Setting the global standard for investment professionals

CFA Institute
Consideration of the Arguments Against Fair Value as the Measurement Basis for Financial Instruments
September 2010

The document is a supplement to the CFA Institute Comment Letter (the "Comment Letter") to the Financial Accounting Standards Board ("FASB" or the "Board") Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Proposed Update" or "Update") dated September 30, 2010 and presents CFA Institute's perspectives to arguments against fair value as the measurement basis for financial instruments.

Many of the arguments against the Proposed Update are the same as those utilized to oppose fair value disclosures, fair valuing debt and equity securities and fair valuing derivative instruments. Below we consider several of the most significant arguments against fair value as the measurement basis for financial instruments:

Fair Value Measures Are Not Relevant or Reliable
In our Comment Letter supplement Fair Value as the Measurement Basis for Financial Instruments ("Basis Supplement") on our website, we consider the arguments against fair value measurement for financial instruments based upon the notion that they are neither relevant nor reliable including a discussion of the relevancy of financial liabilities specifically.

Overall, those arguing against fair value appear to be indicating that the fair value measures which this Proposed Update would extend to are not relevant, yet, as we describe in the aforementioned Basis Supplement, we find substantial evidence that fair value measures are more relevant than amortized cost measures which generally have no relation to current values and result in a lack of comparability between firms. Fair values, on the other hand, represent economic reality and the values at which transactions actually take place. In the aforementioned supplement we have demonstrated how fair values are more decision-useful in investment decision-making and we provide evidence through academic studies, surveys of analysts and market prices relative to book value demonstrate that fair values are relevant to investors and that investors adjust their analysis to incorporate fair values and that share prices consider them. Our conclusion is that such highly relevant measures should not be provided at a lag to the earnings release in the footnotes on a basis inconsistent with other fair value measures.

As discussed more fully in the Basis Supplement our view is that even though historical cost measures are verifiable by comparing to source documentation that such verifiability does not make them reliable as they are not representationally faithful of current asset and liability values. The current financial crisis demonstrated: a) the lack of reliability of existing historical cost measures adjusted for impairments on an incurred loss basis, and b) that share prices were adjusted downward to account for the lack of reliability of book value measures. Our position is that existing estimation techniques exhibit reliability issues which opponents to fair value claim make fair value measures unreliable (e.g. the historical cost estimates also are Level 3 estimates). Fair value measures, however, are subject to a more consistent definition and elements of market discipline to observable inputs. We find that academic studies have demonstrated that fair values are relevant because they are reasonably and sufficiently reliable to be incorporated into share prices and that management can affect the reliability of fair value measurements through effective disclosures, strong internal controls and effective corporate governance. As a part of our consideration of reliability issues, we also evaluate the fair value measurement opponents' position that they can develop highly reliable expected credit loss techniques but cannot reliably incorporate observable interest rate movements and liquidity discounts. We also find that there are numerous illustrations where fair value measurements – for identical financial instruments to which fair value would be extended on a routine basis by this Proposed Update – are already incorporated into the basic financial statements and believe users should question opponents' claims that such fair value measures cannot be determine reliably as this assertion suggests that the reliability of their financial statements could be problematic.

We believe the exception provided in Topic 820 which allows loans to be "fair valued" on a basis other than fair value as defined under SFAS 157 (i.e. exit value) has complicated the advancement of this Proposed Update for certain investors because the impact of the movement from amortized cost to fair value is not perfectly transparent to them and their existing concern over the poor quality of disclosures translates to the use of fair value measurements for recognition purposes. However, we believe the recognition of such measurements in the basic financial statements will be a catalyst to improving the quality of these measurements.

Overall, we believe the issue before accounting standard setters is one of relative improvement in estimates, information quality, transparency and decision-usefulness in their decision to move toward fair value for financial instruments. The issue isn't one of perfect reliability or verifiability. Our view is that fair value can improve information quality, transparency and decision-usefulness.

Misinformation Regarding Provisions of the Proposed Update

There has been significant dissemination of disinformation about the Proposed Update. Much of this disinformation focuses the media and investors solely on the fair valuing of loans rather than considering all aspects of the Proposed Update and recognizing that the FASB has arrived at a reasonable compromise between those who prefer amortized cost reporting and those who prefer fair value. This distraction is also keeping investors who still seek an amortized cost approach (net interest margin focus) from moving beyond the recognition and measurement provisions of the Update to the credit impairment and interest income provisions – which will, in fact, change the net interest margin – even if the recognition and measurement provisions were abandoned. (We found few analyst reports, possibly just one, which included a comprehensive discussion of the interest income provisions of the Proposed Update and their impact on interest income.) Below we consider various misconceptions and/or misunderstandings which interfere with a complete understanding of the Update's impacts on the financial statements.

1) Loans Will Be Fair Valued Through Net Income – Some are connecting the Proposed Update with the FASB's project on Other Comprehensive Income (OCI) with what would appear to be the intent of conveying that: the fair value adjustments are through "income," the definition of other comprehensive income is changing; or that OCI is a "new category." The OCI project is simply a change in presentation of information already located in the equity statement or in the notes to the financial statements. Further, loans held for contractual cash flows have their fair value differences reflected in accumulated other comprehensive income with changes in the difference between amortized cost and fair value reflect in other comprehensive income – in the same manner that available-for-sale securities are treated today.

   The following excerpt from a comment letter[1] highlights this misunderstanding of comprehensive income:

   > ***Fair value accounting changes the concept of "comprehensive income" within FASB's Conceptual Framework.***
   >
   > *Within the Accounting Standards Codification,* ***"comprehensive income" and "other comprehensive income" have historically been understood in relation to an entity's ability to generate favorable cash flows****. That is why the fair values of loans held for investment and held-to-maturity securities (not subject to other than temporary impairment) are excluded from comprehensive income. Such fair values are not relevant to the generation of future cash flows.* ***To now include changes in these fair values within a statement of comprehensive income is to change one of the main objectives of financial reporting: relevance.*** *Relevance is further corrupted by the related FASB exposure draft that would require one statement of comprehensive income that presents net income as a subtotal and practically redefines "the bottom line", which will reflect all fair value changes.* ***Bankers believe that the objective of the performance statement is to reflect how effectively management executes its business model. The current proposals complicate that objective.*** *While we acknowledge that fair values may provide information useful to some, we disagree that such information is relevant to an institution's performance when the institution manages such assets and liabilities for the collection of specific cash flows unrelated to their market values.*
   >
   > ***Such a change to the concept of relevance requires extensive and comprehensive deliberation on the Conceptual Framework****, not only as it affects banks, but entities in all industries. With this in mind, we urge FASB to reject any change to the options provided for presentation of the current performance statement and, prior to issuance, complete its review of the Conceptual Framework.*

   This quote mistakenly notes that fair value accounting changes the concept of comprehensive income in the FASB's Conceptual Framework. It does not. As we have noted since the inception of the use of other comprehensive income, there is no conceptual justification for, or definition of, other comprehensive income. Further, the remarks would imply that the inclusion of fair value adjustments changes the conceptual definition of other comprehensive income as if to imply that fair value adjustments have never been reported in other comprehensive income heretofore. Fair value changes for available-for-sale securities, pension assets and derivatives used in cash flows hedges have been included in other comprehensive income and comprehensive income for upwards of a decade. Still further, the notion that relevance as defined in the FASB's Conceptual Framework is being corrupted or altered by the inclusion

[1] ABA Comment Letter (1 of 3) to FASB on Proposed Update; Comment Letter #229; Donna J. Fisher; ABA; August 31, 2010; pg. 9.

of additional fair value changes because it violates the objective of relevance is unclear. If this were the case, relevance was corrupted previously by the inclusion of any items in other comprehensive income which would imply that all such fair value changes belong in net income. The quote also notes that comprehensive income and other comprehensive income have been "*understood in relation to an entity's ability to generate favorable cash flows."* Neither comprehensive income nor other comprehensive income have any connection with cash flow generating ability – they are income not cash flow measures. In fact, the advent of other comprehensive income can be seen as a compromise to reflect longer term changes in value, which may not directly or immediately result in cash flows but which are value relevant, in equity. Finally, the notion that a change in location of the presentation of OCI will alter a reflection of the bank's business model is inaccurate as net income remains unchanged by the presentation change and the elements of net interest margin which are included in net income are maintained for items held for receipt of contractual cash flows. If a bank classifies loans as held for contractual cash flows under the Proposed Update, the fair valuing of these loans through accumulated other comprehensive income will not alter the elements of net income which investors currently utilize in their analysis of a bank's performance.

Misunderstandings regarding OCI are evident in certain of the comment letters as follows:

> *"To now be required to arbitrarily calculate the fair value of individual loans and then mark any differences from book value to the* ***new* Other Comprehensive Income Account** *could be detrimental to our bank's capital account.........Again, any differences in amortized cost and the new fair value basis is to be recorded directly to the* ***new* Other Comprehensive Income account**.[2]

As evidenced by another comment letter, some investors don't understand that the Proposed Update allows fair value adjustments to be included in OCI, not net income, and will not impact Tier One Capital:

> *"**In my view, the only reasonable solution to this issue is to reflect fair value adjustments in Other Comprehensive Income**. Because OCI is not a component of bank regulatory capital, **this treatment would mitigate the impact market volatility can have on bank earnings, capital ratios and credit availability**."*[3]

2) *Net Interest Margin Will Disappear* – There appears to be a misconception that the fair valuing of loans will result in the loss of net interest margin. Some analysts/investors calling for the retention of the existing model don't seem to realize that if loans are classified as held for receipt of contractual cash flows, that net interest margin will be retained through the recycling provisions in the Proposed Update. Those who are interested in net interest margin should be most focused on is the credit impairment and interest income provisions of Proposed Update. The computation of interest income will change with the inclusion of the allowance account, yet this is rarely discussed with analysts/investors by those against the Proposed Update. The quotes above illustrate this point and the quote of one analyst highlights the misconceptions on this point.

