INTRODUCTION

The American Accounting Association has charged the Financial Accounting Standards Committee (the Committee) with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the Financial Accounting Standards Board (FASB) Exposure Draft, *Fair Value Measurements* (hereafter the ED) issued in June 2004. The opinions in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The ED proposes procedural guidance for measuring most fair value estimates required by other authoritative accounting pronouncements. This guidance would apply broadly to financial and nonfinancial assets and liabilities. The ED also proposes expanded footnote disclosure concerning the methods and inputs used to determine fair value estimates. These disclosures are intended to assist financial statement users in assessing the reliability of fair value estimates reported in the primary financial statements.

Two important factors contribute to the perceived need for the general guidance on fair value measurement proposed in the ED. First, the current set of accounting standards includes no single source of generally applicable guidance for defining or estimating the fair value measurement attribute. Instead, fair value measurement guidance is primarily contained in a cross-referenced patchwork of accounting standards related to financial instruments. The ED

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1 The primary scope exceptions concern assets and liabilities measured at fair value under pronouncements that address share-based payment transactions, leasing transactions, and revenue recognition transactions measured using vendor-specific objective evidence of fair value.
proposes a single standard to guide all fair value estimates. Second, recent accounting standards reflect increasing acceptance of fair value as a measurement attribute (as compared to, say, amortized cost). Given the high likelihood that future accounting standards will also incorporate fair value measurements, defining the fair value measurement attribute — along with high-level procedural guidance for consistent estimation of that attribute — becomes increasingly important for the efficient application of new and existing accounting standards.

The ED includes the following four significant components:

(1) It defines fair value as an exchange price in a current hypothetical transaction between knowledgeable, unrelated, and willing parties.

(2) It establishes a hierarchy of inputs to be used in determining fair value estimates. The hierarchy reflects the principle that more reliable estimates are obtained from market inputs. Accordingly, the most desirable (i.e. “Level 1”) estimates are based on quoted prices for identical assets or liabilities in active markets. “Level 2” estimates are based on quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for factors relevant to the specific asset or liability being measured. Finally, “Level 3” estimates are derived from internal valuation models.

(3) It identifies three valuation techniques — market approach, income approach, cost approach — that are to be consistently applied.

(4) It specifies disclosures for each interim and annual period for which fair values are reported in the primary financial statements. These disclosures include information on the fair value amounts at the end of the period, how the fair values were determined, and the effect of the remeasurements on earnings for the period.

**OVERALL EVALUATION**
In brief, the Committee supports the formulation of a single standard providing fair value measurement guidance. Given the fragmented guidance provided by existing standards, a single standard would increase the efficiency and consistency of measuring fair values across the many standards that require fair value reporting and disclosure. Further, disclosure of information that is potentially diagnostic about the relative reliability of specific financial statement information (e.g., via disclosure of fair value estimation techniques and inputs), should allow financial statement users to more efficiently and effectively incorporate that information into their judgments and decisions. However, we believe that additional disclosures beyond those proposed by the FASB would be informative to the users of financial statements (e.g., sensitivity analysis, breakdown of unrealized gains/losses based on how the related fair value amounts were determined). Moreover, the Committee identified several portions of the ED that are unclear or appear to contain conceptual inconsistencies. But before summarizing our comments on specific aspects of the ED, we first discuss relevant academic research findings that informed our views.

RESEARCH ON FAIR VALUE ESTIMATES

A considerable body of research jointly examines the relevance and reliability of fair value estimates derived from various sources.\(^2\) The majority of these studies assess whether fair value disclosures for financial instruments are associated with share prices. These studies assume that if fair values of firms’ net assets are relevant to investors and reliably measured, the amounts will be positively related to share prices. Loosely speaking, in terms of statistical analysis, this means that coefficients on assets (liabilities) will be positive (negative) when share price is

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\(^2\) An important caveat to note with respect to this literature is that these estimates are not determined under a uniform definition of fair value and the definitions employed might not be consistent with the ED’s definition. Even so, for ease of exposition, we use the term “fair value” to refer to all such estimates discussed in this section.
regressed on fair value information and relevant control variables. These studies also assume that securities markets efficiently and correctly process all relevant information.

