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Response to FASB Exposure Draft, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115"

American Accounting Association's Financial Accounting Standards Committee
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INTRODUCTION AND OVERVIEW OF THE EXPOSURE DRAFT

The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged with responding to requests for comments from standard-setters on issues related to financial reporting. The Committee is pleased to respond to the Financial Accounting Standards Board (FASB) Exposure Draft, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115" (hereafter, the ED), issued in January 2006. The comments in this letter reflect the views of the individuals on the Committee and not necessarily those of the American Accounting Association.

The ED proposes a fair value option under which, on a contract-by-contract basis, entities may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities.[1] All fair value changes must be reflected in earnings, including, in the case of debt liabilities, gains and losses resulting from changes in the preparer's own creditworthiness. To compensate for the lack of comparability due to the fair value option, the ED requires certain financial statement presentations and disclosures. A key requirement is that on the Statement of Financial Position preparers must distinguish between assets and liabilities measured pursuant to the fair value election and

[1] Also included within the scope of the ED are unrecognized firm commitments that involve only financial instruments. Scope exceptions include investments that the preparer would otherwise consolidate, financial obligations for pension benefits, other postretirement benefits, employee stock option and stock purchase plans, financial liabilities recognized under lease contracts, and financial liabilities for demand deposit accounts.

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assets and liabilities measured using another measurement attribute. The ED also requires various disclosures, including information useful in assessing how changes in fair values affect earnings.

The fair value option is intended to allow preparers to offset the accounting effects of fair value changes in related assets and liabilities without having to apply complex hedge accounting rules. To the extent companies currently apply different measurement attributes to hedged sets of financial instruments, the proposed rule could mitigate the volatility in reported earnings arising from the mixed-attribute accounting model currently in place. The FASB is concerned that the ''effect on earnings from using mixed measurement attributes under U.S. GAAP may not be representative of the economics of the reporting entity's activities.''[2] By providing a fair value option, the ED also furthers the FASB's objective of achieving international convergence in financial reporting standards as the International Accounting Standards Board (IASB) has recently incorporated a fair value option into its authoritative literature (IASB 2005).

The ED differs from FASB's previous proposals along several important dimensions. For example, the FASB's recent Exposure Draft, ''Fair Value Measurements,'' proposes guidance for measuring fair value estimates of financial and nonfinancial assets and liabilities required by other authoritative accounting pronouncements.[3] In contrast, the ED remains silent regarding measurement issues, includes only financial assets and liabilities, and allows the preparer (not the standard-setter) to determine, without justification, when to apply the fair value measurement basis.

Although the Committee continues to support the use of fair value as a measurement attribute in settings where fair values are obtained from actively traded markets, we have a number of reservations about the approach taken in this ED. Specifically, the Committee is concerned that an unconstrained contract-by-contract election of fair value will reduce the reliability and transparency of financial information, and impose additional costs on the users of that information. The Committee is also concerned that the ED does not provide sufficient guidance regarding the presentation of fair value information in the financial statements and related footnotes.

The remainder of our response proceeds as follows. In the next section, we summarize relevant academic research. We follow this discussion with specific comments on the ED. We conclude with a summary of our perspective on fair value accounting and the fair value option.

RELEVANT RESEARCH

Two areas of academic research are of central importance to the ED. The first examines the joint relevance and reliability of fair value estimates for financial instruments. The second examines the determinants and consequences of managers' accounting choices.

Research on Fair Value Estimates

Early research on fair value accounting focused on the relevance and reliability of financial instrument fair value estimates reported by banks and, to a lesser extent, other financial institutions such as property-casualty insurers and closed-end mutual funds. This early work generally shows that fair values obtained from actively traded markets are more

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[2] Available at: http://www.fasb.org/project/fv_option.shtml.

