingency for pending or threatened litigation might be accrued under Statement 5, but there is no financial instrument because there is no contractual obligation until a settlement
has been reached and the entity has agreed to pay. The liability would not be subject to the requirements of this Preliminary Views unless and until it becomes a contract.

Possible Claims and Assessments

158. Possible claims and assessments would not be subject to the requirements of this Preliminary Views. They are not liabilities because no past event has created a current obligation for a possible future claim or assessment. If they become liabilities, they are actual claims and assessments.

Actual Claims and Assessments

159. Claims under insurance policies, warranties, or other conditional obligations are financial instruments if they are required to be settled in cash or other financial instruments. They would be reported initially and subsequently at fair value. Assessments generally are imposed by governments or agencies and are not contractual. Thus, they are not financial instruments and would not be subject to the requirements of this Preliminary Views.

Risk of Loss from Catastrophes Assumed by Property and Casualty Insurance Companies Including Reinsurance Companies

160. Insurance contracts create conditional contractual obligations to pay cash (and rights to require payment of cash), which are financial instruments. The risk of losses that have not yet occurred but are expected to occur during the current contract period is not a separate liability. It would affect the fair value measurement of the insurance or reinsurance company’s financial liability.

Guarantees of Indebtedness of Others
161. Financial guarantees represent conditional contractual obligations to pay cash (and rights to require payment of cash), which are financial instruments. They would be reported at fair value initially and subsequently.

**Obligations of Commercial Banks under "Standby Letters of Credit"**

162. Standby letters of credit represent conditional contractual obligations to pay cash (and rights to require payment of cash) in exchange for a note. They would be reported at fair value initially and subsequently.

**Agreements to Repurchase Receivables (or to Repurchase the Related Property) That Have Been Sold**

163. An agreement to repurchase receivables that have been sold is a financial instrument. If the transaction qualifies for reporting as a sale under Statement 125, the transferor would report the repurchase agreement as an asset or liability (depending on its net value). That asset or liability, which is a financial instrument, would be measured at fair value.

164. If the transfer does not qualify for reporting as a sale, the cash received would be reported as a loan and the assets transferred would continue to be recognized. The loan would be reported at its fair value as would the assets transferred, if they are financial instruments.

**FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises**

165. Both short-duration and long-duration insurance policies would be affected if they require settlement in cash or give either party the option to require settlement in cash. The Board has not yet decided whether insurance policies that require the issuer to provide goods or services would be within the scope of any final Statement on fair values or would continue to be reported
under the requirements of Statement 60. (Refer to paragraphs 138–144 for further discussion of that issue.) The portions of Statement 60 that do not relate to financial instruments would remain in effect, for example, the discussion of investments in real estate. This appendix does not provide details on how assets, liabilities, revenues, and expenses would be presented because the Board has not yet discussed those matters.

**Premiums—Short-Duration Contracts**

*Current Requirement in Paragraphs 13 and 14 of Statement 60*

166. Premiums from short-duration contracts are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. If premiums are subject to adjustment and the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium can be reasonably estimated.

*Application of This Preliminary Views*

167. An insurance contract represents a conditional obligation to pay, which is a financial instrument. A contract liability would be recognized when the policy becomes effective and would be measured initially and subsequently at fair value, which includes the present value of the expected cash flows related to future claims. (In concept, fair value is the hypothetical amount that another insurer with the same credit standing as the policy issuer would charge to assume the policy liability. That might be different from the initial entry price to the policyholder, and, if so, the policy issuer would recognize a gain or loss when the policy is issued.) The
income statement would reflect the effects of changes in fair value in the period in which changes occur.
Premiums—Long-Duration Contracts

Current Requirement in Paragraphs 13 and 14 of Statement 60

168. Premiums from long-duration contracts are recognized as revenue when due from policyholders.

Application of This Preliminary Views

169. The contract represents a conditional obligation to pay, which is a financial instrument. Some contracts have other features such as policy loans and cash surrender values, but those features do not change the contracts’ status as financial instruments. When the policy becomes effective, a contract liability would be recognized and measured initially and subsequently at fair value. (Again, fair value would be the amount that another insurer with the same credit standing as the policy issuer would charge to assume the policy liability. That might be different from the entry cost to the policyholder, and, if so, the policy issuer would recognize a gain or loss when the policy is issued.) The income statement would reflect the effects of changes in fair value in the period in which changes occur.