> *"The release of the exposure draft seemed to cause quite a stir in the financial and banking community. A number of interested parties have voiced their opinions about why the proposal is good or bad and why it must be adopted or revised/trashed. **In our view, many of the responses appear to be one-sided arguments or unintentional mischaracterizations of the proposal. We have seen FASB's proposed changes categorized as a "full mark-to-market" of the balance sheet, or leading to a "fair value" net interest margin (FV NIM). Although the proposal is subject to interpretation, we do not see "full mark-to-market" or "FV NIM" as completely accurate portrayals or principal outcomes."***[4]

---

2 Example of Comment Letter Indicating Misunderstanding of Proposed Update's Ability to Use Other Comprehensive Income for Loans and Securities Held for Contractual Cash Flows: Anthony R. Davis, CFA; Comment Letter #136; July 6, 2010.

3 Example of Comment Letter Indicating Misunderstanding of Other Comprehensive Income: Lee Ellen Hogan Comment Letter to FASB on Proposed Update; Comment Letter #198; August 19, 2010.

4 Frederick, Cannon; Keefe, Bruyette & Woods; *Accounting for Financial Instruments: FASB Proposes a New World for Accounting;* July 27, 2010.

3) *Bank Capital Will Be Adversely Impacted by Fair Valuing Loans* – There is misinformation regarding the Proposed Update and its impact on bank regulatory capital. Some indicate the Proposed Update would result in the "mark-to-market" of loans which would be a charged to bank capital, potentially destroying capital, capital ratios and resulting in further systemic risk. However, Tier One capital computations for banks currently exclude the unrealized gains or losses on debt securities and will likely do the same for loans held for contractual cash flows fair valued through other comprehensive income. Further, regulators have different means of obtaining information as well as measuring and monitoring banks – which investors do not – and U.S. GAAP should not be driven by the regulatory needs of one industry. Bank regulators can adjust their definitions of bank capital to mitigate this perceived risk. As evidenced by the same quote above, this point is not clear to investors:

   > *"In my view, the only reasonable solution to this issue is to* ***reflect fair value adjustments in Other Comprehensive Income****. Because OCI is not a component of bank regulatory capital,* ***this treatment would mitigate the impact market volatility can have on bank earnings, capital ratios and credit availability****."*[5]

4) *Fair Value Accounting Is Mark-to-Market Accounting* – As we previously noted in our consideration of reliability issues associated with fair value measurements, we have found that greater understanding is needed with respect to how fair value measurements are determined – particularly where market prices do not exist and where inputs are unobservable. Through review of comment letters and discussion with investors we have found the colloquial use of the term "mark-to-market" has resulted in a misconception regarding how fair value measurements are determined where market prices may not exist. We have found that investors do not have a deep understanding or appreciation of the fair value measurements concepts (e.g. observable vs. unobservable inputs) in Topic 820 (SFAS 157).[6]

Despite the considerable efforts of the FASB staff to communicate the provisions of the Update, the comment letters posted on the FASB website highlight these and other misconceptions regarding the Proposed Update. We believe the FASB should review the comment letters received, and as one of their redeliberation objectives, ascertain whether there is an appropriate level of understanding regarding all key aspects of Proposed Update.

Our review of the letters to the FASB suggests there are many commentators on the single issue of fair valuing loans and that many such commentators do not have an appreciation of the fair value measurements concepts nor do they express views, or alternative approaches, on how credit impairments or interest income should be measured. The measurement of credit impairment and interest income under the Proposed Update should be of interest to those who advocate retaining a mixed measurement model.

We believe the FASB should undertake a broader educational campaign to clarify these misunderstandings and misconceptions regarding the Proposed Update and to seek input from a broader constituency on all aspects of the Proposed Update.

---

[5] Ibid 2.

[6] FASB Topic 820, *Fair Value Measurements and Disclosures*, formerly Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements,* defines fair value as an exit price and establishes a fair value hierarchy where fair value measurements are classified by the observability of their inputs. Level 1 measurements are based upon inputs which are quoted prices in active markets. Level 2 measurements are based upon inputs other than quoted prices within Level 1 but that are observable either directly or indirectly. Level 3 measurements are based upon inputs which are unobservable.

Mixed Measurement Model (Management Intent & Business Model Matters) & Volatility (Created, Unnecessary & Irrelevant)

Why Some Support A Mixed Measurement Model

Some do not support the FASB's Proposed Update because they believe a mixed attribute model is a better measurement approach. They arrive at this conclusion through the following beliefs:

1) *Management Intent and Business Model Matters* – Management intent and business model should impact the reported value of a financial instrument. Specifically, supporters of a mixed measurement model indicate:
   a. It provides flexibility to measure and report financial instruments in a manner that best reflects management's intent and the business reason for holding the instrument.
   b. Management's business purpose for holding the instrument is an important consideration in evaluating the results of a company.
   c. Fair value does not reflect the primary business purpose for holding them which is contractual cash flows and, as such, should be presented at amortized cost.
2) *Volatility Created by a Fair Value Model is Unnecessary & Irrelevant* – Supporters of a mixed measurement model believe fair value fluctuations are irrelevant when an enterprise intends to hold a financial instrument to maturity. Specifically they indicate:
   a. Longer lived instruments that will be held for the long-term should not reflect the effects of short-term market movements.
   b. The positive and negative impacts of short-term market movements can inappropriately create unpredictable results from holding those instruments.
   c. Instruments that are to be sold in the near term (e.g. trading assets) or complex instruments where the cash flows cannot be reliably predicted should be reported at fair value through net income.

Why CFA Institute Does Not Support A Mixed Measurement Model

We do not support the mixed measurement approach where some financial instruments are at fair value and some are at amortized cost because:

1) *Fair Value is the Relevant Measure* – Fair value is the most relevant measure when making a capital allocation decision. We have demonstrated amortized cost has limited relevance to decision-making.
2) *Management Intent Does Not Alter the Value of a Financial Instrument* – We do not support the management intent classification notion which underlies the premise of those who support a mixed measurement model because we do not believe that management intent alters the value of a financial instrument. A financial instrument's "value" is not different because one financial institution expects to hold it and another expects to sell it before maturity. Such reporting flexibility creates differences in appearance but not actual valuation. Further, intent can change over time or with management change and this should not alter the valuation of the instrument. An investor who is attempting to determine whether to buy a particular financial institution's securities should not be willing to pay a different price because of different measurements of an identical basket of securities held by the institution who intends to hold the basket to maturity and another which intends to hold the basket for sale;
3) *Lack of Consistency* – Utilizing different measurement methods creates a lack of consistency and confusion in measurement across the reporting entity and a lack of comparability between reporting entities. It promotes a difference in measurement for the exact same instrument across two different enterprises, which cannot provide investors with useful information; and
4) *Economic Mismatches Are Not Evident* – Economic mismatches are hidden by the reporting of assets at fair value and liabilities at amortized cost. Fair value highlights these mismatches by reporting the changing value of assets and liabilities.

Lack of Conceptual Justification & Illustration of Why Management Intent Matters

In our review of the Basis of Conclusions to the Proposed Update, we do not see a conceptual justification for the alternative view which would retain a mixed measurement model. The basis for the alternative view seems to be a repetition of the conclusion rather than a logical explanation or conceptual basis for the superiority of a mixed measurement approach. Further, while this "belief" is stated or asserted in comment letters as a reason not to support the Proposed Update, there is no illustration or empirical evidence cited to support that intent-based accounting alters the value of a financial instrument to an investor. If the FASB considers the alternative view, there should be an articulate and coherent argument as to why the business model impacts the reported value of a financial instrument and how amortized cost results in better investment decisions.

As we stated in our Comment Letter, we believe that despite the use of a mixed measurement type approach in this Proposed Update that the FASB's proposal is a reasonable middle-ground. Those who prefer amortized cost and net interest margin for certain financial instruments held for receipt or payment of contract cash payments will receive this information. Those who prefer fair value will see it in the basic financial statements, but through equity (other comprehensive income) not net income. The FASB's Proposed Update is a reasonable compromise to accommodate the different information needs of users. Further, we support a dual presentation of amortized cost and fair value as we believe both have information content, we just believe that fair value is the most relevant for investment decision-making.

Volatility is Not Unnecessary or Irrelevant Because It is a Reflection of Economic Reality & Valuation Changes Are Important to Investors

Connected to the argument against the use of a fair value measurement model and toward a mixed measurement attribute model is the notion that volatility reported by a fair value measurement model is unnecessary and irrelevant to financial reporting. (i.e. Just to be clear, the volatility for those items which will be classified as being held for receipt of contractual cash flows – many, if not most, loans – would be in equity (other comprehensive income) not net income.) The financial statement volatility is relevant if an investor's holding period is not the same as the enterprise's entry and exit times and prices. Management/enterprise intent and enterprise holding periods and investor intent and holding periods are rarely the same. Accordingly, there is always a need to know the current value to make efficient capital/investment allocation decisions regardless of whether the financial instrument is held-for-sale or held for receipt of contractual cash flows (held-for-investment). Fair valuing the financial instrument enables an investor to ascertain whether the assets of the enterprise are providing market returns and what price they should pay for the securities of the enterprise. Because a loan may be held-to-maturity and its value converge to its original notional value (i.e. not necessarily either historical or amortized cost) does not mean that the volatility is irrelevant. While there may be short-term fluctuations and volatility within the financial statements, the presentation of fair value along with amortized cost will provide those who are interested in the current value of the assets and liabilities with greater information on the price they want to pay. While the movements may not be crystallized by the enterprise, they are relevant to the investor, as they will be crystallized by the investor who has a different holding period.