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

Existing research provides mixed evidence of a weaker relation between share prices and fair values of other financial assets and liabilities for which there is no established market. Specifically, Nelson (1996) concludes that fair values of banks’ net loans, deposits, long term debt, and off-balance sheet instruments disclosed under SFAS 107 are not related to share prices. Whereas Eccher et al. (1996) suggest that fair values for loans and off-balance sheet financial instruments are significantly related to share prices in limited settings. Barth et al. (1996) find that loan portfolio fair values are reliably associated with bank share prices provided other loan related variables (such as the level of non-performing loans) are included in the regression. Finally, Venkatachalam (1996) suggests that improved fair value disclosures for off-balance
sheet instruments under SFAS 119 explain why he finds that fair values of derivatives are associated with share prices.

Although studies on U.S. firms are limited to fair values of financial instruments, some evidence exists regarding the reliability of fair values for non-financial assets for firms in the U.K. and Australia. Barth and Clinch (1998) examine fair values of investments, property, plant, and equipment (PPE), and intangible assets reported by Australian firms. They find that the fair values of investments and intangible assets are positively associated with share value, but the fair value of PPE is associated with share prices only in limited settings. Evidence from the UK suggests that upward revaluations in PPE are associated with realized future operating performance, measured by operating income and cash from operations (Aboody et al. 1999).

Dietrich et al. (2000) find that appraisers’ start-of-the-year fair value estimates understate actual selling prices whether property values are increasing or decreasing. In addition, fair value estimates are found to be less accurate when they deviate substantially from historical costs, suggesting that appraisers have greater difficulty deriving estimates as property values increasingly diverge from historical cost.

Some studies also attempt to assess how the exercise of judgment by managers affects the reliability of fair value disclosures. Bernard et al. (1995) find little evidence that Danish banks, which are required to use market value accounting for regulatory purposes, manipulate reported fair values to avoid regulatory intervention. Similar to the U.S. banking sector, they find some evidence that managers delay reporting credit risks by gradually recognizing loan losses. Bernard et al. (1995) are also careful to note that the Danish system includes rigid regulatory oversight,

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3 Australian GAAP permits firms to revalue noncurrent assets upward when the asset’s recoverable amount exceeds its carrying amount, and requires firms to revalue noncurrent assets downward when the asset’s recoverable amount falls below its carrying amount. Recoverable amounts can be calculated based on the present value or nominal value of net cash flows arising from the asset’s use and disposal.
which may contribute to the reliability of fair value estimates in this setting. Dietrich et al. (2000) find that managers exercise discretion over annual PPE revaluations to smooth reported earnings and increase reported PPE fair values prior to issuing new debt. However, reliability increases when fair values are obtained from external appraisers and are audited by one of the larger international accounting firms. Similarly, Muller and Riedl (2002) find that market-makers set lower bid-ask spreads for firms using external appraisers. This evidence is consistent with Level 1 estimates (which are based on external market inputs) reducing information asymmetry to a greater extent than Level 3 estimates (which incorporate more entity inputs). In contrast to these two studies, Barth and Clinch (1998) find no difference in reliability between internal and external appraisals for Australian firms’ revaluations.

Although not definitive, the evidence discussed above supports the FASB’s emphasis on market inputs and disclosure of the extent to which fair value estimates rely on management judgment and discretion. In general, the U.S. based research evidence suggests that disclosed fair value estimates for financial instruments include differing levels of reliability and that the variation in reliability is related to the extent to which fair value estimates include publicly observed markets-based information versus management-produced fair value estimates. The most consistent evidence of reliable fair values is found for investment securities traded in active markets. The evidence regarding the reliability of other fair value estimates is somewhat mixed, and suggests that reliable estimates could be limited to certain settings. Although the evidence from non-U.S. firms is important, differences in legal and business environments between the U.S. and other countries renders less clear the U.S. based standard setting implications of research conducted using data from foreign jurisdictions.
Holthausen and Watts (2001) and Lys (1996) review the value relevance literature and conclude that the implications of this literature for financial accounting standard setting are questionable. Barth et al. (2001) offer a differing perspective on this issue, however. For our part, we wish to highlight two limitations common to the value-relevance research discussed above. First, a statistically significant relation between fair value information and share prices could arise because the information set used by investors is correlated with (but does not necessarily include) the fair value information disclosed in the financial statements. Accordingly, existing research does not address whether users rely on the fair value information disclosed in the financial statements per se, or obtain this information from other sources. For example, banks provide significant loan and investment information through regulatory filings.