Unpaid Claim Costs

Current Requirement in Paragraphs 17 and 18 of Statement 60

170. A liability for unpaid claim costs, including incurred but not reported claims, is recognized when insured events occur. The liability for unpaid claims is based on the entity’s estimate of the ultimate cost of settling the claims.
Application of This Preliminary Views

171. A liability for unpaid claim costs, including incurred but not reported claims, is recognized when insured events occur. The liability for unpaid claims would be an estimate of the price that a market participant with the same credit standing as the policy issuer would charge for assuming the liability.

Claim Adjustment Expenses

172. Claim adjustment expenses are recognized when the related liability for unpaid claims is accrued.

Application of This Preliminary Views

173. Claim adjustment expenses would be a factor in determining the fair value of the liability for unpaid claims.

Future Policy Benefits

Current Requirement in Paragraph 21 of Statement 60

174. A liability for future policy benefits relating to long-duration contracts is recognized when premium revenue is recognized. The liability for future policy benefits is the present value of future benefits and related expenses less the present value of future net premiums.

175. The discount rate is the entity’s expected investment yields, net of expenses. The estimates of cash flows reflect the entity’s estimate of the effect of the following factors:

?? Mortality
?? Morbidity
?? Terminations
176. The cash flows are adjusted for the entity’s internal estimate of the risk of adverse deviation in the assumptions. The original assumptions are used in future periods to determine changes in the liability. Changes in the liability are recognized in income when the changes occur.

*Application of This Preliminary Views*

177. The contract liability would be recognized at its fair value, which includes the present value of the expected future policy benefits, policyholder dividends, policy maintenance costs, retrospective and contingent commissions, and experience-based refunds. Thus, expected future policy benefits, net of expected future premiums, would not be a separate liability. It would be a factor in determining the fair value of the contract liability, which is a financial instrument.

178. All of the factors listed in paragraph 21 of Statement 60 probably would be considered in determining the fair value of the contract liability. However, the discount rate would not be based on investment yields. It would be either the current risk-free rate (if all risk factors are considered in developing probability-weighted cash flows) or a rate that reflects the credit risk of the policy issuer and other risks.

179. Assumptions would change each period to reflect current market conditions. Changes in the fair value of the contract liability would be recognized in income when they occur.
Policy Acquisition Costs

*Current Requirement in Paragraph 29 of Statement 60*

180. Policy acquisition costs are capitalized and charged to expense in proportion to premium revenue recognized.

*Application of This Preliminary Views*

181. Policy acquisition costs are not assets because they do not represent a probable future benefit. The costs would be charged to expense as they are incurred. Policy acquisition costs could be viewed as related to development of a customer relationship, which is a noncontractual asset. However, that asset would not be recognized under this Preliminary Views.

Costs Other Than Claims, Policy Benefits, and Policy Acquisition Costs

*Current Requirement in Paragraph 27 of Statement 60*

182. Costs other than claims costs, policy benefit costs, and policy acquisition costs are charged to expense as incurred.

*Application of This Preliminary Views*

183. Those costs would be charged to expense as they are incurred.

Premium Deficiencies—Short-Duration Contracts

*Current Requirement in Paragraph 33 of Statement 60*

184. If the expected claim costs, claim adjustment expenses, dividends to policyholders, unamortized acquisition costs, and maintenance costs for short-duration contracts exceed related unearned premiums, a premium deficiency is recognized.
Application of This Preliminary Views

185. Recognition of a premium deficiency would not be necessary. The fair value of the contract liability would reflect any premium deficiency.

