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CFA Centre's Response

IASB-FASB Questionnaire

Information about Changes in Fair Values of Financial Instruments

April 2006

Before answering the following questions, we believe that there are several questions that need to be asked to frame the information that should be provided in FV measurement disclosures for financial instruments. Some of the questions are:

- **What are the financial instruments held by the company?**
- **What the company is doing with these financial instruments – for what purpose do they hold these instruments?**
- **What are management's policies and procedures for using certain financial instruments?**
- **How extensively does the company use these instruments as part of its risk management?**
- **What are the inherent risks and the exposures to these risks?**
- **How effective, or ineffective, are the positions in these financial instruments as hedges in managing risk exposure of the company?**
- **What methods are used to estimate fair value when market values are not readily available?**
- **What key assumptions are used to calculate these fair values?**
- **How sensitive are these fair values to certain assumptions, such as changes in interest rates or foreign currency exchange rates?**
- **What are the effects on operating segments?**

Question 1: Current use of fair value information about financial instruments

(a) Which types of companies (or industries) do you analyze?

The CDPC comprises investment professionals evaluating and analyzing a broad group of publicly traded companies which cover numerous industries and sizes of companies – small to large cap.

(b) What *quantitative* information about fair values of financial instruments and changes in fair values of financial instruments do you currently use? How do you use that information, and where do you obtain it from?

Generally, quantitative information is obtained from note disclosures required by accounting standards, such as FAS 107, FAS 115, and FAS 133. Additionally, quantitative information is obtained from regulatory disclosures, e.g., SEC Item. 305 – Market Risk Disclosures, statutory reports for banks and insurance companies.

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Information is used to make adjustments to the financial statements to reflect the current value of the company and to make adjustments to this value as changes in market conditions arise. Additionally, this information is used to understand the risk factors (interest rate, foreign currency rates, commodity prices, etc.) that can affect future financial statements of the company and how any use of derivatives has changed those risk factors. Ultimately, we need to have sufficient information to make an independent assessment of a company's financial condition and future performance.

(c) What *qualitative* information about fair values of financial instruments and changes in fair values of financial instruments do you currently use? How do you use that information, and where do you obtain it from?

Again, information is generally obtained from the note disclosures and regulatory requirements for filing annual reports and MD&A. Refer to the response above to (b) for use of information.

(d) What other types of information or breakdown of information about financial instruments measured at fair value do you wish you had? How would you use that information?

Information currently provided in the notes to the financial statements and regulatory disclosures is not adequate for making appropriate adjustments to a company's financial statements – balance sheet and income statement – to properly reflect the fair value of financial items and the effect on the company's operations. Many of the questions noted above are not answered with the current disclosures. Some of the shortcomings include:

- **Information is too aggregated to fully understand the underlying risks and exposure to those risks. The line items on the financial statements combine financial instruments which have varying types of risks and exposure to these risks. For example, companies report a single amount for "trading securities" which comprises many types of financial instruments with different risks and exposures to these risks that are sensitive to changes in interest rates, credit worthiness, foreign currency rates, price of commodities, market liquidity, etc. We need to know the changes in the composition of the trading portfolio to fully understand the underlying risks and exposure to those risks.**
- **The financial statements – balance sheet, income statement and cash flows – do not provide the same level of disaggregation or alignment of items in order to connect the activity and transactions between these statements and the changes in balance sheet items from period to period. In other words, it is very difficult, if not impossible, to understand fully why or what caused the value of balance sheet items to increase or decrease between the reported periods.**
- **The changes in fair values are grouped within items on the income statement and it is not clear where these changes are buried, such as COGS, other operating revenues or expenses, non-operating items, etc. We would like to see fair value information displayed separately in the income statement.**
- **The explanations of companies' risk management policies and procedures are "boilerplate" disclosures and have little to no informational value. We would**

like to see a discussion and analysis by similar financial instruments not grouped by management's intent to hold the asset, such as trading securities, etc.

- **Information about foreign currency exposure is often minimal. We would like to see changes in foreign currency exposure, such as what percentage of revenue or cash flows in a given foreign currency, to better understand the exposure to that foreign currency and potential effects on the marginal tax rates.**
- **Quantitative information often reflects amounts "as of" the end of the period and is not reflective of what went on during the period. Companies often make changes [window dressing] at the end of the period to better reflect the financial condition. We would like to see weighted average quantitative data for the period.**

Information is used to make adjustments to the financial statements to reflect the current value of the company and to make adjustments to this value as changes in market conditions arise.

<u>Question 2: Understanding the reasons why fair values changed during a period</u>

You may find it helpful to read the short discussion of factors that can cause changes in fair values in the appendix to this request before answering these questions.

(a) In what circumstances is it important for you to understand why the fair values of financial instruments changed during a period? Are the nature of the company's activities and the significance of financial instruments to its balance sheet and income statement factors? What other circumstances or conditions affect the relative importance of understanding why fair values changed?