[3] Prior FASB proposals also retained the authority of standard-setters to determine which financial instruments should be reported at fair value, and focused on other fair value reporting issues, such as disclosure versus recognition. For additional discussion of prior fair value proposals, see AAA FASC (1998, 2000, 2005).

reliably associated with share prices than fair value estimates derived from thinly traded markets or internal estimation models. In this section, we summarize the findings of more recent academic research, most of which also examines fair value estimates using accounting data of commercial banks and other financial institutions. Because the core operations of these firms comprise financial instruments, their valuation may be subject to fewer reliability concerns. In addition, financial instruments play a pervasive role in these firms' operations, so an income measure that includes changes in financial instruments' fair value estimates could be a sufficiently reliable proxy for financial performance. The Committee notes that the findings of the extant literature may not be readily generalizable to a broader class of firms and financial instruments.

Hodder et al. (2006) examine the properties of GAAP net income, GAAP comprehensive income, and a computed proxy for a full fair value (FFV) income measure that includes all fair value changes in income for a sample of more than 200 commercial banks. The authors find that earnings volatility under FFV measurement is more than three times the volatility of currently reported comprehensive income, and more than five times the volatility of currently reported GAAP net income. In addition, they find the incremental volatility in FFV income is associated with various measures of market risk and expected returns, including CAPM beta, the sensitivity of stock returns to changes in interest rates, and the volatility of stock returns. They conclude that FFV income volatility ''relates more closely to capital-market pricing of that risk than either net-income volatility or comprehensive-income volatility'' (Hodder et al. 2006, 337).

Three observations emerge from the Hodder et al. (2006) study. First, the authors address the concern raised by some financial institutions that FFV accounting could lead to excess income volatility not commensurate with economic realities. Second, in a valuation context, market participants are interested in assessing both the expected future cash flows and the appropriate discount rate for those cash flows. Loosely speaking, these two components are analogous to the numerator and denominator, respectively, of a shortcut, income-annuity-type valuation model. Prior research has focused on the association between stock prices and fair values of financial assets and liabilities, and thus has not provided evidence on the usefulness of fair value information for estimating the numerator versus the denominator. The study is an early attempt to show that fair value information reported by financial institutions may be relevant in risk or discount rate assessment. Third, the study results suggest that, for assessing risk, market participants use information that is highly correlated with the volatility of financial institutions' FFV income. While the results do not necessarily suggest that the market actually uses the fair value estimates in assessing risk, greater inclusion of fair value estimates could make financial statements a more comprehensive source of value relevant information for financial institutions.

Another recent study, Hirst et al. (2004), examines how disclosure versus recognition of fair value estimates affects equity analysts' risk and value judgments. Using an experimental research design, the study compares a FFV model (where all fair value changes are included in net income) with a partial recognition model (where some fair value changes flow through the income statement, and the rest are disclosed in footnotes). The research reveals that risk and value judgments of bank equity analysts reflect differences in interest-rate risk only under FFV income measurement. Under the partial recognition approach, the study finds that equity analysts do not distinguish between banks with exposed and hedged risk positions. If fair value accounting is appropriate, then Hirst et al.'s (2004) findings suggest that recognition under FFV income measurement is more likely to enable equity analysts to reach informed risk and value judgments.

Ahmed et al. (2006) examine if investors' valuation of derivative financial instruments depends on whether the fair value of these instruments is recognized or disclosed. Using a sample of banks that simultaneously held recognized and disclosed derivatives prior to SFAS No. 133, the study finds that recognized derivatives fair values are value relevant (i.e., associated with stock prices), whereas disclosed fair values are not. The study also compares the value relevance of derivatives fair values disclosed in banks' footnotes in the pre-SFAS No. 133 regime to the value relevance of derivatives fair values required to be recognized in financial statements after SFAS No. 133. Using a sample of banks that had only disclosed derivatives prior to SFAS No. 133, Ahmed et al. (2006) find no evidence of value relevance for the fair value of derivatives in the pre-SFAS No. 133 period (when they were disclosed in footnotes), but find consistent evidence of an association between stock prices and derivatives fair values for the same set of banks in the post-SFAS No. 133 period (when they were recognized in financial statements). Taken together, Hirst et al. (2004) and Ahmed et al. (2006) suggest that financial statement recognition and footnote disclosure are not substitutes. Overall, the ED's requirement to report fair value changes in GAAP income under the fair value option is consistent with recent evidence in academic research on the saliency of recognized items compared with disclosed items.[4]

In summary, recognition of additional financial instrument fair values is consistent with the evidence in recent research on the banking industry that firm risk is better captured by the volatility of full fair value income than the volatility of net income or comprehensive income under current GAAP, and that capital market participants are more likely to use recognized fair value numbers than they are to use disclosed numbers. However, this research examines only the relevance and reliability of fair value estimates for an industry in which the core operations comprise financial instruments. Therefore, the Committee reiterates that these findings may not readily generalize to a broader class of firms.

