# American Accounting Association's Financial Accounting Standards Committee Response to FASB Exposure Draft, "Fair Value Measurements"

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Overview of the Exposure Draft

The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged 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 (hereafter, the ED) issued in June 2004. The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The ED proposes procedural guidance for measuring the majority of fair value estimates that are reported in the primary financial statements and in the notes to those statements. The ED also recommends expanded footnote disclosure related to the source of the inputs used to arrive at fair value estimates. These disclosures are intended to assist financial statement users in assessing the reliability of fair value estimates reported in the primary financial statements.

Two important factors contributed to the perceived need for the general fair value measurement guidance proposed in the ED. First, the current set of promulgated accounting standards includes no single source of generally applicable "Level A GAAP" guidance for defining or estimating the fair value measurement attribute. Instead, Level A measurement guidance is primarily contained in a cross-referenced patchwork of financial instruments related accounting standards (e.g., SFAS 107). The ED proposes a first step in establishing a single standard to guide all fair value estimates. Second, recent accounting standards reflect the increased acceptance of fair value as a reportable measurement attribute (as compared to, say, amortized cost). Given the high likelihood that future accounting standards will continue to rely on fair value, a single definition of the fair value measurement attribute — along with high-level procedural guidance for consistent estimation of that attribute — became increasingly important for efficient application of new and existing accounting standards.

The ED includes four significant components, along with corresponding implementation guidance: (1) defines fair value and the measurement objective, (2) identifies three levels of inputs that can be used in fair value estimates, (3) identifies three types of procedures that can be used to estimate fair value and (4) specifies the type of fair value related information that should be disclosed when fair values are reported in the primary financial statements.

The FASB has invited comment on all matters related to the ED, but has specifically requested comments on 14 listed issues. The Committee will limit its comments to those issues for which empirical research provides some insights and, more generally, to those sections of the ED that are either conceptually inconsistent or unclear. Therefore, our comments are limited to Issues 1, 4-7, 9, and 11.

The Committee has previously commented on other fair value and financial instruments related documents issued by the FASB and other standard setting bodies. To the extent that the comments expressed in those letters are germane to the measurement issues contained in the ED, we will reiterate those comments. However, to better understand our perspective with respect to reporting fair value information in the financial statements and related notes, we refer you to those comment letters (AAA FASC 1998, 2000).

The Committee supports the formulation of a single standard providing fair value measurement guidance. Given the fragmented fair value measurement guidance in existing standards, a single standard could plausibly increase the efficiency and consistency of measuring fair values across the many standards that require fair value reporting and disclosure. Further, disclosure of information that is potentially diagnostic about the relative reliability of specific financial statement information (e.g., via disclosure of fair value estimation techniques and inputs), should plausibly allow financial statement users to more efficiently and effectively incorporate that information into their judgments and decisions.

In the sections that follow, we provide comments and suggestions about the ED. Before addressing the specific issues listed on pages i through iv of the ED, we provide an overview of academic evidence that is potentially useful as the Board deliberates issues related to the reliability of fair value measurements.

# Implications of Research on the Reliability of Fair Values

A considerable body of research jointly examines the relevance and reliability of fair value estimates derived from various sources. The majority of these studies assess whether fair value disclosures for financial instruments are associated with share prices. These studies assume that if fair values of firms' net assets are relevant to investors and reliably measured, the amounts will be positively related to share prices. Loosely speaking, in terms of statistical analysis, this means that coefficients on assets (liabilities) will be positive (negative) when share price is regressed on fair value information and relevant control variables. These studies also assume that securities markets efficiently and correctly process all relevant information. Taken together, these assumptions specify a simple model for impounding fair value information into stock prices and a minimum

<sup>&</sup>lt;sup>1</sup> An important caveat to note with respect to this literature is that these estimates are not determined under a uniform definition of fair value that is consistent with the ED's definition. For ease of exposition, we use the term "fair value" to cover all such estimates discussed in this section.

level of competence that investors (as a group) must possess so that we can evaluate the model's predictions.

The evidence generally shows that fair values obtained from actively traded markets are more reliably associated with share prices than fair value estimates derived from thinly traded markets or internal estimation models. For example, research on banks and property-casualty insurers indicates that fair values of equity investments and U.S. Treasury securities are related to share prices, but fair values for investments with less readily available market prices (e.g., corporate and municipal bonds) are not (Barth 1994; Petroni and Wahlen 1995). One notable exception to these relative reliability findings is documented in Carroll et al. (2003). In particular, using a sample of closedend mutual funds, they find a strong statistical association between share prices and fair values for investment securities traded in thin markets. They attribute the difference in their results to the fact that the net assets of closed-end mutual funds consist entirely of financial instruments reported at fair value.