We determine a company's valuation based on fair value information. Therefore, we need to understand the cause and effect of changes in the value of financial instruments to formulate reasonable assumptions and make appropriate estimations of a company's future performance and adjustments to its valuation. The nature of the company's activities related to financial instruments and knowing their significance is very important to understanding the risks and exposure to these risks and how sensitive instruments' values are to changes in market conditions. Essentially, we need sufficient information to answer the 10 questions noted at the beginning of our survey response.

(b) Which factors that cause changes in fair values of financial instruments are most important for you to understand, and why?

In particular, we would like to have disclosures – quantitative and qualitative information – which answer the following questions (previously noted at the beginning of our survey response):

- **What methods are used to estimate fair value when market values are not readily available?**
- **What key assumptions are used to calculate these fair values?**
- **How sensitive are these fair values to certain assumptions, such as changes in interest rates or foreign currency exchange rates?**

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We would like to have a rollforward by portfolio of similar financial instruments starting with the beginning fair value balance, showing the changes between the beginning and ending fair value balance for the period reported as follows:

Beginning balance 200X

Cash flows:

- Interest income
- Interest expense
- Purchases
- New borrowings
- Redemptions/settlements
- Maturities

Change in a specified risk-free interest benchmark rate (does not include the change in credit quality)

Change in the effective duration [effective duration is the estimated percentage decline in the portfolio's fair value caused by a one-percentage point increase in interest rates.]

Change in the credit quality [historical default rate use for the change in credit quality]

Change in foreign currency rate(s)

Other (explain what comprises this amount)

Ending balance at 200X

A more detailed illustration of this format is provided in our response to Question 4(b).

(c) If you had more information about the reasons why the fair values of financial instruments changed in a period, how would you use that information?

Same as response to question 1(b). We would want to have more information about the causes and effects of changes in fair value in order to improve or better calibrate the adjustments to a company's financial condition and future performance.

(d) Currently, companies that hold loans and other types of receivables usually report them at historical cost with an allowance for *bad debts*. If those financial assets were measured at fair value, which would reflect changes in credit quality, would you still require the same type of information about write-offs or potential write-offs of bad debts and, if so, why? (An alternative that the Boards have discussed but found difficult to determine objectively would be an indication of the effect of changes in credit quality on fair value).

No. This response presumes that the rollforward information, as identified in our response to (b), is provided.

(e) As set out in the accompanying text, there are many difficulties in quantifying the effects of individual factors on the fair values of financial instruments. How would the fact that some of the assumptions used in producing such information would necessarily be arbitrary affect the usefulness to you of such information?

We acknowledge that the above factors (noted in the rollforward) are interactive with one another and therefore, the changes in fair values will not be linear in occurrence. Nonetheless, we would like to have a standard format for this information [as noted in the rollforward in item (b)] in order to provide consistency in the data over time and to minimize manipulation in calculating the fair value measurement.

Question 3: Reporting interest income and expense for financial instruments measured at fair value

You may find it helpful to read the short discussion of interest income and expense for financial instruments measured at fair value in the appendix to this request before answering these questions.

(a) How do you currently use interest income and interest expense on loans, securities, and other financial instruments?

To determine the interest spread or margin and to assess the profitability of the book of business and sensitivity, or movement of the spread, to changes in interest rates over time.

(b) Do you use the current market cost of debt securities issued or loans payable (and current market return on investments in debt securities or loan assets)? If so, how?

We use this information to make adjustments to the financial statements to reflect the current value of the company and to make adjustments to this value as changes in market conditions arise.

(c) Should interest expense (or income) be reported in the income statement? If so, should the measurement of it reflect the contractual cash flows, the anticipated actual cash flows, or the current market cost of debt securities issued or loans payable (or return on investments in debt securities or loan assets)? Why?

We believe that cash flows related to interest expense and interest income should be separately displayed in the statement of cash flows. This presentation of interest income and expense is consistent with our view that statement of cash flows should be prepared using the direct method. The change in effective interest rate (current yield) should be provided based on the weighted average fair value of individual portfolios of fixed income instruments that have similar risk characteristics.

(d) If interest expense (or income) should reflect the current market cost (or return), how would you calculate that cost (or return)? For example, you might consider using the year-end interest rate, an average rate for the year for an instrument with a similar term to maturity, the current short-term interest rate or an implied forward interest rate. Should the rate reflect the actual credit quality of the instrument, the original credit quality, or a risk-free cost of money?

We would like to see the change in interest income or expense disaggregated between the change in the bench mark rate and change in credit quality. Please refer to the rollforward noted in our response to Question 2(b).

Question 4: Understanding the exposure to future changes in fair values of financial instruments

(a) How do you currently assess exposure to changes in fair values of financial instruments? How do you use that information in your financial analyses?