In our review of the research related to risk relevance of fair value measures we noted that Hodder et al. (2006)[7] conducted research on the risk relevance and explanatory power of net income, comprehensive income and their constructed measure of full-fair-value income for a sample of 202 commercial banks from 1996 to 2004. They researched three questions regarding these income measures including the volatility of each of these measures, the extent to which the income measures were associated with market-based risk measurements, and the ability of these income measures to moderate capitalization of

[7] Hodder, Leslie D., Hopkins, Patrick E., Wahlen, James M.; *Risk Relevance of Fair Value Income Measures for Commercial Banks;* The Accounting Review; 2006.

earnings in bank share prices and explain capital-market pricing of bank risk. An overview of their findings is as follows:

> *"We investigate the risk relevance of the standard deviation of three performance measures: net income, comprehensive income, and a constructed measure of full-fair-value income for a sample of 202 U.S. commercial banks from 1996 to 2004. We find that, for the average sample bank, the volatility of full-fair-value income is more than three times that of comprehensive income and more than five times that of net income.* ***We find that the incremental volatility in full-fair-value income (beyond the volatility of net income and comprehensive income) is positively related to market model beta, the standard deviation in stock returns, and long-term interest-rate beta.*** *Further, we predict and find that the incremental volatility in full-fair-value income (1) negatively moderates the relation between abnormal earnings and banks' share prices and (2) positively affects the expected return implicit in bank share prices.* ***Our findings suggest full-fair-value income volatility reflects elements of risk that are not captured by volatility in net income or comprehensive income, and relates more closely to capital-market pricing of that risk than either net-income volatility or comprehensive income volatility****."*

A more detailed consideration of their findings is as follows:

> *"Taken together, our results suggest that the majority of our sample banks are not fully hedged against year-to-year changes in fair values of their reported financial instruments, and that volatility in net income and comprehensive income provide an incomplete picture of their fair-value-risk exposure.* ***The results show that, for our sample of banks during our study period, the volatility of incremental FFV income captures elements of bank risk that the capital markets price, but that the volatilities of net income and incremental comprehensive income omit. We believe these findings are relevant for U.S. and international accounting standard setters as they consider whether to develop standards that would recognize in income fair-value changes for all financial instruments.*** *[(1)] These findings are also useful to capital-market participants and researchers interested in explaining the relations among banks' accounting numbers, share prices, and risk. The findings in this paper are also useful for bank regulators as they evaluate the role of fair-value measurement in monitoring bank capital adequacy. Academic research has established the risk-relevance of net income volatility (e.g., Beaver et al. 1970), the value-relevance of fair values for a subset of financial instruments (e.g., Barth 1994), and the risk-relevance of market risk-related disclosures (e.g., Schrand 1997). We extend these three lines of research by demonstrating the risk-relevance of FFV-income volatility. "*

(1) We cannot generalize these finding to settings in which full fair-value income measurement is mandatory and bank managers face explicit contracting and regulatory constraints that depend on full fair-value income numbers. We do not purport that these results demonstrate the desirability of full fair-value accounting. Our evidence on the risk-relevance of full fair-value income volatility is only one of many facets of full fair-value accounting that standard setters might weigh in their deliberations. For a more complete debate and critique of the strengths and limitations of drawing inferences for accounting standard setters from capital-markets-based accounting research, see Holthausen and Watts (2001) and Barth et al. (2001).

In considering their first research question regarding the volatility of income measures they make interesting observations regarding what banking institutions have said about comprehensive income and volatility during previous periods of accounting change:

> *"Our first research question asks: How do the volatilities of these three income measures compare?* ***These comparisons are interesting because, during the last decade, bank managers and their representatives have made conflicting assertions regarding the usefulness of income measures that include changes in fair values of financial instruments and derivatives.*** *For example, in the* ***mid-1990s banking organizations criticized the Financial Accounting Standards Board's (FASB) proposal for comprehensive-income measurement and reporting because it would fail to fully reflect banks' risk-management activities, trigger ''excessive''volatility in comprehensive income, and lead investors to overstate their risk assessments (Hirst et al. 2002)****. In striking contrast to their prior statements, these same organizations recently defended the recognition of fair-value changes on a subset of financial instruments in the currently reported measure of comprehensive income as being the ''optimal means of reporting financial performance'' for banks.* ***They asserted that FFV accounting will provide a ''false and***

misleading picture'' of excessive volatility in banks' profitability (Dean 2000, 3) and will misrepresent banks' risk because it is irrelevant and unreliable (Joint Working Group of Banking Associations on Financial Instruments 1999)."

Overall, the research finds the volatility on a fair value basis is not irrelevant because it captures elements of bank risk that the capital markets price, but that volatilities of net income and comprehensive income omit.

Only Investors With Volatility Plays Are Interested in Fair Value Accounting
Some who are not in favor of the Proposed Update indicate that fair value information is only needed or useful to short-sellers and those making volatility plays. This is not correct. Investors making long-term investment decision want and need to know whether the price they are paying for a security of a financial institution is appropriate for the risk being undertaken by the institution. Even a long-term investor wants to know the appropriate value of an investment so as to know when to buy and sell their investment, and fair value information is helpful for all investors to make their own assessment of the risks and ask more informed questions of management. Finally, all investors need to understand the volatility of the enterprise's assets and liabilities.

Consider a very simple example. If a company has issued a 20-year, 3% coupon bond and the market interest rate for comparable bonds being issued in today's environment is 7%, it is irrational for an investor to pay the amortized cost for such an instrument. Such an instrument should trade at a discount to the instrument with the 7% coupon and comparable risk. Given this reality, placing a large number of instruments such as those described above into a portfolio and placing them into a holding company that trades as an equity investment should not make the amortized cost information – that is not relevant at the instrument level – relevant at the holding company portfolio level.

Volatility is Created By Fair Value Accounting
Some argue that volatility in capital, or net income, is created by the use of fair value measurements. This argument is unsupported. Reporting fair values does not create volatility it merely reports the existing economic volatility. As noted in a recent edition of The Analyst's Accounting Observer[8]:

> *"**It's more accurate to say that amortized cost accounting creates smoothness where volatility really exists**. **Fair value reporting removes the veneer of something and reveals just what resources a lender has available for further lending activity**. Amortized cost-based capital hides that position and can mislead investors about the kind of lending risk a financial institution is capable of shouldering."*

When investors make trading decisions they are not reacting to accounting, they are reacting to the implied risks and rewards of their stake in the bundle of investments that the financial institution represents. If they perceive their risk of loss to be higher due to a series of events, they will be willing to pay a lower price for the aggregate portfolio than they would have prior to the incorporation of that new information.

---

[8] The Analyst's Accounting Observer, *It's Déjà Vu All Over Again: The Fair Value Accounting Wars*, Jack T. Ciesielski, CPA, CFA, August 16, 2010, p. 8-9.

Additional Observations on Business Model Based Accounting Standards

Supporters of the mixed measurement model indicate a preference for the IASB's measurement model because they believe it better represents the business model of the organization. We have two additional observations regarding the concept of business model in the context of accounting standard setting:

1) *Is the IASB Model Better for All Businesses?* – The IASB's approach to the measurement of financial assets does not better match the business model for insurance enterprises when taken together with the IASB's Insurance Contracts project. The Insurance Contracts project would call for an update of expected cash flows and discount rates for insurance liabilities while the assets would most likely be held at amortized cost. While banks believe the IASB's approach results in a better reflection of their business model, the same statement cannot be made for insurance enterprises. Further, a financial institution which owns both a bank and insurance enterprise may be remeasuring its more complex insurance financial instruments through net income while retaining its banking liabilities at amortized cost while both the banking and insurance operations have a "hold-to-maturity" business model. We raise this issue to highlight that accounting standard setters cannot build accounting standards that accommodate all possible business models nor the business model of one particular industry. Business model based accounting standards can never be conceptually consistent among all industries and enterprises and can only result in confusion and complexity for investors.
2) *Business Model of the Enterprise* – There appears to be a misconception that support for fair value which is, in part, premised on the belief that business model and management intent do not alter the value of a financial instrument is a suggestion that business model is unimportant to the valuation of the enterprise. This is not the case. Valuation of the enterprise incorporates its use of financial instruments (both asset and liabilities), intangibles assets, and other assets and liabilities over time to match and mitigate risks and produce spread/cash flows given the market timing of such cash flows for the enterprise. As such, the perception that supporting fair value irrespective of intent for specific financial assets and liabilities is a dismissal of a financial institution's business model is mistaken.

Fair Value Accounting Is Procyclical & Caused the Financial Crisis

Popular Beliefs Regarding Fair Value Accounting, Procyclicality & Their Contribution to the Financial Crisis

Hand-in-hand with the volatility argument comes the pro-cyclicality argument against fair value accounting. Pro-cyclicality is an economic, not accounting, phenomenon. When asset values rise, the owners of those assets can sell or pledge them to obtain funds for expansion. Lenders base their decisions on the market value of these assets, not their historical cost. In addition, lenders often increase the proportion of asset value they are often willing to lend when asset prices are rising. When asset values decline, these reverse as we saw in the recent financial crisis. Accounting does not, however, create pro-cyclicality, it simply reflects changes in the values of assets and liabilities in the periodic financial statements used by investors to make their decisions.