While the predominant empirical archival research on fair value accounting focuses on issues relating to risk assessment, relevance versus reliability, and disclosure versus recognition, emerging theoretical research in accounting emphasizes the macroeconomic implications of a switch to fair value accounting (Plantin et al. 2005, 2006; Allen and Carletti 2006; Gorton et al. 2006). Although this research does not directly address the narrow issues raised in the ED, the Committee believes that standard setters should consider some of the broader consequences of a move to a fair value accounting regime.[5]

In a frictionless or perfect market, prices of assets and liabilities fully reflect the fundamentals, thereby providing an unambiguous case for mark-to-market accounting.[6] The

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[4] The Committee notes that the emphasis by market participants on recognized versus disclosed items could be due to perceived or actual differences in reliability. When FASB issued its "Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value (Preliminary Views)" on December 14, 1999, Ernst & Young, in a comment letter dated May 26, 2000, specifically raised the issue of the difficulty in determining whether "sufficient, objective verifiable evidence exists to audit" fair value estimates. The comment letter also distinguished between recognized items and footnote disclosures: "Although verifiability problems also are present in auditing fair value disclosures under Statement 107, the problems generally would be more pronounced in the primary financial statements because of the greater focus on those statements by users." This view appears to suggest that audit firms may employ a higher standard for "sufficient, objective verifiable evidence" when auditing recognized items versus disclosed items, and that preparers may use a correspondingly higher measurement standard for recognized items. Recent experimental evidence in Libby et al. (2006) suggests that auditors have different perceptions of the reliability of disclosed versus recognized financial statement items in the context of stock-compensation and leases.

[5] In at least one instance, the FASB has considered the broader economic consequences of a new accounting standard. See Herz and Batavick (2004) for a discussion of the capital allocative efficiency of expensing employee stock options.

[6] The role of accounting would be quite trivial in that world given "market prices are fully observable and common knowledge to all" (Plantin et al. 2006, 2).

argument in the theoretical literature is that when more than one imperfection exists in a market, merely removing one of them may not improve overall welfare (Plantin et al. 2005). In fact, a benign attempt to correct a single imperfection (e.g., move to fair value accounting) in a dynamic market may potentially exacerbate the adverse effects of other imperfections (e.g., agency problems). The key insight is that in an imperfect fair value world, prices would reflect not only fundamentals, but would also influence the behavior of market participants, thereby affecting market outcomes. The influence is likely to be more pronounced when fair value numbers are incorporated into financial statements that have been certified or subject to "independent assurance" testing. In this world, market participants' actions would reflect fundamentals as well as strategic behavior; consequently, a portion of the market price volatility is endogenously driven by the fair value accounting regime. The ultimate consequence is that real decisions are muddled by the accounting measurements (Plantin et al. 2005, 2006). What is more, the excess "accounting-based" volatility is more likely when assets (or liabilities) subject to mark-to-market accounting are long-lived, illiquid, or senior—the same categories of assets (or liabilities) that are likely to have large measurement issues in a fair value world. Overall, emerging theoretical work suggests that the very fact balance sheets are mark-to-market values can make asset prices less value relevant (Gorton et al. 2006). While the theoretical research raises issues that the FASB might consider as beyond its purview of the ED, the Committee believes that the FASB should consider the broader economic consequences of a move to a complete fair value accounting in the long run and a comprehensive fair value option in the near future (Phase 2).

Research on Managers' Accounting Choices

Another area of academic research related to the ED is the work examining the determinants and consequences of managers' accounting choices, which generally show that managers act opportunistically with respect to accounting policy choices (see AAA FASC [2004] for a summary of this literature). The evidence is mixed, however, regarding whether market participants see through managers' opportunistic behavior.