Existing research provides mixed evidence of a weaker relation with share prices for fair values of other financial assets and liabilities for which there is no established market. Specifically, Nelson (1996) reports that there is no systematic evidence that fair values of banks' net loans, deposits, long term debt, and off-balance sheet instruments disclosed under SFAS 107 are related to share prices. However, Eccher et al. (1996) suggest that fair values for loans and off-balance sheet financial instruments are significant in limited settings. Barth et al. (1996) find that loan fair values are reliably associated with share prices only when other loan related variables (such as the level of non-performing loans) are also included in the regression. Finally, Venkatachalam (1996) suggests that improved fair value disclosures for off-balance sheet instruments under SFAS 119 explain why he finds that fair values of derivatives are associated with share prices.

Although studies on U.S. firms are limited to fair values of financial instruments, there is some evidence on the reliability of fair values for non-financial assets for firms in the U.K. and Australia. Barth and Clinch (1998) examine fair values of investments, property, plant, and equipment (PPE), and intangible assets reported by Australian firms.<sup>2</sup> They find that the fair values of investments and intangible assets are positively associated with share value, but the fair value of PPE is significant only in limited settings. Evidence from the UK suggests that upward revaluations in PPE are associated with realized future operating performance, measured by operating income and cash from operations (Aboody et al. 1999). Dietrich et al. (2000) find that appraisers' start-of-the year fair value estimates understate actual selling prices whether property values are increasing or decreasing. In addition, fair value estimates are found to be less accurate when they deviate substantially from historical costs, suggesting that appraisers have

<sup>&</sup>lt;sup>2</sup> Australian GAAP permits firms to revalue noncurrent assets upward when the asset's recoverable amount exceeds its carrying amount, and requires firms to revalue noncurrent assets downward when the asset's recoverable amount falls below its carrying amount. Recoverable amounts can be calculated based on the present value or nominal value of net cash flows arising from the asset's use and disposal.

greater difficulty deriving estimates as property values increasingly diverge from historical cost.

Some studies also attempt to assess how the exercise of judgment by managers affects the reliability of fair value disclosures. Bernard et al. (1995) find little evidence that Danish banks, which are required to use market value accounting for regulatory purposes, manipulate reported fair values to avoid regulatory intervention. Similar to the U.S. banking sector, they find some evidence that managers delay reporting credit risks by gradually recognizing loan losses. Bernard et al. (1995) are also careful to note that the Danish system includes rigid regulatory oversight, which may contribute to the reliability of fair value estimates in this setting. Dietrich et al. (2000) find that mangers exercise discretion over annual PPE revaluations to smooth reported earnings and increase reported PPE fair values prior to issuing new debt. However, reliability increases when fair values are obtained from external appraisers and are audited by one of the larger international accounting firms. Similarly, Muller and Riedl (2002) find that market-makers set lower bid-ask spreads for firms using external appraisers. This evidence is consistent with Level 1 estimates (which are based on external market inputs) reducing information asymmetry to a greater extent than Level 3 estimates (which incorporate more entity inputs). In contrast to these two studies, Barth and Clinch (1998) find no difference in reliability between internal and external appraisals for Australian firms' revaluations.

Although not definitive, the evidence discussed above supports the FASB's emphasis on market inputs and disclosure of the extent to which fair value estimates rely on management judgment and discretion. In general, the U.S. based research evidence suggests that disclosed financial instruments fair value estimates include differing levels of reliability and that the variation in reliability is related to the extent to which fair value estimates include publicly observed markets-based information versus management-produced fair value estimates. The most consistent evidence of reliable fair values is found for investment securities traded in active markets. The evidence regarding the reliability of other fair value estimates is somewhat mixed, and suggests that reliable estimates could be limited to certain settings. While it is also important to consider the evidence from non-U.S. firms, differences in legal and business environments between the U.S. and other countries renders less clear the U.S. based standard setting implications.