Second, the U.S. based research evidence is largely derived from analysis of companies for which financial instruments comprise core operating assets and liabilities (e.g., banks, insurance companies, closed-end mutual funds). Such firms may be fundamentally different than firms for which this is not the case, potentially calling into question the generalizability of the results to other sectors of the economy. For example, users of the financial statements of financial institutions might have a greater understanding of the extent to which reported and disclosed fair values are based on independently observed market prices versus internally generated estimates made by management. The origin (and corresponding reliability) of fair value estimates for the majority of companies in the U.S. (i.e., non-financial firms) might be less clear to investors.

Evidence reported in Wong (2000) is consistent with this view. In that study, Wong reports that neither aggregated nor disaggregated SFAS No. 119 fair value disclosures for derivatives provides incremental risk exposure information for a sample of 145 Fortune 500
manufacturing firms. His lack of statistically significant results could be attributable to research
design related factors (e.g., the size of the effect is so small as to be virtually undetectable) or
could reflect the fact that the Level 3 fair value estimates that comprise the disclosures are
insufficient and/or of indeterminate reliability. In the latter scenario, supplemental disclosures
about the process that generates the fair value estimates could provide incremental information
that aids investors in assessing the reliability of such estimates. The Committee believes that
explicitly reporting the process for determining the fair value estimates can be incrementally
informative to users of financial statements.

Overall, the Committee supports establishing a single standard to guide the measurement
of fair values, with the expectation that the availability of sufficiently reliable fair value
estimates will be a factor in determining whether a particular standard requires fair value
recognition. Further, the Committee supports increased disclosure of information about the
process used to estimate fair values. As we discuss in further detail in the next section, however,
we believe that additional disclosure beyond that proposed by the FASB would be informative to
the users of financial statement information.

RESPONSES TO SPECIFIC ISSUES

The FASB invited comment on all matters related to the ED, but specifically requested
comments on 14 listed issues. The Committee’s comments are limited to those issues for which
empirical research provides some insights, or those sections of the ED that are conceptually
inconsistent or unclear. The Committee has previously commented on other fair value related
documents issued by the FASB and other standard setting bodies. This letter reiterates comments
expressed in those letters to the extent they are germane to the measurement issues contained in
the ED. However, to better understand our perspective on reporting fair value information in the
financial statements and related notes, we refer readers to those comment letters (i.e. AAA FASC 1998, 2000).

**Issue 1: Definition of Fair Value**

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

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

Some members of the Committee, however, do not perceive an inconsistency between the definition and application of the fair value measurement attribute. These members view the
definition of fair value and the context within which it is applied (i.e. the valuation premise) to be distinct, albeit related, attributes. While the definition of fair value can be entity-independent, the valuation premise (e.g. value in-use or value in-exchange) cannot. Further, these members argue that ignoring the valuation premise in determining fair value could lead to unsatisfactory outcomes. For example, if installation costs are ignored regardless of the valuation premise, immediately after purchasing an asset for use in income producing activities, firms would suffer impairment losses equal to the installation costs incurred to prepare the assets for use.

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

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

Related to our previous comments, some members of the Committee perceive a contradiction between the definition of fair value in paragraphs 4 and 5 of the ED and the valuation premise described in paragraph 13. The definition of fair value provided in paragraph 5 of the ED suggests a pure value-in-exchange perspective where fair value is determined by the
market price that would occur between willing parties. In contrast, the valuation premise described in paragraph 13 suggests that the fair value estimate can follow either a value-in-use perspective or a value-in-exchange perspective.