In considering the implications of this prior research, the Committee emphasizes that there are several key differences between the accounting choices examined in the extant literature and the fair value election proposed by the ED. For example, the accounting choices studied in the prior literature were at the entity or account level, not the contract-by-contract level proposed by the ED. Although the contract-by-contract option may increase managerial manipulation, the irrevocability of the option may restrict the ability of managers to opportunistically change the measurement basis.

SPECIFIC COMMENTS IN RESPONSE TO ISSUES IN THE ED

Before the Committee addresses the seven issues for which the FASB is seeking comment (i.e., five scope issues, one credit risk issue, and one disclosure issue), we provide comments on the financial reporting philosophy underlying the ED. As noted in paragraph A3(d) of the ED, the FASB believes fair values provide more relevant and understandable information than cost or cost-based measures. The Committee conceptually agrees with this view on applying fair value as a measurement attribute for most financial instruments. However, this view is predicated on the systematic, transparent reporting of reliable fair value information by all firms operating in similar economic circumstances.

The Committee is concerned that the fair value option included in the current ED will result in unsystematic and nontransparent reporting of fair value information by firms. In particular, the ED proposes that the current mixed-attribute measurement model become even more fragmented, with fair value and nonfair value measurements available on a contract-by-contract basis for an increased set of balance sheet accounts.[7] The Committee notes that the actual transparency of information in any context is jointly determined by features of the sources of information (e.g., financial statements) and features of the persons attempting to use those information sources (e.g., investors). Research indicates that analysts and investors already have difficulty comprehending and using information in the current mixed-attribute reporting environment (e.g., Hirst and Hopkins 1998). Allowing firms to choose different measurement attributes on a contract-by-contract basis for otherwise identical financial instruments will likely lead to diminished comparability within and between companies and over time. Therefore, the actual transparency of financial information will likely also be diminished.[8]

The Committee believes that an entity-wide or account-level option for fair value reporting is more consistent with the choices typically given to preparers for financial reporting recognition and measurement. At this level of election, the Committee believes that the market for accounting information would, in equilibrium, lead to selection of the appropriate accounting model for different entities. For instance, if sophisticated financial institutions prefer fair value accounting, and if the users of their financial statements believe similarly, then market forces would lead to the choice of fair value accounting for entities in that segment of the capital market. However, the ED does not provide a convincing rationale for allowing preparers to elect fair value as the measurement basis for financial instruments on a contract-by-contract basis rather than at the entity or account level. Further, the Committee is unable to identify the means through which an unconstrained contract-by-contract election will lead to improved financial reporting.[9]

In addition, the Committee is concerned that the ED is inconsistent with the perspective taken in SFAS No. 154, *Accounting Changes and Error Corrections.* The Committee presumes that a change in the measurement basis from historical cost to fair value would be considered a change in accounting principle. SFAS No. 154 discusses the importance of consistent application of accounting principles to similar types of transactions:

> A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data. (SFAS No. 154, ¶4)
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> In the preparation of financial statements, once an accounting principle is adopted, it shall be used consistently in accounting for similar events and transactions. (SFAS No. 154, ¶12)

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[7] We currently see this type of contract-by-contract accounting for one financial instrument—marketable securities. However, even here the Committee notes that the firm's designation of marketable securities is limited by management's intent regarding its use (i.e., trading, available-for-sale, or held-to-maturity).

[8] The Committee notes that analysts and investors often use data services (e.g., Compustat) to compile basic financial statement information. Expanding the existing set of common financial statement accounts to include alternative measurement bases will likely also lead to a higher incidence of miscoding (i.e., measurement error) in these data sets. Under the current reporting model, the appearance of common accounts in financial statements jointly conveys information about the underlying structural properties of the reported item and the attribute used to measure the item. The proposed fair value option will erode this diagnostic relationship.

[9] As Schipper (2003, 62–63) indicates, "if similar things are accounted for the same way, either across firms or over time, it becomes possible to assess financial reports of different entities, or the same entity at different points in time, so as to discern the underlying economic events. If little value is attached to having the same accounting treatment applied to identified classes of similar items, then preparers of financial reports could reasonably be left to choose the reporting that best suited their own communication strategies." One possibility is that the FASB believes that either the consistency principle is of little value in the given context or the firm disclosures would be transparent regarding their communication strategies.