We wish to highlight two limitations common to the research discussed above. First, the U.S. based research evidence is largely derived from analysis of companies for which financial instruments comprise *core* operating assets and liabilities (e.g., banks, insurance companies, closed-end mutual funds). Such firms may be fundamentally different than firms for which this is not the case, potentially calling into question the generalizability of the results to firms in general. For example, it is plausible that the users of the financial statements of financial institutions have a greater understanding of the extent to which reported and disclosed fair values are based on independently observed market prices versus internally generated estimates made by management. The origin (and corresponding reliability) of fair value estimates for the majority of

companies in the U.S. (i.e., non-financial firms) is likely less clear to investors. Evidence reported in Wong (2000) is consistent with this view. In that study, Wong reports that neither aggregated nor disaggregated SFAS No. 119 fair value disclosures for derivatives provides incremental risk exposure information for a sample of 145 Fortune 500 manufacturing firms. His lack of statistically significant results could be attributable to research design related factors (e.g., the effect size is so small as to be virtually undetectable) or could reflect the fact that the Level 3 fair value estimates that comprise the disclosures are insufficient and/or of indeterminate reliability. To the extent that these measures have indeterminate reliability, supplemental disclosures about the process that generates the fair value estimates could provide incremental information that helps investors. The Committee believes that it is plausible that explicit reporting of the process leading to the fair value estimates can be incrementally informative to users of financial statements.

Second, a statistically significant relationship between fair value information and share prices could arise because the information set used by investors is correlated with the fair value information disclosed in the financial statements. Accordingly, existing research does not address whether users rely on the fair value information disclosed in the financial statements per se, or obtain this information from other sources. <sup>3</sup> For example, banks provide significant loan and investment information through regulatory filings.

Overall, based on the research findings to date, the Committee supports establishing a single standard to guide the measurement of fair values, with the expectation that the reliability of fair value estimates based on non-market inputs will be a factor in determining whether a particular standard should require fair value recognition. Further, the Committee supports increased disclosure of reliability related information about the process used to estimate fair values. As we note in the "specific issues" section of this letter, we believe that the exposure draft should have gone a bit further in requiring reliability related information (e.g., disclosing sensitivity analysis and a breakdown of unrealized gains or losses based on how the related fair value amounts were determined).

## Specific Comments in Response to Issues in the ED

# Issues 1: Definition of Fair Value

The Committee believes that the ED includes some inconsistency between the definition and application of the fair value measurement attribute. The ED proposes a definition of fair value that is relatively independent of the entity-specific use (settlement) of the assets held (liabilities owed) by companies. In contrast, the proposed standard and related implementation guidance includes measurement that is, at times, directly determined by the entity-specific use of the asset (settlement of the liability) in question.

<sup>&</sup>lt;sup>3</sup> For further discussion of these issues, see Holthausen and Watts (2001) and Skinner (1996). Relatedly, Lys (1996) provides some evidence that disclosed fair value estimates for financial assets and liabilities deviate from investors' estimates of fair value.

Some of the inconsistency with respect to fair value measurement could be attributable to the attempt to apply general, high level fair value guidance to the idiosyncratic attributes of specific accounts and transactions. In some cases, the application to specific accounts and transactions requires deviation from an entity-independent notion of fair value to one that includes consideration of the specific type and use of assets held (and liabilities owed) by companies. For example, as we note in our discussion of Issue 6 (below), Example 3 in Appendix B, paragraph B7 (a) suggests that the fair value of a machine should include an adjustment of quoted market prices (based on comparable machines) for any installation costs. However, such an adjustment is dependant on the individual circumstances of the company that purchases the equipment. That is, such installation costs are included in the fair value of an asset only when the firm intends to use that asset for income producing activities. Otherwise, if the firm intends to sell the asset such installation costs are ignored.

Some members of the Committee, however, do not perceive an inconsistency between the definition and application of the fair value measurement attribute. These members interpret the definition of fair value proposed in the ED as agnostic regarding the valuation premise, and the valuation premise as the context within which the definition is applied. These members argue that ignoring the managerial intent for purchasing or keeping an asset would lead to unsatisfactory outcomes. For the same example described above, if we ignore all installation costs regardless of the intent of an entity's use of the asset, then a firm after having purchased the equipment and incurring installation costs would determine a fair value that is equal to the purchase price of the equipment. This would result in an immediate impairment loss on property, plant and equipment purchased for use in income producing activities.

The Committee is raising the example of machinery installation costs as an example of the confusion we experienced in trying to reconcile the high level (seemingly entity independent) definition of fair value with the contextually determined application standards. We note that Introduction of the ED suggests that that the intent of the proposed guidance in the ED is to establish fair value measures that would be referenced in other authoritative accounting pronouncements. Presumably, these other pronouncements would also establish reasonable deviations for the entity-independent notion of fair value. The Committee believes that the most effective general purpose fair value measurement standard would define and operationalize a general notion of fair value that is consistent between the definition, accounting standard and implementation guidance. To the extent that the Board generally believes that fair value is an entity-specific concept, the high level definition should reflect that, as well.