Premium Deficiencies—Long-Duration Contracts

Current Requirement in Paragraph 35 of Statement 60

186. If existing liabilities for long-duration contracts plus the present value of future gross premiums are less than unamortized acquisition costs plus the present value of future benefits and settlement and maintenance costs, a premium deficiency is recognized.

Application of This Preliminary Views

187. Separate requirements for recognition of a premium deficiency would not be necessary. The fair value of the contract liability would reflect the effect of any premium deficiency.

Policyholder Dividends

Current Requirement in Paragraph 41 of Statement 60

188. Policyholder dividends are recognized based on the entity’s internal estimate of future dividends.

Application of This Preliminary Views

189. Expected policyholder dividends would be a factor in determining the fair value of the contract liability. The amount would reflect the market’s estimate of future dividends, not the estimate of the individual issuer.
Retrospective and Contingent Commissions

Current Requirement in Paragraph 44 of Statement 60

190. Retrospective commissions and experience-based refunds are recognized based on the entity’s experience. Contingent commissions are recognized in the period in which related income is recognized.

Application of This Preliminary Views

191. Expected retrospective commissions and experience-based refunds would be a factor in determining the fair value of the contract liability. The amount would be based on what the market would expect, not on the individual issuer’s experience. Contingent commissions would be a factor in determining the fair value of the contract liability. The amount would be based on what the market would expect, not on the individual issuer’s experience.

Noncontractual or Intangible Assets

192. A number of items contribute to the value of a relationship between a policy issuer and a policyholder. Some are contractual and some are noncontractual. Unlike the credit card relationship and the demand deposit relationship discussed in paragraphs 101–132, there normally are no observable prices (at least in the United States) for the policy issuer-policyholder relationship as a whole. The estimate of an exit price will depend heavily on internal information and assumptions. The price in reinsurance transactions should provide evidence about the possible exit price for some of the contractual rights and obligations embodied in the policy issuer-policyholder relationship. However, reinsurance transactions typically would not include assignment of noncontractual rights to the reinsurer, and the prices
would not provide evidence about their values. Thus, the unresolved issue related to credit card contracts and demand deposit agreements does not apply to insurance policies in the United States. Therefore, only the rights and obligations that are financial instruments would be reported at fair value; noncontractual rights would not be recognized.
DECISIONS IN THE NEXT PHASE OF THE PROJECT

How Should Financial Instruments Be Displayed in a Statement of Financial Position?

193. Display of a single amount clearly is the best choice for many financial instruments. One other possibility would be to display two separate numbers, one for cost and the other for changes in fair value after acquisition or incurrence, for example, for adjustments made to a portfolio instead of individual instruments. Disclosure of cost or unrealized appreciation or depreciation on the face of the balance sheet is another possibility. Separate display (or disclosure) of the effect of changes in an entity’s credit risk on its liabilities also might be desirable.

194. Compound instruments may be treated differently. A compound instrument might be displayed as either a single item, or the components might be presented as separate items.

195. Statement 133 requires separate presentation of embedded derivatives that are not "clearly and closely related" to their host contracts if the host contracts are not reported at fair value with changes in earnings. (That permits the derivative portion but not the nonderivative portion to be used as a hedging instrument. It also permits an entity to avoid reporting the nonderivative portion at fair value with changes in earnings.) The Board has no current plans to amend Statement 133 as a part of this project. However, if all financial instruments are reported at fair value with changes in earnings, the clearly-and-closely-related criterion would apply only to derivatives embedded in contracts that are not financial instruments.
196. In some instances, two financial instruments might be displayed as a single amount under a consensus of the EITF or a staff interpretation arising from deliberations of the Derivatives Implementation Group. The Board should consider whether combined display is appropriate if all financial instruments are reported at fair value.