We use sensitivity information when provided to make adjustments to the financial statements to reflect the current value of the company and to make adjustments to this value as changes in market conditions arise. Additionally, this information is used to understand the risk factors (interest rate, foreign currency rates, commodity prices, etc.) that can affect future financial statements of the company and how any use of derivatives has changed those risk factors. Ultimately, we need to have sufficient information to make an independent assessment of a company's financial condition and future performance.

(b) What types of information relating to exposures to future changes in fair values of financial instruments would be useful to you? What would be the most informative way to present such information? Please be as specific as possible about how such information should be prepared. How would you calculate and present any of the suggested information?

Generally, we believe that sensitivity analysis, or stress testing, of key assumptions (presented for each portfolio of similar instruments) are most useful in understanding the risks' potential effects to the value of the financial instruments and ultimately, to the financial performance and value of the company.

The following excerpt from the FAPC's comment letter dated 7 September 2004 to the FASB's Fair Value Measurement ED, provides specific disclosures for fair value measurement in addition to those noted in the ED –

EXCERPT

Fair Value Disclosures

Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

We believe that the disclosures could be enhanced significantly. These disclosures are critical to a user's understanding of the financial statements and of the effects of changes in fair values of assets and liabilities on the balance sheet and earnings. Besides the additional disclosure on interest rates [Issue 2], we believe three other disclosures would be helpful for users of financial statements. First, disclosures should be required that define and explain the models used for Level 3 valuations for each the various classes of assets to which they are applied. These estimates are likely to be idiosyncratic and highly subjective, relying extensively on entity inputs as compared to market inputs. Consequently, greater transparency is needed for such estimates.

Second, *changes* in fair values from period to period are highly informative in charting the progress of management in its responsibility to create new wealth for shareholders. Consequently, we would like to see more disclosures regarding the *changes* in fair value between periods. This should be in the form of an additional table similar to that shown in B22 of the Exposure Draft. We provide such a model below that we believe would be helpful to users of financial statements, and is similar to disclosures prepared by oil and gas companies under SFAS 69, *Disclosures about Oil and Gas Producing Activities*.

Asset	Fair Value Amount	Quoted Prices: Identical Items	Quoted Prices: Similar Items	Valuation Models: Significant Market Inputs	Valuation Models: Significant Entity Inputs
Value at 12/31/X5	335	255	25	40	15
Changes in valuation due to prices	40	(20)	5	25	4
Changes in valuation due to volumes or additional contracts	6	10	4	2	1
Changes in valuation due to factors other than prices, volumes, transfers between categories, and accretion of discount	(10)	4	6	7	6
Changes in valuation due to transfers between categories					
Accretion of discount	5	3	1	1	1
Realized gains/(losses)	3	2	6	(27)	(5)
Value at 12/31/X6	379	254	47	48	22

Any changes between categories such as Fair Value Amounts to Valuation Models: Significant Market Inputs should be thoroughly explained. We believe that the disclosure above provides the best method to compare the valuation of the business between periods as well as to compare entities. We also believe it provides users with the ability to judge management's performance in its stewardship of entity assets and liabilities as opposed to market driven factors.

Finally, we believe that the last sentence in B22 should be changed to state that a similar table *should* be presented for liabilities.

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<u>Question 5: Relative importance of different types of information</u>

What are your views on the relative importance of the different types of information that you suggest should be required?

For more than a decade, we have been expressing the need for fair value information about financial instruments, in particular, the measurement and recognition of derivatives and related disclosures explaining the types of financial instruments held by a company. Putting items into the financial statements (balance sheet and income statement), which can and do have a material impact on a company's both present and future financial condition and performance, is paramount. This is especially the case for financial services firms and other firms which hold significant positions in financial instruments.

More recently in membership surveys conducted in 2000 and 2003, more than two-thirds of the respondents highlighted a need for better information about financial instruments. They indicated that information about derivatives and hedging activities is very to extremely important in their evaluation and analysis of a company's performance and financial condition; while more than 70% considered the quality of this information to be average to poor. Information about risks factors and sensitivity of key assumptions were ranked similarly by respondents. Additionally, respondents to the 2003 survey placed a greater importance on fair value information over historical cost information for assets and liabilities. (A similar question was not asked on the 2000 survey.)

The IASB and FASB records contain several letters on this topic from CFA Institute. Some of these letters include:

- IASB **ED 7, *Financial Instruments: Disclosures*** - ED 7 Finl Inst Disclosures
- FASB **ED**, ***Fair Value Measurements (dated 7 September 2004)***
- IASB **ED**, ***Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement ─ The Fair Value Option* -** IAS 39 - FV Recog and Msrmt 04
- IASB ED5, *Insurance Contracts* - <u>*GFRAC ED 5 - Insurance Contracts*</u>
- JWG Draft Standard and Basic Conclusions, *Financial Instruments and Similar Items* - JWG - Finl Instr 02