## Issues 4 and 5: Valuation Premise and Fair Value Hierarchy

Relatedly, some members of the Committee perceive a contradiction between the definition of fair value in paragraphs 4 and 5 of the ED and the valuation premise described in paragraph 13. The definition of fair value provided in paragraph 5 of the ED suggests a pure value-in-exchange perspective where fair value is determined by the market price that would occur between willing parties. In contrast, the valuation premise

described in paragraph 13 suggests that the fair value estimate can follow either a going-concern/value-in-use perspective or a value-in-exchange perspective.

Moreover, the fair value hierarchy described in the ED gives the highest priority to fair value measurements based on market inputs regardless of the valuation premise. Some members of the Committee feel that for a going-concern or in-use valuation premise quoted market prices need not necessarily be an appropriate measure of fair value. This is especially true when there is considerable divergence between the liquidation value for an asset and the going-concern value determined on a firm specific basis as the present value of future cash flows from that asset. In such instances, following the fair value hierarchy would lead more to value-in-exchange based fair values as opposed to being consistent with the valuation premise based fair values.

The Committee believes that: (a) integrating the two perspectives into the definition of fair value in paragraphs 4 and 5 and (b) elaborating on the differences between the two perspectives would significantly help the practical application of this standard.

# Issue 6: Reference Market

Some members of the Committee were confused by the guidance related to determining the appropriate reference market. With respect to the Level 1 reference market, the ED states that when multiple active markets exist the most advantageous market should be used. The most advantageous market is determined by comparing prices across multiple markets *net of any transactions costs*. However, the ED suggests that such transactions costs shall be ignored in determining the eventual fair value measurement. In our view, ignoring transactions costs is problematic because we believe such costs are an ordinary and predictable part of executing a transaction.

In Example 5 (paragraph B9(b)) where two markets, A and B, are considered, price in Market B (\$35) is more advantageous than the price in Market A (\$25) when transactions costs are ignored. However, the fair value estimate is determined using the price in Market A because the transactions cost in Market B (\$20) is much higher than that in Market A (\$5). The guidance is less clear if we modify this example by reducing the transaction cost for Market B to \$15. In this instance, neither market is advantageous in a "net" sense, but Market B is advantageous in terms of the fair value determination prior to transactions costs. This provides managers the opportunity to cherry pick a high or low unrealized gain (or loss) amount based on their reporting objectives.

This is in sharp contrast to Example 3 (Appendix B, paragraph B7 (a)) where, in determining the fair value of a machine, the valuer adjusts the quoted market prices, based on comparable machines, for any installation costs if an in-use valuation premise is deemed appropriate. Such installation costs are ignored only when the firm intends to sell the assets (Appendix B, paragraph B7 (b)). Thus, managerial intent plays an integral role in deciding the fair value of an asset. But, the ED is silent on the importance of managerial intent except in paragraph 13 where different valuation premises such as "in-

use" and "in-exchange" are considered. Moreover, while the requirement that transactions costs be ignored may be justified when an in-use valuation premise is appropriate, the acceptability of ignoring these costs is less clear when an in-exchange valuation premise is appropriate.

# Issue 7: Pricing in Active Dealer Markets

Some Committee members believe that the use of bid (ask) prices for assets (liabilities) is inconsistent with the general concept of fair value and seems to be biased toward valuing assets (liabilities) at liquidation value instead of a going-concern value. Limiting our discussion to the asset case, if a buyer establishes a long position through a dealer, then the buyer must pay the ask price. By purchasing the asset at the ask price, the buyer is taking the position that he/she expects to earn an acceptable rate of return on the investment in the asset (at the higher price). If, immediately after purchasing the asset, the buyer applies the ED's proposed fair value measurement guidance (i.e., bid-based valuation), the buyer would incur a loss on the asset equal to the bid-ask spread (ignoring transactions costs).

It seems that for any given dealer-traded asset, the bid price is only relevant if the holder of the asset position wishes to liquidate that position. While the Committee is not in favor of managerial intent-based fair value measures, we also are not comfortable with the bias toward a liquidation-basis (i.e., "in-exchange") valuation premise for assets held by a going concern (i.e., "in-use"). If the Board decides to retain in the final standard bid-based (ask-based) accounting for dealer traded assets (liabilities), then we propose that the final standard more clearly describe the conceptual basis for liquidation basis asset and liability valuation.