However, those who do not support fair value accounting declare it to be "pro-cyclical" and indicate that, at a minimum, it exacerbated, if not directly contributed to, the recent financial crisis. Critics have said that current standards, particularly those relating to the use of fair value measurements, impose "procyclical" burdens on financial institutions and can cause instability in the financial system. For example, they contend that fair value can overstate the "true" value of financial assets in "irrationally exuberant" up markets and understate their true value in times of market turmoil and decline. They also contend that reporting declining asset values in down markets constrains banks' ability to make loans and

causes them to sell assets at depressed prices to conserve capital, thereby exerting further downward pressure on asset values.[9]

Fair value accounting, the argument goes, required institutions to write down the value of their investments to amounts that were the result of inactive, illiquid or irrational markets and that did not reflect the underlying economics of the securities. They claim that these writedowns created the need to raise additional capital and led to a negative impact on markets and prices, leading to further writedowns and financial instability. Remarks such as the following work to continue the misconception that the financial crisis was caused by fair value accounting:

> *"**An economic version of the bubonic plague is ready to reemerge: mark-to-market accounting. This rule was the principal reason that the financial disaster of 2007--09 threatened to destroy our financial system**."*[10]

> *"**Fair value accounting will add unnecessary procyclicality to the financial system……..By implementing fair value accounting, systemic risk is added to the financial system by unnecessarily adding to volatility of bank capital, and, thus, procyclicality.** Whether linked to regulatory accounting or not, procyclicality both adds to the cost of capital of banks and exacerbates financial cycles…………**Those who believe that fair values of financial assets and liabilities are effective predictors of credit losses need look no further than the power of procyclicality as it ravaged its way through the economy in 2007 and 2008."***[11]

Further, there is a popular misconception that the standard on fair value accounting (SFAS 157 or Topic 820) that went into effect in 2007 somehow caused a wholesale expansion of fair value accounting by financial institutions that escalated the depths of the financial crisis. However, this standard only provided a formal definition and a methodology for estimating fair value – it did not expand its use nor require write-downs which are covered by different literature. For large banks, the expansion in fair value was driven more by market trends such as an increase in assets held on a short-term basis (e.g. loans awaiting securitization), a higher volume of credit exposures reclassified to the trading book, and higher derivatives exposures. Steve Forbes' articulates this misconception in his article issued subsequent to the issuance of the Proposed Update:

> *"In effect, mark-to-market accounting rules forced financial institutions to value securities for capital purposes as though they were day-trading accounts. **Traditionally, an asset was held at book value for regulatory capital purposes unless it was disposed of or became impaired. In 2007 that standard was overturned by the Financial Accounting Standards Board (FASB).** When panic set in regulators and auditors forced banks and insurers to write down the values of assets to absurdly low levels that weren't even remotely justified by their cash flows."*[12]

---

9 Excerpted from the remarks of Robert H. Herz Chairman, Financial Accounting Standards Board, AICPA National Conference on Current SEC and PCAOB Developments, December 8, 2009. (http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156571228)

10 Forbes, Steve; *Stop This Horror Before It Starts Again;* Forbes; June 28, 2010.

11 Ibid 1, pg.10.

12 Ibid 10.

In this same article, Steve Forbes proposes that fair value accounting led to massive write-downs in assets during the financial crisis:

> ***"Mark-to-market is like being told to mark down the value of your house to a price that it will fetch within the next 24 hours. An absurdly destructive concept. But it explains why the massive losses financial institutions took were mostly book losses and not actual cash losses on bad paper."***

As we illustrate from the academic studies below, Forbes' assertion that fair value accounting resulted in massive write-down of loans or other assets is incorrect.

We believe that banking regulation is responsible for creating counter-cyclical regulation; that is not the function of financial reporting.

What Studies Subsequent to the Financial Crisis Find Regarding Fair Value Accounting, Procyclicality & Causes of the Financial Crisis

When the market is provided with information it may act on it. Hence, all transparent, relevant, decision-useful information can be seen as being pro-cyclical if market participants act upon it when they receive it. The question before accounting standard setters is whether this pro-cyclicality was exacerbated by financial reporting standards. Barth et al. (2010)[13] best articulates the differences in natural and amplified pro-cyclicality:

> *"**Procyclicality is a natural consequence of an economic downturn, particularly one caused by the bursting of an asset market bubble.** For example, in the case of the bursting housing bubble, homeowners reduced consumption, causing retail and wholesale businesses reliant on consumer spending to scale back operations, and so on. More generally, procyclicality naturally occurs throughout the business cycle. **However, the concern of policymakers is that institutional features of financial reporting and the regulatory system could amplify natural procyclicality.** For example, requiring banks to hold more capital during an economic downturn because bank assets have become riskier could result in less lending than otherwise would be the case, thus amplifying the downturn. **Hereafter, we distinguish between natural procyclicality and amplified procyclicality potentially arising from financial reporting and the regulatory system**."*

FASB Chairman Herz in his remarks at the 2009 AICPA National Conference on Current SEC and PCAOB Developments[14] asks those considering the issue to consider two questions: 1) is fair value accounting pro-cyclical?, and 2) if so, should accounting and reporting be purposefully altered to avoid such procyclical effects?:

> *"I am not an expert in macroeconomics or organizational and market behavior, but I would pose **two questions**: **first, does fair value accounting actually have a "procyclical" effect?** And, **second, to the extent that the answer is "yes," should that fact lead to a conclusion that accounting and reporting should to be purposefully altered to avoid such procyclical effects**."*

---

13 Barth, Mary E. and Landsman, Wayne R.; *How Did Financial Reporting Contribute to the Crisis?;* European Accounting Review; July 2010.

14 Ibid 9.

We have reviewed studies which have sought answers to Chairman Herz's questions and found the following:

1) <u>*SEC Report to Congress (December 2008)*</u> – The SEC's December 2008 Report to Congress[15] undertaken as part of a mandate contained in the Emergency Economic Stabilization Act of 2008, concluded that fair value was not the source of the bank failures during 2008 and concluded that, contrary to the assertions of some parties, the credit crisis in the U.S. did not result from fair value accounting but, rather, from growing (and often masked) credit losses, asset quality problems, and eroding investor and lender confidence.

2) <u>*Federal Reserve Bank of Boston Working Paper (January 2010)*</u> – Another study done by the Federal Reserve Bank of Boston[16] concluded that "there does not appear to be a strong link between fair value accounting, regulatory capital and pro-cyclical market impacts." Instead, the paper notes that loan loss provisions had a significant impact on regulatory capital for most institutions studied. It concluded as follows:

   > *"... **<u>it would appear that fair value accounting had a minimal impact on the capital of most banks in the sample during the crisis period through the end of 2008.</u> Capital destruction was due to deterioration in loan portfolios and was further depleted by items such as proprietary trading losses and common stock dividends. These are a result of lending practices and the actions of bank management, not accounting rules.** Furthermore, the data suggests that banks were not raising significant capital through distressed asset sales; rather they were relying on government programs as well as debt and equity markets. **There was no clear observable evidence to back the assertion that fair value accounting, linked to regulatory capital rules, caused banks to sell investments at distressed prices and thus promote a pro-cyclical effect that accelerated the decline in investment asset prices**."*

3) <u>*IMF 2009 Working Paper (March 2009)*</u> – Another study of procyclicality and fair value accounting by the International Monetary Fund (IMF)[17] reached the following conclusion:

   > *"**<u>The paper finds that, while weaknesses in the FVA methodology may introduce unintended procyclicality, it is still the preferred framework for financial institutions.</u>** It concludes that capital buffers, forward-looking provisioning, and more refined disclosures can mitigate the procyclicality of FVA. Going forward, the valuation approaches for accounting, prudential measures, and risk management need to be reconciled and will require adjustments on the part of all parties."*

4) <u>*Academic Study of Laux and Leuz (October 2009)*</u> An academic study conducted by Laux and Leuz (2009)[18] considered whether fair value accounting contributed to the crisis. They found that while there were downward spirals and asset-fire sales in certain markets they were not attributable to fair value accounting:

   > "***The recent financial crisis has led to a major debate about fair-value accounting. Many critics have argued that fair-value accounting, often also called mark-to-market accounting, has significantly contributed to the financial crisis or, at least, exacerbated its severity.*** *In this paper, we assess these arguments and examine the role of fair-value accounting in the financial crisis using descriptive data and empirical evidence.* ***<u>Based on our analysis, it is unlikely that fair-value accounting added to the severity of the current financial crisis in a major way.</u> While there may have been downward spirals or asset-fire sales in certain markets, we find little evidence that these effects are the result of fair-value accounting. We also find little support for claims that fair-value accounting leads to excessive write-downs of banks' assets.*** *If*

---

[15] Office of the Chief Accountant – Division of Corporation Finance; *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*; December 2008.

[16] Shaffer, Sanders; *Fair Value Accounting: Villain or Innocent Victim: Exploring the Links Between Fair Value Accounting, Bank Regulatory Capital and the Recent Financial Crisis;* Federal Reserve Bank of Boston; January 31, 2010, Working Paper No. QAU10-01 (http://www.bos.frb.org/bankinfo/qau/index.htm.) The study sampled U.S. top-tier bank holding companies with assets greater than $100 billion, representing 65% of total assets of all top-tier bank holding companies at December 31, 2008.

[17] Novoa, A., Scarlata, J., Sole, J.; *Procyclicality and Fair Value Accounting;* IMF Working Paper; March 2009.

[18] Laux, C. and Leuz, C.; *Did Fair Value Accounting Contribute to the Financial Crisis;* Journal of Economic Perspectives; October 2009.

anything, empirical evidence to date points in the opposite direction, that is, towards overvaluation of bank assets."