The Committee acknowledges that the fair value option is more consistent with the FASB's stated preference for fair value accounting (SFAS No. 154, ¶14; ED, ¶A3). However, by allowing preparers to choose, without justification, between fair value and another measurement basis for similar events and transactions, the Committee believes the ED is inconsistent with the spirit of SFAS No. 154. The Committee recommends that the final standard refer to the requirements in SFAS No. 154 for consistent application of accounting principles for similar events and transactions.

The ED also does not provide guidance on the level at which the "unit of account" should be determined for estimation purposes. For example, consider warranty obligations. The ED would allow the provider of a warranty to elect the fair value option for each warranty contract. However, the ED is silent as to whether the fair value measurement must be done on a contract-by-contract basis. If the preparer regularly provides warranties, then the expected cash flows likely can be better estimated at the portfolio level, rather than at a single contract level. The Committee believes that the FASB should provide some guidance on the appropriate unit of account to mitigate implementation concerns.

Scope (Issues 1 through 5)

The Committee has reservations about the broad scope of the ED, both in general and in relation to IAS No. 39. Specifically, the Committee is concerned that the ED does not propose reasonable limitations on firms' ability to elect the fair value option. An example of such a limitation is provided in the IASB's amendment to IAS No. 39, which does not allow the fair value option when "investments in equity instruments ... do not have a quoted market price in an active market, and whose fair values cannot be reliably measured" (IASB 2005, ¶9). As another example, the IASB's amendment to IAS No. 39 limits the eligibility of the fair value option to cases where fair value measurement of financial instruments significantly reduces an "accounting mismatch" under current GAAP, or where a group of financial instruments are managed on a fair value basis in accordance with a documented risk management or investment strategy. The IASB requires firms to provide narrative description as to how one or both of these conditions are met. Although the FASB includes international convergence as a motivation for proposing the ED, differences between the ED and IAS No. 39 may impede progress in attaining convergence. The Committee suggests that scope limitations of the type in IAS No. 39 should be considered by the FASB.

The Committee is also concerned that the ED does not provide for the disclosure of historical cost information for financial instruments recognized at fair value pursuant to the fair value option. Although the FASB did not invite comments on the reporting of supplemental historical cost information and the previously discussed reliability concerns, the Committee believes they are important components of an informative fair value reporting framework.

The remainder of this section summarizes the Committee's views with respect to more specific scope issues. The scope of the ED includes investments being accounted for under the equity method and investments in equity securities that do not have readily determinable fair values, and excludes other financial assets and liabilities, such as pensions, leases, demand deposits, and investments that would otherwise be consolidated. In the following paragraphs, we summarize recent research related to some specific items listed in the scope-related issues.

With respect to equity method investments, Graham et al. (2003) find that fair value disclosures of equity method investments with a quoted market price are associated with stock prices and returns of investor firms. The ED's inclusion of equity method investments is consistent with Graham et al.'s (2003) call for the FASB to re-examine its prior decision to exclude all equity method investments from fair value recognition or disclosure. However, as Graham et al. (2003) acknowledge, their analysis is based on investments with quoted stock prices. Consequently, their findings may not generalize to privately held investments for which fair value estimates may be less reliable. The IASB's decision to limit fair value accounting to equity method investments with quoted market prices is consistent with the Committee's concerns regarding reliability of fair value estimates of privately held equity method investments, as discussed above.

With respect to scope exceptions, the ED indicates that demand deposits are excluded because their fair values include a nonfinancial component, presumably representing the economic value of core deposits. Barth et al. (1996) find that the value of core deposit intangibles is reflected in bank stock prices. Their statistical estimates suggest that core deposits command a premium of 5 to 7 cents on the dollar. Recall our earlier discussion notes that Hodder et al. (2006) find that the incremental volatility in full fair value income is associated with various measures of market risk and expected return. In calculating full fair value income, Hodder et al. (2006, 372) include a researcher-constructed estimate of the fair value of demand deposits that is based on a static discounted cash flow approach used by bank regulators that "calibrates demand deposit prices to observed prices for deposit purchase/assumption transactions." Although this approach does not consider the value of an intangible asset that is associated with core deposits, it does suggest that conventional regulatory valuation of the financial component of demand deposits provides information that is relevant to investors. The Committee is unable to provide additional guidance to the FASB, however, given that Hodder et al. (2006) do not isolate the importance of demand deposit valuation to the incremental ability of the full fair value accounting model to explain changes in market risk and expected return.