Moreover, the fair value hierarchy described in the ED gives the highest priority to fair value measurements based on market inputs regardless of the valuation premise. Some members of the Committee feel that quoted market prices need not necessarily be an appropriate measure of fair value when a value in-use premise is being considered. This is especially true when a quoted price for an identical asset in an active reference market (i.e. a Level 1 estimate) exists, but is significantly different from a value-in-use estimate computed by taking the present value of the firm-specific future cash flows expected to be generated by the asset (i.e. a Level 3 estimate). In such instances, following the fair value hierarchy might lead to a fair value estimate more in character with a value in-exchange premise than a value in-use premise.

The Committee believes that: (a) integrating the two valuation premises (i.e. value in-use and value in-exchange) into the definition of fair value itself and (b) elaborating on the differences between the two premises would help ensure more consistent application of the standard.

**Issue 6: Reference Market**

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

In Example 5 (paragraph B9(b) of the ED) where two markets, A and B, are considered, price in Market B ($35) is more advantageous than the price in Market A ($25), ignoring transaction costs. However, the fair value estimate is determined using the price in Market A because the transactions cost in Market B ($20) is much higher than in Market A ($5). The guidance is less clear if we modify the example by reducing the transaction costs for Market B to $15. In this instance, neither market is advantageous in a “net” sense, but Market B would yield the highest fair value estimate (ignoring transaction costs), which provides managers an opportunity to pick the most desirable figure based on their reporting objectives.

Omitting transaction costs from the fair value estimate in Example 5 contrasts sharply with Example 3 (Appendix B, paragraph B7 (a)) where the in-use fair value estimate of a machine is determined by adjusting the quoted market price of a comparable machine by installation costs. Installation costs are ignored only if the firm intends to dispose of the asset (Appendix B, paragraph B7 (b)). Thus, managerial intent plays an integral role in determining whether fair value is computed with or without installation costs, but the same does not hold for transaction costs. The Committee agrees that ignoring transaction costs is justified when a value in-use premise is appropriate, but the Committee questions the appropriateness of ignoring transaction costs when a value in-exchange premise is adopted.

**Issue 7: Pricing in Active Dealer Markets**

The ED requires that the fair value of financial instruments traded in active dealer markets where bid and asked prices are readily available be estimated using bid prices for assets and asked prices for liabilities. Some Committee members believe that this requirement is
inconsistent with the general concept of fair value and seems to be biased toward valuing assets and liabilities at value in-exchange instead of value in-use. Limiting our discussion to the asset case, if a buyer establishes a long position through a dealer, the buyer must pay the asked price. By purchasing the asset at the asked price, the buyer clearly expects to earn an acceptable rate of return on the investment in the asset (at the higher price). Moreover, if after purchasing the asset, the buyer immediately applies the ED’s proposed fair value measurement guidance (i.e., bid price valuation), the buyer would incur a loss on the asset equal to the bid-ask spread.

In general, the bid price seems relevant only if the holder wishes to liquidate his/her position. Although the Committee is not largely in favor of managerial intent-based fair value measures, we are uncomfortable with a bias toward a value in-exchange premise for assets in-use. If the Board decides to retain bid-based (ask-based) accounting for dealer traded assets (liabilities) in the final standard, then we propose that the final standard more clearly describe the conceptual basis for liquidation basis asset and liability valuation.

**Issue 9: Level 3 Estimates**

Level 3 estimates require considerable judgment both in terms of the selection and application of valuation techniques. As a result, estimates using different valuation techniques with different assumptions will likely yield widely varying fair value estimates. Examples 7 and 8 in Appendix B of the ED illustrate the wide variance in fair value estimates obtained with different valuation techniques. The ED allows considerable latitude in both the valuation technique and inputs used. Due to their incentives, managers might use the flexibility afforded by the proposed standard to produce biased and unreliable estimates. The measurement guidance proposed in the ED is similar to the unstructured and imprecise category of standards analyzed by Nelson, Elliott and Tarpley (2002). They find that managers are more likely to attempt (and
auditors are less likely to question) earnings management under such standards compared to more precise standards.