5) Academic Study of Baderscheter, Burks and Easton (March 2010) – Another academic study of procyclicality and fair value accounting by the Baderscheter et al (2010)[19] found little evidence that fair value accounting contributed to the commercial banking industry crisis as is commonly alleged by critics:

   "U.S. accounting rules have been blamed for contributing to the recent financial crisis. Critics argue that fair value accounting exacerbated the crisis by forcing write-downs of assets, which curtailed bank lending and triggered asset sales, leading to further price declines. Defenders counter-argue that the role of fair value accounting in U.S. bank regulation is not sufficient to lead to the pro-cyclical effects alleged by the critics*; they point out that most bank assets are not fair valued, and the assets that are fair valued likely have little effect on regulatory capital, especially when banks do not intend to sell the assets at low prices. We contribute to this debate by examining the effects of fair value losses on bank holding companies' regulatory capital and sales of securities.* ***We find that fair value accounting had only a small effect on regulatory capital. Furthermore, we find no evidence of increased loss selling or general selling of securities during the crisis, and little evidence that accounting charges trigger securities sales. Overall, our findings indicate that fair value accounting did not affect the commercial banking industry in the ways commonly alleged by critics."***

6) Academic Study of Barth and Landsman (July 2010) – Another academic study regarding financial reporting's contribution to the financial crisis by Barth et al (2010)[20] finds fair value accounting played little or no role in the crisis, but they do find that lack of transparency regarding asset securitizations and derivatives was insufficient for investors.

   "We scrutinize the role financial reporting for fair values, asset securitizations, derivatives and loan loss provisioning played in the Financial Crisis*. Because banks were at the center of the Financial Crisis, we focus our discussion and analysis on the effects of financial reporting by banks.* ***We conclude fair value accounting played little or no role in the Financial Crisis."***

   Barth et al (2010)[21] also considered and discussed the impact existing incurred loss models had on the financial crisis and how potential expected loss models might compare to incurred loss models and fair value. Overall, those who believe fair value is procyclical need to accept that the expected loss model they support is also procyclical and the incurred loss model is procyclical to the downside. Consider the following:

   "As noted above, on average, loans comprise a significant proportion of bank assets, and therefore banks' financial reporting for loans, particularly loan loss provisioning, was also central to the Financial Crisis. ***Loan loss provisioning may have contributed to the Financial Crisis through its effects on procyclicality and on the effectiveness of market discipline****. Recognizing losses is naturally procyclical and provides information to markets about loan values. The extent to which loan loss provisioning is procyclical, natural or amplified, and provides information depends on how provisions are determined.*

   During the Financial Crisis, loan loss provisioning under U.S. GAAP and IFRS was based on an incurred loss model. Under an incurred loss model, banks do not recognize a provision for a loan loss until there is objective evidence the loan has been impaired. As a result, a bank would not necessarily recognize losses based on external indicators of economic loss in the value if its loans, e.g., the bursting of the housing bubble, even though such indicators suggest that a substantial number of borrowers will default on their loans. ***The incurred loss model is not as procyclical as other loss models discussed below because it delays loss recognition. In addition, it can only be procyclical during economic downturns because under this model loans are only written down, not up. However, to the extent that financial markets rely on financial reporting information when making capital allocation decisions, such delayed and asymmetric recognition of losses potentially deprives the markets of timely information regarding the value of bank assets. Thus, the incurred loss model can reduce the effectiveness of market discipline.***

---

[19] Badertscher, B., Burks, J., Easton, P.; *Fair Value Accounting, Other-Than-Temporary-Impairments, and the Financial Crisis;* University of Notre Dame; March 2010.

[20] Ibid 13.

[21] Ibid 13.

> ***One approach to mitigate the effects of delayed and asymmetric recognition of losses associated with the incurred loss model is to implement an expected loss model for loans.*** *Under this model, a bank would reflect in its loan loss provisions all changes in expected future cash collections from its loans, including expected increases as well as decreases. Such a model is currently under consideration by the IASB.* ***A beneficial effect of the model is more timely and symmetric loss recognition, which can enhance market discipline because markets have more timely information about loan values. However, an effect of more timely information is an increase in natural procyclicality relative to that associated with the incurred loss model****. A shortcoming of the* ***expected loss model is that it does not change the discount rate used in calculating the present value of the expected cash flows to reflect changes in interest rates****. As a result, it does not fully reflect the value of expected future cash collections, which makes the information provided to financial markets about the value of bank loans incomplete.*
>
> ***The fair value model overcomes this shortcoming of the expected loss model because a bank would reflect in its loan loss provisions not only changes in expected future cash collections, but also changes in the discount rate the market would apply to those cash flows****. Changes in discount rates arise from changes in general market rates of interest, changes in credit risk, and changes in the price of credit.* ***Thus, relative to the incurred loss and expected loss models, the fair value model is the most effective from the standpoint of market discipline because it provides financial markets with the best information about loan values****. As with the expected loss model, an effect of timely and symmetric loss recognition is an increase in natural procyclicality relative to that associated with the incurred loss model.* ***Whether the fair value model results in a greater procyclicality relative to the expected loss model is difficult to determine because ignoring changes in discount rates when determining loan loss provisions as in the expected loss model can result in recognized loan amounts that are higher or lower than actual loan values****. More importantly, it is not possible to determine the extent to which measuring loans at fair value would have amplified procyclicality during the Financial Crisis. First, as noted in section 3, loans were not measured at fair value for financial reporting purposes. Second, it is unknown what prudential filters bank regulators would have applied to the fair value amounts."*
>
> *"Regardless of the measurement model used for loan loss provisioning, some have advocated—notably the Bank of Spain—overlaying a "through-the-cycle" adjustment to the provision amounts. This overlay, also referred to as "dynamic provisioning," would effectively increase loan loss provisions in economic upturns, and decrease them in economic downturns.* ***The goal of dynamic provisioning is to mitigate natural procyclicality by creating a capital cushion for banks during economic upturns that can be used to buffer capital declines during economic downturns. To the extent that this adjustment creates or uses a capital cushion that is not reflective of loan values, dynamic provisioning is unlikely to be acceptable for financial reporting purposes. However, such an adjustment could be an effective regulatory tool to address amplified procyclicality****."*

Further, Barth et al. (2010)[22] highlights that managing procyclicality is the responsibility of banking regulators not accounting standard setters and that loss of information by not having impairments measured at fair value could hinder market disciplinary tool.

> *"Regardless of any role that fair value accounting played in the Financial Crisis,* ***it is important to recall that it is the responsibility of bank regulators, not accounting standard setters, to determine how best to mitigate the effects of procyclicality on the stability of the banking system****. To meet their objectives of prudential supervision,* ***bank regulators have many tools at their disposal,*** *including application of prudential filters (as illustrated by the filter for fair value losses on available-for-sale assets), relaxation of regulatory capital ratios during economic downturns, e.g., by altering risk-weighting of specific assets, and use of counter-cyclical measures in loan loss provisioning for regulatory purposes. Moreover, as noted earlier,* ***the effectiveness of market discipline as a regulatory tool could be undermined if investors' informational needs were hindered by not having impairments for bank assets measured at fair value*** *as required by IFRS or US GAAP.*
>
> *"****We also conclude that because the objectives of bank regulation and financial reporting differ, changes in financial reporting needed to improve transparency of information provided to the capital markets likely will not be identical to changes in bank regulations needed to strengthen the stability of the banking sector. We discuss how loan loss provisioning may have contributed to the Financial Crisis through its effects on procyclicality and on the effectiveness of market discipline.*** *Accounting standard setters and bank regulators should find some common ground.* ***However, it is the responsibility of bank regulators, not accounting standard setters, to ensure the stability of the financial system****."*

[22] Ibid 13.

Conclusion: Fair Value Accounting Did Not Create or Exacerbate the Crisis
It is clear that neutral parties who have studied whether fair value accounting was procyclical did not find that fair value accounting in and of itself contributed additional levels of procyclicality beyond the amounts that were inherent in the risks and rewards of the economics of the associated financial instruments or that it unnaturally amplified the economic phenomenon of procyclicality. Those, like the IMF, who did find procyclical effects found that fair value accounting was still the most appropriate accounting for financial institutions.

Though the immediate causes of the recent financial crisis are complex, it is clear that a decline in lending standards; poor lending and investing decisions; an increase in risk-taking in a quest for higher yields; inadequate risk management; the use of off-balance sheet transactions; the increased use of derivatives without sufficient collateralization; abuse of the securitization mechanism, and a system-wide increase in financial leverage were all important contributors to the crisis rather than fair value accounting. Fair value measurement is only the messenger, reporting economic changes as they occur.

CFA Institute believes that fair value accounting provides greater transparency to a company's financial condition and can, therefore, be useful in bringing certain problems to the attention of the financial markets earlier than amortized cost measurements, allowing such problems to be dealt with expeditiously. In contrast, the mixed-attribute system often masks information that investors need to effectively assess firm value and risk. Fair value accounting is, therefore, especially important during the early stages of firm stress so that investors can make appropriate decisions regarding the deployment of capital. As we describe below, we find that much of what those opposed to the Proposed Update want is a U.S. GAAP reporting policy which reflects their regulatory interests rather than the interests of investors.

Accounting Standards Should Address Prudential Regulatory Concerns
Many opponents the Update are unsupportive because they believe the proposals will change regulatory reporting for banks who presently utilize U.S. GAAP as a starting point for their regulatory filings and because the inclusion of fair value adjustments will increase bank capital requirements. Below we consider the differences in investor and regulatory interests and the purpose of financial reporting in contrast to regulatory reporting. We also evaluate the FASB Update in light of these competing interests and objectives.

Investor and Regulatory Interests are Different
Equity investors are interested in market based returns for risk associated with their investment and in the preservation and return of, and risk appropriate return on, their capital. The interests and authority of equity investors are not the same as those of prudential regulators. Prudential regulators seek to mitigate the level of risk to which creditors to the financial institution are exposed. They work to protect depositors, or insureds, and to reduce systemic financial risks. While the interests of regulators (e.g. solvency and liquidity) are important concerns and they may, at times, be mutually beneficial to investors and other creditors, they are not the sole concerns of equity investors. Prudential regulators do not seek to protect the interests of equity investors. Regulators have an informational advantage over credit and equity investors in that they can, and do, mandate accounting and reporting requirements and they can, and do, force financial institutions to take actions which they think are in the best interest of not only the institution but also the safety and soundness of the financial system in a broader economic context.