Changes in Creditworthiness (Issue 6)

Under the ED, a preparer electing the fair value option for its debt would report changes in fair value of those liabilities as gains and losses in earnings, including those resulting from changes in the preparer's own creditworthiness. Given the ED's focus on valuation of liabilities, we briefly highlight the prior research findings on the value relevance of liabilities. Existing research provides mixed evidence for a relation between share prices and fair values of financial liabilities for which there is no established market. Barth et al. (1996) find weak support for an association between bank stock prices and the difference between the fair value and book value of their long-term debt. Venkatachalam (1996) finds that changes in the fair value of long-term debt are weakly associated with changes in market value of the equity of banks. Other studies in the banking industry (Eccher et al. 1996; Nelson 1996) find no reliable evidence for the value relevance of financial liabilities. Simko (1999) examines the association between liability fair values and stock prices of nonfinancial companies. He finds a significant association in periods when the fair values of liabilities are substantially lower than their book values. However, in each year the explanatory power is consistently lower for industries whose returns exhibit low covariation with observed interest rate changes. Regarding the value relevance of financial instruments, he concludes that "fair values is limited in the absence of consideration of nonfinancial instrument fair values" (Simko 1999, 247).

The above studies are primarily based on data disclosed under the requirements of SFAS No. 107 and SFAS No. 119. Note that the definition of fair value in SFAS No. 107 focuses on the amount market participants would be willing to pay, similar to that in the FASB's Exposure Draft, "Fair Value Measurements" (FASB 2004). Given that an issuer's creditworthiness impacts market participants' assessments of the value of the issuer's liabilities, the fair value estimates disclosed under the requirements of SFAS No. 107 and SFAS No. 119 should have considered the issuer's credit risk. To the extent this was the case, the results in the prior literature are relevant to the FASB.

A limited set of academic studies directly examine the effects of changes in the creditworthiness of debt issuers on the value relevance of their liabilities. Lipe (2002) examines the potential effects of applying fair value accounting to Boston Chicken's debt instruments during a time when the company's credit quality substantially deteriorated. Based on this case study, Lipe (2002) concludes that a partial application of fair value accounting could result in financial statements that do not reflect the economic realities of companies facing financial distress. Using the option pricing framework and a large sample of firms, Barth et al. (2006) examine how recognizing changes in the fair value of debt would impact financial statements. Under a full fair value accounting system, where unrealized gains/losses of all assets and liabilities are recognized in net income, companies would report higher (lower) net income than under the current GAAP when their creditworthiness improves (deteriorates). Not surprisingly, if fair value changes of *only* debt/liabilities were recognized, then firms with improved (worsened) credit ratings would report lower (higher) net income compared with that under current GAAP. However, Barth et al. (2006) find that the sign of the current GAAP net income, in most instances, would not change if the fair value changes of all assets were excluded from net income. The limited academic evidence of which the Committee is aware suggests that fair value measurement of liabilities could potentially bias the magnitude of net income figures because of the current mixed-attribute measurement model (i.e., to the extent there are significant unrealized and unrecognized gains/losses from assets).

Presentation and Disclosure Requirements (Issue 7)

The ED requires companies choosing the fair value option to include in net income all fair value changes for the affected financial instruments. As noted above, prior research suggests that inclusion of fair value changes in income can improve the usefulness of banks' financial statements (e.g., Hirst et al. 2004; Hodder et al. 2006). In their experimental study, Hirst et al. (2004) use a comprehensive income-type format to present net income under the full fair value approach. However, the ED does not provide guidance on the structure of fair value information in the income statement.[10]

Although fair value information may be incrementally relevant, the Committee believes insufficient justification exists for abandoning the current accounting model without fully developing a framework for performance statement presentation of fair value changes. For example, under the accounting proposed in the ED, a preparer could elect the fair value option for a new account receivable generated from regular product sales or for a new account payable arising from the purchase of inventory, provided that the receivable and payable are to be settled in cash. Consequently, the initial recognition of receivables and payables, as well as the subsequent recognition of changes in their fair values (e.g., changes in expected bad debts), would be included in the income statement.