The income approach to determining a Level 3 fair value estimate encompasses a basket of valuation techniques including two different present value techniques – the discount rate adjustment technique and the expected present value technique. The ED conjectures that these two techniques should produce the same fair values (see paragraphs A12, A13 & FN 17). But, from an application perspective, this conjecture is not consistent with empirical results from studies of human judgment and decision making. In particular, psychology research repeatedly shows that people are very poor intuitive statisticians (e.g., people consistently make axiomatic violations when estimating probabilistic outcomes). In light of these findings, statements such as “the estimated fair values should be the same” provide preparers, auditors, and users with an unfounded (and descriptively false) belief that the techniques suggested in the ED will produce the same fair value estimates.

Some members of the Committee believe that the ED should explicitly caution preparers, auditors, and users by stating that individuals consistently make these judgment errors. Further, these Committee members recommend that the ED require companies (when practicable) to (i) independently use the discount rate adjustment and expected present value techniques if they decide to use a present value approach to determine fair value and (ii) reconcile the results of the two techniques in a meaningful fashion and document the reconciliation so it can be audited for reasonableness. Moreover, the application of the present value techniques should be independent

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4 FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, describes these techniques, albeit using different terminology. In that Concepts statement, traditional present value refers to the discount rate adjustment technique, while expected cash flow approach refers to the expected present value technique.

5 Probability-related judgments and decisions are among the oldest branches of psychology and decision-science research. Two excellent resources that catalog the problems that individuals have with probability judgments and statistical reasoning are Baron (2000) and Goldstein and Hogarth (1997).
of suggested or existing fair value figures when practicable (e.g., the fair value amount recorded in the previous year’s financial statements), since psychology research finds that pre-conceived targets and legacy amounts unduly influence current judgments and decisions (e.g., through “anchoring” and insufficient adjustment).

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

**Issue 11: Fair Value Disclosures**

As mentioned previously, the Committee believes that the proposed fair value measurement disclosures are not complete. The Committee believes that when a firm uses alternative valuation methods to determine fair value, information regarding the alternative techniques and inputs employed should be provided. Furthermore, users of financial statements would get a better understanding of the reliability of fair value estimates if detailed disclosures are provided on (i) fair value estimates produced by alternative valuation techniques and reasons for selecting a preferred estimate, and (ii) information about the sensitivity of fair value estimates to changes in assumptions and inputs.

The Committee also notes that the expanded set of reliability related disclosures is only required for fair value estimates reported in the balance sheet (paragraph 25). A complete set of financial statements also includes many fair value estimates that are reported in the notes to the financial statements. Some members of the Committee believe that financial statement users
would benefit from receiving the reliability related disclosures for fair values disclosed in the footnotes. Moreover, application of the fair value hierarchy has implications for the reliability of the unrealized gains and losses reported in net (or comprehensive) income. Accordingly, some members recommend that firms be required to disclose a breakdown of unrealized gains or losses based on how the related fair value amounts were determined (i.e., quoted prices of identical items, quoted prices of similar items, valuation models with significant market inputs or valuation models with significant entity inputs.)

**CONCLUSION**

Although the Committee recognizes that the ED is intended to provide fair value measurement guidance, we wish to caution against promulgating pronouncements that completely eliminate historical cost information from the financial statements. Evidence reported in Dietrich, et al. (2000) suggests that historical cost information is incrementally informative even after fair value information is included in regression analyses.

The Committee supports the formulation of a single standard that provides guidance on fair value measurement. We believe that such a standard would improve the consistency of fair value measurement across the many standards that require fair value reporting and disclosure. In this comment letter we identify some potential inconsistencies between fair value definitions and fair value determination, and suggest ways to improve disclosures so that users of financial statements can better appreciate the reliability (or lack thereof) of fair value estimates.
REFERENCES