#### Issue 9: Level 3 Estimates

Level 3 estimates require considerable judgment both in terms of the selection and application of valuation techniques. As a result, it is likely that estimates using different valuation techniques with different assumptions will yield widely varying fair values. Examples 7 and 8 in Appendix B of the ED are illustrative of the wide variance in fair value estimates under different valuation techniques. The ED allows considerable latitude in both the valuation technique and the inputs used and consequently, the fair value estimates are likely to be biased and unreliable. Further, the measurement guidance proposed in the ED is similar to the unstructured and imprecise category of standards analyzed by Nelson, Elliott and Tarpley (2002). In that study, the authors find that these types of standards provide a backdrop against which managers are more likely to attempt (and auditors are less likely to question) earnings management.

From an application oriented perspective, the ED's conjecture that the two methods of expected PV should be equivalent (see paragraphs A12, A13 & FN 17) is normative and is not descriptive of empirically studied human judgment and decision

making.<sup>4</sup> In particular, psychology research repeatedly shows that people are very poor intuitive statisticians (e.g., people consistently make axiomatic violations when estimating probabilistic outcomes). In light of this, statements such as "the estimated fair values should be the same" provide preparers, auditors, and users with an unfounded (and descriptively false) belief that the process suggested in the ED will lead to consistent fair value estimates.

As a warning to preparers, auditors and users, some members of the Committee believe that the ED should explicitly state that individuals consistently make these errors. (i.e.,). Further, these Committee members recommend that the ED should require companies (when practicable) to (1) independently use Method 1 and Method 2 if they decide to use an expected PV technique and (2) reconcile the results of the two methods in a meaningful fashion and document that reconciliation so that it can be audited for reasonableness. The independent application of Methods 1 and 2 also should include independence from existing or suggested fair value target amounts when practicable (e.g., the fair value amount recorded in the previous year's financial statements). Psychology research also consistently finds that specifically suggested judgment and decision goals and legacy amounts have undue (and uncontrollable) influence on current judgments and decisions (e.g., through "anchoring" and insufficient adjustment).

While the disclosures required under paragraph 25 of the ED provide some information to the reader of financial statements regarding the potential reliability of a Level 3 estimate, it does not provide alternative benchmark models that the firm may have considered in determining those fair value estimates. Hence, the Committee also recommends that FASB consider requiring firms to disclose i) fair value estimates under alternative valuation techniques, and ii) sensitivity of fair values to assumptions/inputs used.

#### Issue 11: Fair Value Disclosures

As mentioned previously, the Committee believes that the proposed fair value measurement disclosures are not complete. The Committee believes that when a firm uses alternative valuation methods to determine fair values, sufficient information on both the measurement technique and the inputs used in determining fair value estimates should be provided. Furthermore, users of financial statements would get a better understanding of the reliability of fair value estimates if detailed disclosures are provided on i) fair value estimates from alternative valuation techniques and reasons for why one estimate is preferred over the other and ii) information about sensitivity in fair value estimates due to changes in assumptions and inputs.

The Committee also notes that the expanded set of reliability related disclosures is only required for fair value estimates reported in the balance sheet (paragraph 25). A complete set of financial statements also includes many fair value estimates that are

<sup>&</sup>lt;sup>4</sup> Probability-related judgments and decisions are among the oldest branches of psychology and decision-science research. Two excellent resources that catalog the problems that individuals have with probability judgments and statistical reasoning are Baron (2000) and Goldstein and Hogarth (1997).

reported in the notes to the financial statements. Some members of the Committee believe that financial statement users would benefit from receiving the reliability related disclosures for those disclosed fair values. Moreover, application of the fair value hierarchy has implications for the reliability of the unrealized gains and losses reported in net (or comprehensive) income. Accordingly, some members recommend that firms be required to disclose a breakdown of unrealized gains or losses based on how the related fair value amounts were determined (i.e. quoted prices of identical items, quoted prices of similar items, valuation models with significant market inputs or valuation models with significant entity inputs.)

Although the Committee recognizes that the ED is intended to provide fair value measurement guidance and that other authoritative pronouncements will establish the disclosure requirements for specific areas of accounting, we wish to caution against promulgating pronouncements that completely eliminate historical cost information from the financial statements. Evidence reported in Dietrich, et al. (2000) suggests that historical cost information is incrementally informative even after fair value information is included in regression analyses.

# **Summary and Conclusions**

The Committee supports the formulation of a single standard that provides guidance on fair value measurement. We believe that such a standard would improve consistency in fair value determination across the many standards that require fair value reporting and disclosure. In this comment letter we have: i) identified some potential inconsistencies between fair value definitions and fair value determination and ii) suggested ways to improve disclosures so that users of financial statements can better appreciate reliability of fair value estimates.

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