CFA INSTITUTE | Centre for Financial Market Integrity

31 October 2006

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

RE: Fair Value Accounting

Dear Bob,

Given the extensive discussion of fair value accounting at our meeting with the board on October 17th, we thought it would be useful to summarize our views formally.

As the Board is aware, we are strong proponents of fair value measurement[1] for the following reasons:

1. Fair value is the most relevant measure of assets and liabilities. Historic costs are relevant only to the tax consequences of the sale of assets and the liquidation of liabilities.
2. We believe that corporate managers make decisions based on fair value rather than historic cost. If financial statement users are to make informed resource allocation decisions, they must have the same information.
3. The current mixed attribute model produces financial statements that are hard to interpret as some assets and liabilities are stated at market values and others at cost. Hedge accounting muddies the waters further due to its complexity, lack of transparency, and focus on management intent.
4. Our view of stewardship is that managers must be judged on their ability to earn a reasonable return on the fair value of net assets. Otherwise shareholders would be better served by managers' returning those assets so that shareholders can utilize their resources more productively.

We have supported the Board's efforts over the years to increase the use of fair values in financial reporting. We have recognized the measurement difficulties and supported the Board's decisions to take a step-by-step approach. Despite our general aversion to the provision of alternative choice (options) in financial reporting, we gave our conditional support for the Fair Value Option for financial instruments in the expectation that such a step would serve as a near term bridge to the mandating of fair value reporting in the financial statements for all financial instruments. We would not have supported this proposal if we thought that the option would remain in place for any length of time or would be implemented as an instrument by instrument, contract by contract election.

---

[1] A detailed exposition of our views on fair value can be found in our draft Business Reporting Model, which has been shared with the Board and staff.

However, we have been disappointed at the slow pace of progress in this area. As we stated on October 17th, we believe that the Board should take the following steps:

1. Place a project on the agenda to require that those financial instruments currently reported at fair value in footnotes as required by Statement 107 be reported at fair value in the financial statements with changes in fair value reported in earnings.

2. Set a near term target date for completing the project, e.g., 1 year.

3. Develop a roadmap with target dates for resolving remaining issues such as fair value reporting of equity method investments, warranties and similar obligations, and all other instruments currently excluded from FAS 107 for which projects are not already in progress, e.g., leases.

The argument for step 1 is simply stated. The FAS 107 disclosures have been required since 1992. Preparers and auditors have extensive experience with these data and there should be little or no cost incurred to report these financial instruments in the financial statements at fair value instead of historical cost or amortized cost.[2]

Given the well-defined scope of such a project, the Board should be able to issue an exposure draft in a short time period and a final statement within one year.

Step 3 is admittedly more complex. However we believe that it is long overdue. The application of fair value to financial instruments is, in our view, less difficult than its application to tangible and intangible productive assets.[3] We believe that the obvious next step is to require fair value for all financial instruments.

The use of fair values for all financial instruments would have the following benefits:

a. Enabling financial statement users to see the relationship between financial assets and liabilities and how their fair values reflect changes in interest rates and other attributes over time.
b. Ending hedge accounting for financial instruments, eliminating the complexity, arbitrariness, and lack of transparency that now exists.

The Board has issued Statement 157, providing explicit guidance to issuers on how to implement fair value measurement for all assets and liabilities for which standards require or permit fair value

[2] There is a long history of disclosures moving into the financial statements (stock options and employee benefits are the most recent examples).

[3] We note, however, that preparers and auditors have long experience in measuring the tangible and intangible non-financial assets and liabilities assumed in acquisitions at fair value; the end of pooling resulted in the measurement of all acquisitions at fair value.

reporting. Along with Concept Statement 7, FAS 157 provides support for a rapid expansion of fair value reporting. Some financial instruments (e.g. warranties) could be easily moved to fair value measurement. Others (insurance liabilities) will require more effort.[4] Leases are another difficult area due to the complexity of current GAAP.[5]

Given the standards now in place, it should not be difficult for the Board to define the projects needed to implement fair value for all financial instruments, and to plan the resource allocation required. We believe that a step-by-step approach would be feasible whereby groups of instruments not currently at fair value would move to fair value disclosure in the notes and then to fair value measurement in the financial statements. This approach would ease the transition for preparers and auditors.

We understand that convergence with IASB standards is a high priority for the Board. While we support convergence, we oppose convergence to standards that do not serve shareholder needs. The adoption of standards that improve financial reporting should remain the Board's highest priority.

In closing, we appreciated the opportunity to present our views to the Board in person. As always, we would be happy to provide additional input on any issue before the Board. For further information, please contact Georgene Palacky (georgene.palacky@cfainstitute.org; 434.951.5326).

Sincerely,

/s/ Gerald I. White

Gerald I. White, CFA,
Acting Chair, CDPC
CFA Centre

/s/ Rebecca T. McEnally

Rebecca T. McEnally, CFA, PhD
Director, Capital Market Policy
CFA Centre

Our comments have benefited from, and are supported by, the substantive input of the Corporate Disclosure Policy Council. The members of the Council are:

Gerald I. White, CFA, Acting Chair
Grace & White, Inc.

Jane B. Adams, CPA
Maverick Capital Ltd.

Barry L. Ehrlich, CFA
MCT Asset Management

[4] The mixed attribute model particularly distorts insurance company financial statements and we urge the Board to deal with insurance accounting as quickly as possible.

[5] We have long urged the Board to cut through this complexity by requiring the capitalization of all leases and similar liabilities (e.g. take-or-pay obligations). If that were done the measurement issues would be relatively easy to resolve.

Centre for Financial Market Integrity

Anthony Good, ASIP
Equity Research Consultant

Robert F. Morgan, CFA
Forbes Morgan Consulting

David E. Runkle, CFA
Value Creation Advisors, LLC
Research

Toshihiko Saito, CFA
Capital International

Ted Stevens, CFA
Blackrock Inc.

Cc: Corporate Disclosure Policy Council
Raymond DeAngelo, Managing Director, Member and Society Division, CFA Institute
Kurt N. Schacht, JD, CFA, Executive Director, CFA Centre