**How Should Details of Changes in Fair Value Be Displayed in a Statement of Financial Performance?**

197. Some alternatives that could be considered include the following:

a. No specific requirements
b. Report all changes in fair value as a single amount
c. Separately report changes due to different risk factors:
   (1) Interest rate
   (2) Credit
   (3) Foreign currency
   (4) Commodity price
   (5) Equity price
d. Separately report changes in fair value of instruments in different functional categories (based on expressed intent):
   (1) Trading
   (2) Available for sale
   (3) Held to maturity
   (4) Hedging
e. Separately report changes in fair value for the following reasons:
   (1) Changes in market factors
   (2) Changes due to the passage of time
   (3) Changes in model inputs (changes in estimates)
   (4) Changes in models (changes in methods)
f. Separate realized and unrealized changes:
   (1) Sales and holding gains
   (2) Defaults and changes in credit ratings.

198. Each method of categorization raises a set of questions. For example:

a. If only a single amount is reported, what happens to a bank’s net interest margin and what additional disclosures would be necessary?
b. If changes are separated by risk factors, how would changes due to different risks be separated?
c. If changes due to the passage of time are reported separately, would that be the contractual interest, a level-yield computation, or a computation based on the term structure of interest rates?

What Disclosures Are Necessary?

199. The following are disclosures that might be required in notes to financial statements:

a. Disaggregation of gains and losses to the extent that information is not already provided in the income statement
b. The amount of unconditional contractual cash flows from financial instruments
c. Discussion of conditional cash flows including nature of the cash flows from unusual instruments or as a result of unusual circumstances
d. Models used in estimating fair values
e. Key assumptions used in estimating fair values
f. Creditworthiness assumptions used in estimating exit prices of an entity’s own liabilities
g. Ranges around point estimates used in financial statements
h. Sensitivity to changes in market factors
i. Concentrations of risk (from Statement 105).

What Should Be the Effective Date?

200. The effective date will depend on how long it takes to complete the project and on what form of reporting the Board decides to require (notes, basic financial statements, a second set of fair-value-based financial statements). The outcome of this project cannot be predicted at this stage.

Are Special Transition Provisions Necessary?

201. Transition also depends on what form of reporting the Board decides to require. If reporting all financial instruments at fair value in the basic financial statements were required, an extended transition period would be considered. There are a number of possible ways of easing transition that have been suggested, but the Board has not yet considered any of them. One suggestion was to require additional disclosures in notes to financial statements in the first year or two and presentation of a second set of fair-value-based financial statements for the next
year or two before requiring fair values in the basic financial statements. For a few years after
that, highlighting the effects of the change in the income statement might also be necessary or
desirable.

What Conforming Changes to Other Standards Will Be Needed?

202. The following list includes some of the authoritative pronouncements that probably would
be amended or superseded if the proposals in this Preliminary Views became part of a final
Statement. Before issuing an Exposure Draft, the Board will need to determine more
specifically how those pronouncements would be affected.

a. APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock
   Purchase Warrants
b. APB Opinion No. 21, Interest on Receivables and Payables
c. FASB Statement No. 5, Accounting for Contingencies
d. FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt
   Restructurings
e. FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
f. FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities
g. FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated
   with Originating or Acquiring Loans and Initial Direct Costs of Leases
h. FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for
   Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale
   of Investments
i. FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments
j. FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-
   Duration and Long-Duration Contracts
k. FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity
   Securities
l. FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance
   Enterprises and by Insurance Enterprises for Certain Long-Duration Participating
   Contracts
m. FASB Statement No. 125, Accounting for Transfers and Servicing of Financial
   Assets and Extinguishments of Liabilities
n. FASB Statement No. 126, Exemption from Certain Required Disclosures about
   Financial Instruments for Certain Nonpublic Entities
o. FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*.

(Appendix B describes the effect that this Preliminary Views would have on Statements 5 and 60.)