The Committee suggests that the FASB consider providing guidance to income statement preparers as to how to recognize fair values and subsequent changes. The absence of

[10] "The Board decided that an entity should provide information that would allow users to understand the effect of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election, but did not prescribe detailed guidance on where and how that information should be reported" (ED, p. iii).

guidance could lead to disparate accounting practices, opportunistic presentation, aggregation on the face of the performance statement, and further noncomparability in financial reporting.

The Committee believes that the effect on information-processing costs could be substantial. Given the long history behind the evolution of the current accounting model, market participants have developed various analytical metrics based on the current financial reporting system to assess the timing, magnitude, and uncertainty of the future cash flows of a business. For example, consider the case of commercial banks. Based on the current accounting model, various market participants, including bank analysts and regulators, frequently use a set of financial accounting metrics commonly referred to as ''CAMEL'' (capital adequacy, asset quality, management, earnings, and liquidity).[11] These metrics are proxies for the net interest spread earned, ability to generate non-interest income, operating efficiency, loan quality, balance sheet management, and growth.

If various preparers adopt different approaches to reporting fair value changes in income statements, such disparities will unnecessarily burden the user community. Consequently, the Committee suggests that the FASB provide specific guidance on how the income statement should report fair value changes. For financial instruments whose fair value changes are not contemporaneously included in GAAP net income under existing accounting standards, the FASB could adopt an approach similar to the current reporting standard for other comprehensive income.

This approach offers at least two potential benefits. First, to the extent current GAAP net income satisfies a higher threshold of verifiability than the net income concept envisioned in the ED, market participants could benefit from separation of the current GAAP net income from the additional fair value changes (see Glover et al. 2005).

Second, the use of an ''other comprehensive income'' format would preserve some comparability between financial statements of preparers choosing the fair value option and those preparers that forgo the fair value option. Prior research has consistently shown that presentation format is a key determinant of the effectiveness with which users process information (Hirst and Hopkins 1998; and related papers). Without specific guidance on the presentation format, preparers might choose disparate reporting formats, potentially increasing user information processing costs and reducing the usefulness of the fair value estimates.

Finally, paragraph 6 of the ED requires that the ''election of the fair value option shall be supported by concurrent documentation or a preexisting documented policy for automatic election.''[12] However, the ED does not require preparers to disclose their policy, if any, regarding the contract-by-contract fair value election. The Committee believes that disclosures regarding the reasons for the fair value election, including a discussion of any policy for automatic election, would assist financial statement users in evaluating the rationale behind the accounting choice.

SUMMARY AND CONCLUSIONS

The Committee believes that expanded fair-value-based financial statements may provide users useful information, provided the fair value estimates are reliable. Recent research

[11] Available at: http://www.fdic.gov/bank/individual/bank/index.html.

[12] The Committee would like the FASB to examine whether a preexisting policy for election would be considered an accounting choice. If so, then the final standard should indicate that any changes in the preexisting policy must comply with the requirements of SFAS No. 154.

using fair value data on financial institutions suggests that proxies for full fair value income may help investors better assess firms' risk. In addition, extant research suggests that the *recognition* of fair value changes may increase the salience of fair value numbers to market participants. However, the academic research on fair value accounting has focused mostly on financial institutions, where the core business operations include financial instruments. The Committee is concerned with the FASB's proposal to apply fair value accounting to a broader set of firms without first sufficiently addressing reliability concerns. In addition, the ED provides limited guidance on the income statement presentation of fair value earnings as well as on the extent of footnote disclosure. The Committee believes that presentation and disclosure are important considerations in developing a fair value financial reporting model. In addition, the Committee is not convinced that a contract-by-contract fair value option would necessarily improve the quality of financial reporting and constrain opportunistic earnings management.

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