CFA Institute's positions are developed from that of a buy-side equity investor; accordingly, we believe investors and regulatory interests are quite different.

Accounting Standards & Regulatory Reporting Should Recognize These Differences in Interest

CFA Institute's long-standing position – because of the difference in investor and regulator interests, and because of the legal right of regulators to command information and develop their own reporting basis – is that accounting standards such as U.S. Generally Accepted Accounting Principles ("U.S. GAAP") and International Financial Reporting Standards ("IFRS") should primarily serve the interests of investors. This is what referred FASB Chairman Herz in his remarks at the 2009 AICPA National Conference on Current SEC and PCAOB Developments[23] referred to this as the "de-coupling" of accounting standard setting and prudential regulations.

These views are supported by others who have studied the issue. Barth et al. (2010)[24] observe the purpose of financial reporting to be as follows:

> *"The concepts statements underlying US GAAP and IFRS state that the* ***objective of financial reporting is to provide information that is useful to present and potential investors and creditors*** *and others in making investment, credit, and similar resource allocation decisions (FASB, 2008; IASB, 2008a).* ***This objective applies to general purpose financial reporting for all firms, regardless of industry or whether firms in a particular industry are subject to regulation that uses financial statement information as an input****."*

The IMF in their 2009 Working Paper[25] makes the following comment:

> *"Regardless,* ***accounting frameworks are not meant to address the market-wide or systemic outcomes of their application****, as they are applied only to individual institutions. "*

Our view is that reporting to investors should not be constrained by regulatory requirements. Regulatory reporting requirements, specifically bank regulatory reporting requirements, should not drive U.S. GAAP financial statements because of these differences in objective and asymmetrical access to information. Barth et al. (2010)[26] share these views when making the following observation regarding the differences between financial reporting and regulatory reporting which are similar to the views we have expressed:

> *"The primary objectives of bank regulation are prudential, i.e., to reduce the level of risk to which bank creditors, e.g., depositors, are exposed, and to mitigate systemic financial risks.* ***Although bank regulators may choose to use general purpose financial reporting information in meeting their objectives, one should expect that bank regulators would not limit themselves to information contained in general purpose financial reports.*** *For example, in the US, bank regulators require a variety of additional disclosures relating to recognized assets and liabilities, e.g., non-performing loans and deposits, as well as additional information relating to bank risks. In addition, when calculating measures used as input for their supervision of banks, such as regulatory capital, regulators often make their own adjustments to recognized financial statement amounts to better suit their objectives.* ***Regulatory capital need not be equal to financial reporting capital because bank regulators apply so-called "prudential filters,"*** *i.e., specific 5 adjustments when calculating regulatory capital, to meet their objectives of prudential supervision. Examples include neutralizing pension surpluses, i.e., recognized pension assets, and gains/losses associated with the fair value option in International Accounting Standard (IAS) 39 (CEBS, 2007).* ***In addition, regulators can adjust the risk weights they assign to specific assets when determining required levels of capital.***
>
> *Thus, because prudential filters neutralized the effect on Tier 1 capital of some fair value losses and the larger effect on Tier 1 capital arose from loan losses that were not determined using fair value, critics' assertions that fair value accounting played a significant contributing role in causing procyclicality of bank asset prices during the Financial Crisis appear to be overstated. However, it is not possible to determine the extent to which fair*

[23] Ibid 9.

[24] Ibid 13.

[25] Ibid 17.

[26] Ibid 13.

value accounting would have contributed to amplified procyclicality had the prudential filter relating to fair value losses not been applied. ***Perhaps a motivation underlying criticism of fair value accounting is the concern that bank regulators might remove this prudential filter****."*

Laux and Leuz (2009)[27] make the following observations about the differences in purposes of U.S. GAAP reporting and regulatory reporting:

"Broadly speaking, ***the objective of GAAP is to facilitate financial transactions in markets and contracting in the economy.*** *Financial statements provide standardized information to various parties who use it for investment and credit decisions, to monitor their claims, for private contracting, and regulatory purposes. It is therefore important that accounting numbers are relevant and reliable. However, what is relevant likely differs across users, and relevance and reliability can be in conflict so that the FASB often faces a tradeoff.* ***Bank regulators typically start with banks' financial statements according to GAAP when measuring bank capital and setting capital requirements. But they are not required to use capital according to GAAP, and in some cases they explicitly set up other rules.****"*

If the pursuit of a regulator's mandate to promote financial stability implies that decision-useful information must be withheld from current and prospective investors, there is a very real risk investors will be unable to make informed capital allocation decisions. If addressing the needs of regulators results in limiting relevant, decision-useful information at times when investors are making investment decisions, then the FASB and IASB may be exposing investors to elevated risk and the potential loss of investor capital. From our perspective, given that the needs of regulators can and will diverge, the FASB and IASB have a responsibility to select either investors or regulators as their primary constituents. Given that regulators have the ability to request additional or alternative information and have the freedom to select any valuation approach they see fit for their purposes whereas the filings issued in compliance with standards of the FASB and IASB are the dominant means of information collection for most investors, the Boards have a responsibility to focus on the needs of investors. It is not appropriate for regulatory concerns to result in inadequate or potentially misleading information being provided to investors as this practice has the very real possibility of impairing the operation of the capital markets and causing a destruction of investor capital that could have been avoided with more decision-useful information.

FASB's Proposed Update Is a Pragmatic Compromise

The research we reviewed was uniform in its acknowledgement of the differences in the objectives of financial reporting for investors and regulatory reporting for purposes of capital adequacy determination to prudential authorities it also recognizes a need to balance these interests and find common ground. See the following remarks:

Laux and Leuz (2009)[28] make the following comments regarding the trade-offs that accounting standard setters and regulators may face:

"Moreover, it is ***important to recognize that standard setters and bank regulators face many subtle tradeoffs****. For instance,* ***even if fair-value accounting were to cause downward spirals and contagion, these negative effects during a crisis have to be weighed against positive effects that fair-value accounting and timely loss recognition*** *likely have, by forcing banks to take prompt corrective actions and by limiting imprudent lending ex ante."*

*"…..****it is problematic if accounting rules are relaxed or suspended whenever a financial crisis arises*** *because banks can reasonably anticipate such changes, which diminishes their incentives to avoid risks ex ante.* ***Instead,***

[27] Ibid 18.

[28] Ibid 18.

***it may be more appropriate to adjust regulatory capital requirements as opposed to change the accounting standards themselves**."*

The IMF in their 2009 Working Paper[29] make the following observation regarding the need of accounting standard setters, risk managers and prudential regulators to reach a reconciliation of interests as it relates to fair value accounting:

> *"**A key challenge going forward will be to enrich the FVA framework so that market participants and supervisors are better informed, in order to promote market discipline and financial stability**. The fragmented solution that currently exists between the accounting, prudential and risk management approaches to valuation is insufficient and must be reconciled. **Importantly, this will require adjustments on the part of all three disciplines to resolve these tensions**."*

Barth et al. (2010)[30] make the following comments regarding the need for standard setters and regulators to reach common ground.

> *"**In light of the differing objectives of financial reporting and bank regulation**, standard setters should not be surprised that bank regulators make adjustments to general purpose financial statement information for use in prudential supervision. At the same time, bank regulators should not be surprised that accounting standard setters require information that is not perfectly suited for prudential supervision. **It does not make sense for accounting standard setters to issue recognition and measurement standards that meet the needs of one set of users, including bank regulators, while ignoring the informational needs of others**. However, **it makes sense from the standpoint of efficiency for accounting standard setters and bank regulators to find some common ground** (Bushman and Landsman, 2010)."*

Barth et al. (2010)[31] also make another important point regarding accounting standards allowing transparent decision-useful information into the marketplace to allow market discipline to play its role in the regulatory process.

> *"**Returning to the point that accounting standard setters need to be concerned with the information needs of the capital markets, it is important to note that bank regulators also should be concerned with those needs**. Pillar 3 of Basel II states that regulators can rely on capital market disciplining forces as a tool in prudential supervision. That is, the capital markets can serve as a complementary force to direct bank supervision. The extent to which bank regulators can rely on market discipline to perform this role depends on the quality of information available to the capital markets. **Thus, if accounting standard setters fail to keep the informational needs of capital markets as their first priority, an unintended consequence is that the effectiveness of market discipline as a regulatory tool could be undermined**."*

CFA Institute views the Proposed Update as a reasonable and pragmatic compromise by the FASB that seeks that common ground. We believe the FASB has achieved a balance between investor needs and potential regulatory capital considerations as suggested by the aforementioned quotes. The Proposed Update advances the transparency and market discipline that benefit both market participants by incorporating fair value into the basic financial statements and regulators by not impacting the computation of Tier One capital, which some view as a positive outcome. The reporting of fair values allows the market to self-regulate and also allows regulators to see the impact of fair value on capital requirements and take prudential actions as they see necessary. Simultaneously, it preserves the reporting format that certain investors find useful to their analysis.

---

[29] Ibid 17.

[30] Ibid 13.

[31] Ibid 13.

Is A Case Being Made Against Regulatory Reform or GAAP Accounting Reform?
Those against the FASB's Proposed Update cite political and regulatory bodies and representatives of those bodies in defense of their position to maintain the status quo. We do not find such arguments compelling because the primary objective of accounting standards and financial reporting is to serve the informational needs of investors while regulators have the ability to mandate public or private dissemination of additional information that serve their interests. Accounting standards are meant to serve investor interests. Both the IASB and FASB have at various times openly stated they believe investors are their primary constituency.

Further, many banks opposed to the Proposed Update are ether closely held and/or do not prepare U.S. GAAP financial statements. As such, their opposition to the FASB's Update is really a call to regulators to not make similar changes.

Fair Value Disclosures Are A Sufficient Substitute for Recognition & Measurement
As A Substitute for Measurement & Measurement
Many have argued that fair value as a measurement basis is not necessary given that fair value information, which they acknowledge is highly relevant to investors, is already provided in the footnotes. They declare this approach sufficient for investors. We find it paradoxical argue that such information is highly relevant but should not be provided when it would be most beneficial to investment decision-making.

We believe the fair value information should be presented within the basic financial statements, not only because of its superiority as a measurement basis, but also because delivering relevant information with a significant time lag to the earnings release renders it less relevant.

Additionally, we believe that fair value footnote information is of lesser quality, and providing information in the footnotes requires investors to do the work of incorporating relevant valuation information into the financial statements.

Further, while fair value information included in the notes is currently audited, there exists an exclusion in the accounting guidance which allows a discounted present value approach for certain financial instruments which does not incorporate all the same assumptions as the approach that is required when measuring other financial instruments at fair value (i.e. exit value) in the basic financial statements. Accordingly, the information does not include all relevant fair value assumptions and is less reliable and less relevant.

Finally, investors should not be made to do the work of incorporating relevant valuation information into the financial statements. Users of the financial statements should not be required to manipulate the data to arrive at the relevant financial results of the company. Having to do so decreases transparency to investors who may not be sophisticated enough to understand the highly relevant nature of that information.

As the expression goes, "good disclosure does cure bad accounting."

Too Costly
Many preparers of financial statements have expressed concern that it will be too expensive to provide fair value information, especially if the information must be provided at the time of the earnings release.

We note, however, that if fair value information is already provided reliably in the footnotes on a quarterly basis, the incremental cost to preparers is only the cost of moving the production of these estimates up by approximately two to three weeks. Given that managers closely monitor loan cash flows

and other inputs, that banks have highly sophisticated technological capabilities and that many estimates are made prior to the close of the financials (e.g. estimates regarding impairment of assets) we believe a substantial portion of their work can be done before the quarter close to approximate these estimates which can then be updated if market conditions change significantly by the end of the accounting period. We also note that if a full fair value approach were adopted the time to prepare the credit impairment computations would be eliminated, thereby partially offsetting any incremental costs.

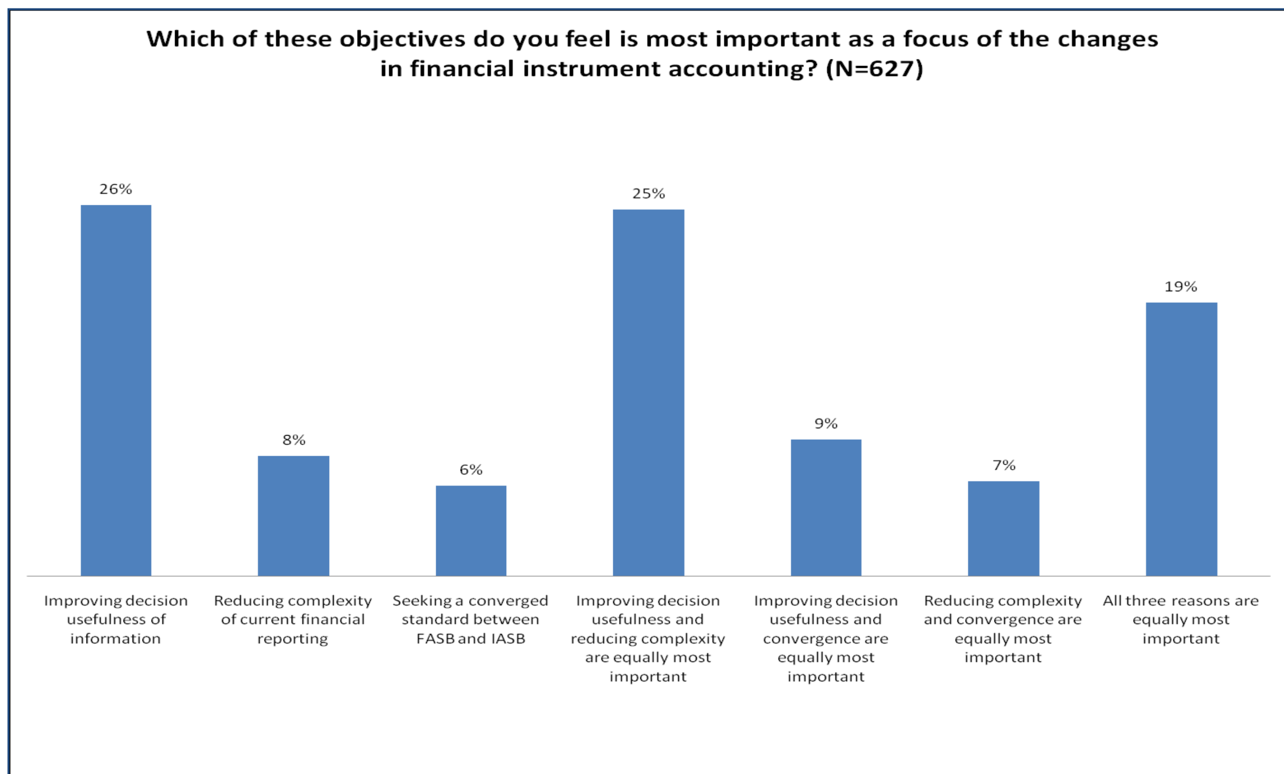
More importantly, we believe that when considering these costs, one must also factor in the cost of not having information relevant to the investment decision-making process at the time of the earnings release. Also the cost of having multiple analysts make estimates of fair value – that are prone to significant amounts of estimation error given limited public information – rather than the entity incorporating the effects using its detailed, non-public information about the financial instruments adds needless market volatility and increases risk premiums. Risk premiums rise because market participants incorporate greater uncertainty into their fair value estimates due to lack of information (i.e. information asymmetry). Uncertainty whether it: a) is caused by the inherent risks and rewards of an investment, or b) an outgrowth of poor disclosures and non-transparency, is factored into a company's cost of capital. While inherent risks and rewards cannot be altered, the risk associated with appropriate fair value measures and disclosures based upon all available information can be mitigated. These costs, or rather lost benefits, must be considered as well.

Some Preparers Presently Don't Prepare Fair Value Disclosures

Lastly, the fact that certain small financial institutions do not prepare audited U.S. GAAP financial statements (i.e. they simply prepare regulatory filings where the information is prepared on a U.S. GAAP basis, without fair value footnotes) and will have to prepare fair value measurements for the first time should not drive the need for reforms in financial instrument accounting. Regulators can make accommodations for such entities, as they deem necessary.

Convergence Has Primacy
CFA Institute members have overwhelmingly supported the premise of one set of high-quality, understandable, and enforceable global accounting standards. CFA Institute members have repeatedly emphasized that high-quality accounting standards are more important than convergence and that convergence should not be an objective in-and-of itself.

As a part of our IFRS Financial Instruments Accounting Survey (2009 FI Survey) conducted in November 2009 just subsequent to the release of International Financial Reporting Standard 9 ("IFRS 9"), *Financial Instruments: Classification and Measurement*, we asked members about their views on the most important objectives as it relates to changes in financial instrument accounting. We found that improving decision-usefulness and reducing complexity were substantially more important than seeking a converged solution. The following from the 2009 FI Survey chart illustrates this message:

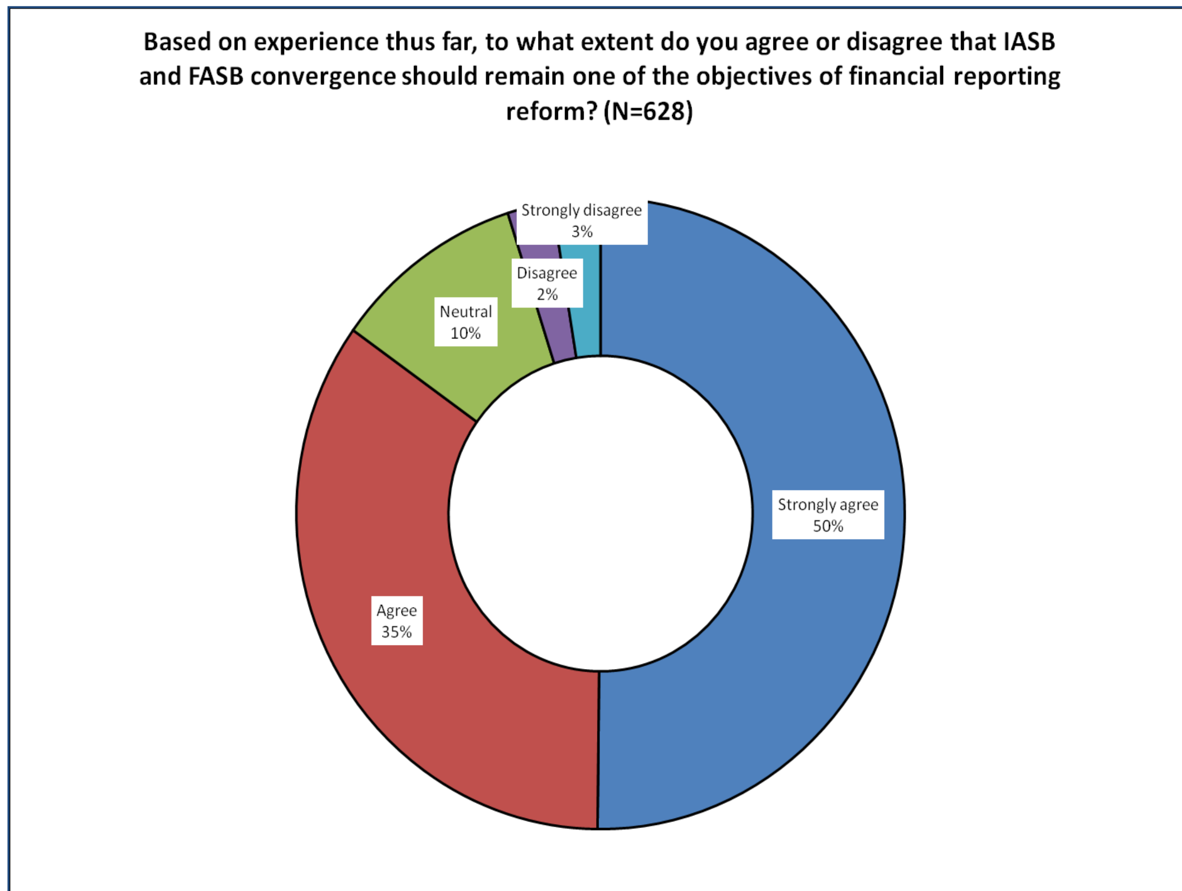


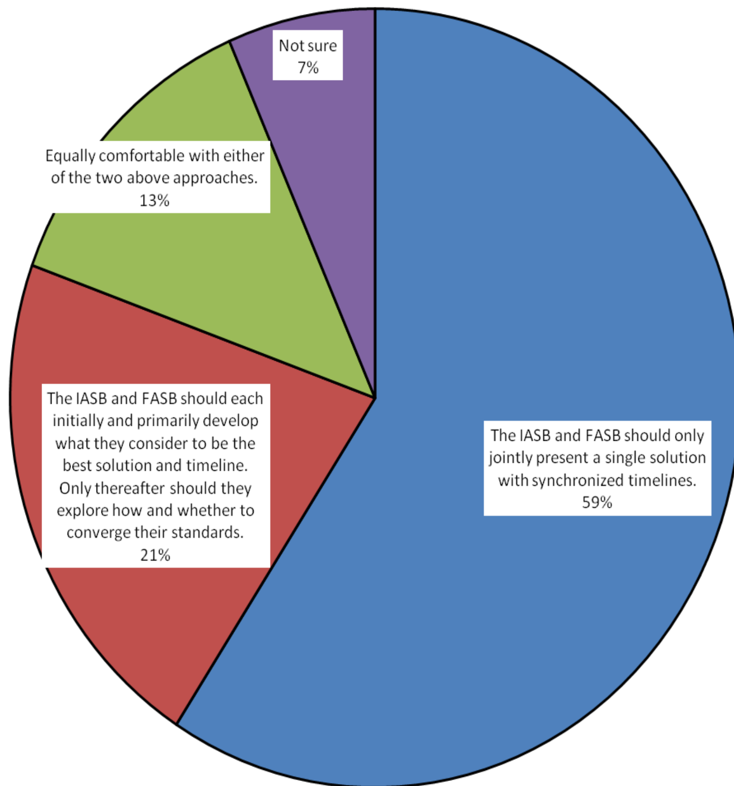
In other words, convergence is a noble goal, but it needs to be subordinated to other, sometimes competing, goals. In terms of priorities, the majority of our membership believes creating an accounting model that seeks the highest quality accounting standard – one that produces decision-useful information – is a higher priority than convergence. If convergence means adopting a lower quality standard, then convergence should not be pursued. We would rather accept lower quality information for jurisdictions unwilling to move to the higher-quality standard than to have all jurisdictions adopt the model producing the lower quality information in the name of convergence. Such a policy of mandatory convergence does a disservice to jurisdictions attempting to pursue more progressive approaches in hopes of producing more transparent, decision-useful information.

The position promulgated by those who are against Proposed Update suggests that IASB's IFRS 9 accounting and recognition model be adopted because it has already been issued by the IASB is not

consistent with the spirit of the convergence process and promotes what some refer to as "a race to the bottom." The convergence process should not be governed by a race to see which standard setter can produce a standard first and accompanied by the notion that such standard should be followed because it was issued first. Such thinking and advocacy efforts promote "first adopter inertia," a race to lower quality standards, and a diminution of convergence efforts.

Also as a part of the 2009 FI Survey we ask our members about whether they thought convergence should remain an objective of financial reporting and the process by which that convergence should be accomplished. As shown in the first chart below, we found that 85% of respondents agreed that convergence should be an objective of financial reporting. Of these respondents, 59% thought that the convergence process could be improved by issuing joint standards with single solutions and 21% thought single standards with different timelines with differences to be resolved later was the best approach as shown in the second chart. Accordingly, we agree process improvements could be made, but given the path established by the IASB and FASB related to convergence, it seems ill advised to simply accept a standard because it has been adopted by one standard setter first. Following this line of thinking the IASB should simply adopt the FASB's insurance reporting model and eliminate their project on insurance contracts.




On the assumption that convergence will remain a key objective, which of the following would you consider to be the most appropriate process? (N=627)
Not sure 7%
Equally comfortable with either of the two above approaches. 13%
The IASB and FASB should each initially and primarily develop what they consider to be the best solution and timeline. Only thereafter should they explore how and whether to converge their standards. 21%
The IASB and FASB should only jointly present a single solution with synchronized timelines. 59%

FASB's Dual-Measurement Model is Less Decision-Useful than IASB's Mixed Measurement Model

Some have adopted a position that the IASB's "mixed measurement" model is more decision-useful than the FASB's "dual measurement" approach. It is a perspective that places its supporters in a position of denying, or at least substantially delaying, the need for fair value information, which empirically has been demonstrated to both more value relevant and conceptually superior.

Given that the classification criteria adopted by the FASB and IASB in their respective models is relatively similar, a financial statement user has the ability to compare the amortized cost information in the FASB's dual measurement category to the amortized cost category in the IASB. Putting aside the issue of non-comparable impairment approaches in the two models, the FASB model provides amortized cost information for a comparable class of financial instruments as does the IASB's model. The FASB approach is additive in that it also provides the fair value information. Those supporting the mixed measurement approach obtain the intent-based information they desire and those who prefer fair value are provided with the information they require at the same time as the amortized cost information but with greater quality given the measurements are reflected in the basic financial statements. How then could the FASB's model be less decision-useful as these supporters claim?

We highlight this issue because there is nothing compulsory about the use of fair value information by a financial statement user. The FASB model maintains amortized cost information for the most controversial financial instruments while strengthening the decision-usefulness of the financial statements by allowing users the ability and freedom to focus on the information that they believes allows them to make the most informed investment decisions. An investor can either: 1) focus solely on the amortized cost information, 2) focus solely on the fair value information, or 3) factor both types of information into their analysis. It is counterintuitive that users would want to deny themselves timely information which has been empirically demonstrated to be linked to the valuation of financial institutions' share price. What is the "net subtraction" of the FASB's dual measurement approach for IASB supporters of a mixed measurement model?

As stated previously, some users who express disagreement with the FASB's proposal to incorporate the fair value information on the face of the statement of financial position often make the argument that the information is not reliable. While we do not agree with them, we believe that they are entitled to their perspective and have full discretion to ignore the fair value information presented for dual measured financial instruments. Inherent in their position that they do not rely on fair value information is that other market participants should not have the ability to rely on that information either. As evidenced by: a) the results of our numerous surveys of our members, and b) the research which demonstrates a correlation between fair value measurements and financial institution share price; there are clearly users who believe fair value information is decision-useful.

It appears much of the controversy associated with the Proposed Update stems from an implied recognition that there is not a universal dismissal of the fair value information. If fair value information was not decision-useful and was dismissed by all users, then there would not be such strong opposition to its incorporation into the financial statements because the existing amortized cost information is provided and there would be no expectation that it would alter anyone's investment decisions. With this in mind, if someone is stating that they do not use the fair value information, then their opinion on whether it should be disclosed should not be relevant to the IASB and FASB because these constituents have no stake in whether recognized in the financial statements, disclosed in the notes to the financial statements or entirely omitted from the financial statements. If one party to a potential trade uses only amortized cost information and the counterparty uses just fair value information or both amortized cost and fair value information, an accounting model that does not provide the fair value information is leaving the user of fair value information at an unfair disadvantage that exposes that party to unnecessary risk associated with the timing difference in the information release of earnings reports and footnote information as well

as the relaxed auditing and measurement practices of footnote disclosures. Material omissions of relevant information such as fair value measurements result in changes in investment decisions of those who would rely on the information being omitted and increases the implied risk attached to the decision.

Ultimately, it is paradoxical that some can argue that the IASB is a more decision-useful model given that it reduces the availability and timeliness of information used in investment decision-making and thereby increases the risk associated with an investment decision.

In their 2008 publication, *The Fair Value Controversy: Ignoring the Real Issue,* professors at the EDHEC Business School[32] make the following observations regarding the IASB's mixed measurement model that, in fact, make the use of fair value murky or complex for users:

> *"**In general, it is our conviction that the contribution of fair value to the information made available to users of the books should not be confused with the IASB's choice of the mechanisms to reflect that information. In other words, it is the accounting distortions** [(a)] (treatment of assets at market value and of many financial firm liabilities at historical cost, treatment of hedges, classification of assets into three categories with an excessively differentiated impact on the profit and loss and/or the balance sheet, and so on) **that make fair value accounting murky and complex**. **The current crisis is likely to be a real test of IFRS in a period of turmoil, and we think that this turmoil will provide further evidence for our criticism of the choices made by the IASB**."*
>
> [(a)] *- In this respect, it is worth recalling that the temporary measure planned initially for three years (from 2005 to 2007), consisting of keeping most assets at market value and most banking and insurance liabilities at historical cost, is still in place (and will be until 2011). We believe that this choice is one of the major sources of pure accounting volatility—volatility that in no way reflects economic reality—in the profit and loss of firms in the finance industry.*

[32] Escaffre, L., Foulquier P., Touron, P.; *The Fair Value Controversy: Ignoring the Real Issue;* EDHEC Business School Financial Analysis and Accounting Research Centre; November 2008.