CFA INSTITUTE
Centre for Financial Market Integrity

15 September 2006

Sir David Tweedie
Chair, International Accounting Standards Board
30 Cannon Street
London EC4M 6Xh
United Kingdom

Re: Discussion Paper – Measurement Bases for Financial Accounting – Measurement on Initial Recognition

Dear Sir David:

The CFA Centre for Financial Market Integrity (CFA Centre) of CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") Discussion Paper – *Measurement Bases for Financial Accounting – Measurement on Initial Recognition* ("DP"). The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

General Comments

Instead of commenting on specific issues addressed in the DP, we would like to provide some comments regarding key aspects of fair value measurement and why believe that fair value measurement is superior to other measurements, such as historical cost, replacement cost or other variations of these measurements.

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 85,000 financial analysts, portfolio managers, and other investment professionals located in 129 countries of which more than 68,000 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 134 affiliated Member Societies and Chapters in 55 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council comprises individuals, who are investment professionals with extensive expertise and experience in the global capital markets, as well as CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures which meet the needs of investors.

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Why Fair Value versus Other Measurements

The CFA Institute has expressed a long-standing preference for measuring a company's assets and obligations at fair value. In 1993, CFA Institute observed:

> *It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past…Historic cost itself is in reality historic market value, the amount of a past transaction engaged in by the firm…Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms (or even within a single firm). There is no financial analyst who would not want to know the market value of individual assets and liabilities.*[3]

More recently, the CFA Centre's noted in its draft paper "A Comprehensive Business Reporting Model: Financial Reporting for Investors" (the Paper):

> *Decisions about whether to purchase, sell, or hold investments are based upon the fair values of the investments and expectations about future changes in their fair values. Financial statements based on outdated historical costs are less useful for making such assessments. **Fair values, by definition, impound all of the most current assessments about the value of an investment and any future changes in that value**. [Emphasis added.]*
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> *To be useful in making these assessments, reported information must be timely, accurate, understandable, and comprehensive. **The financial statements must recognize, as they occur, all events or transactions that affect the value of the company's net assets and, hence, common shareowners' wealth.** [Emphasis added.]*

Fair value measures, we believe, reflect the most current and complete estimations of the value of the asset or obligation by including the amounts, timing, and riskiness of the expected future cash flows attributable to a particular asset or obligation. If financial decisions are based upon the underlying attributes of fair values, it seems only logical that market participants would seek to have and thus, require information which embodies such values.

To this end, items in the statement of financial position must be reported at current fair value and changes in these values should be reported as they occur in the statement of recognized earnings and expenses. Therefore, simply providing note disclosures with fair value information is not adequate. In other words, disclosure is not a substitute for the proper measurement and recognition of items in the financial statements.

[3] *Financial Reporting in the 1990s and Beyond*, Association for Investment Management and Research, 1993, p. 39.

The Current Mixed-Attribute Model

Currently, financial statements include some items reported using a continuum of measurements with historical cost at one end and market-based values at the other end, and in combination, result in the so-called *mixed-attribute model* for measurement and recognition. Unfortunately, investors who rely on fair values for decision making must expend considerable effort trying to restate to fair value all decision-relevant financial statement items that are measured at historical cost or some other variation of this basis. Their success depends on the sufficiency of disclosure and on the relative reliability of the measurements in the disclosures. Most, if not all, of this effort would be eliminated if the financial reporting standards were to require that companies record assets and liabilities at fair value at inception with periodic revaluation. Indeed, the managers of companies have the best knowledge of the values of the assets and liabilities and, presumably, base their own investment decisions on behalf of the company on such values.

Volatility and Risks

Opponents of fair value reporting argue that measuring and recognizing assets and liabilities at fair value in the financial statements *introduces* volatility into the financial statements. We argue to the contrary: If fair value measurement results in greater volatility, then the measurement has merely unmasked the true economic reality that was already there. Moreover, we argue that historical cost based measurements produce smoothed results and thus, provide little or no value in assessing the underlying risks, and the exposure to those risks, affecting the value of a company's asset and/or obligation.

One of the most important evaluations investors must make is to ascertain the degree of risk to which an investment is exposed: the greater the volatility, the greater the risk. The risk is then weighed against the investment's expected returns. Reporting methods that mask true volatility do a great disservice to investors, impair their ability to make well-founded investment decisions, and can result in inefficient allocations of capital.

If managers choose to hedge economic risks, then comprehensive fair value reporting will allow better hedging decisions and reflect the extent to which these hedging activities have been successful. To achieve this, the reporting should provide full fair value disclosure of both (1) the economic risks hedged and (2) the results of the hedging activities. That is, the fair values for the hedged items and their related hedges must not be netted or deferred, concealing both the underlying risks and management's activities to alter or manage those risks.

Valuation Premise

Generally, we believe that the relevant valuation premise for assets and liabilities is **value-in-exchange**, unless forced liquidation is imminent. The valuation premise should seek to minimize the use of entity-specific subjective factors which are used in determining a **value-in-use** measurement. For example, to the extent that the valuation premise considers physical location of real estate or other non-financial assets, an attribute of the asset itself and not management's intent for the asset, we concur that this is appropriate. We would not deem it appropriate for the valuation of an asset to be biased upward relative to a value-in-exchange amount simply because management intends to continue using the asset.

Estimating Fair Value

In the absence of an actual exchange transaction for an asset or liability, we believe that the fair value (market exchange price) should be estimated. Further, in determining the estimate, the *current* exchange transaction is an appropriate benchmark for measurement and for assessing the quality of the measurement. We believe that managers should look first to the most objective sources of fair value, for example, observable prices for the same or similar assets or liabilities in liquid markets. In the absence of such market-determined measurements, managers must report the best estimate of fair value as determined by widely accepted and applied valuation methods and by using market-based inputs.[4]

Although we have some concerns about certain aspects of the measurement and recognition process, we believe it is essential that adoption of fair value measurements proceed. It is our view that the FASB's guidance in its proposed Statement on Fair Value Measurement, together with other applicable valuation standards and generally accepted valuation practices, provide a sufficient basis for proceeding with fair value. Over time as market participants - issuers, auditors, valuation specialists, investors and creditors - gain practical experience in producing and using fair value measurements, we would expect to see fine tuning of guidance addressing the application of fair value measurements.

Hierarchy of Fair Value Measurements

We believe that the following are key elements for determining a hierarchy of fair value measurements

- The *highest priority or weighting* should be given to market inputs that reflect quoted prices in active markets for identical assets and liabilities;

[4] The FASB expects to release a final fair value measurement standard soon. This standard will define fair value, provide guidance on its application in the form of a hierarchy that is intended to foster consistency in its application, and improve fair value disclosures.

- The *lowest priority or weighting* should be given to entity inputs developed based on an entity's own internal estimates and assumptions.

- Fair value shall be estimated using quoted prices for *identical* assets or liabilities in active reference markets whenever that information is available.

- Quoted prices used for a Level I estimate should *not* be adjusted.

- If quoted prices for identical assets or liabilities in active markets are not available, fair value shall be estimated using quoted prices for *similar* assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available.

The difficulty is likely to emerge with Level 3 and Level 4 estimates. These estimates, by definition, will arise only when higher level methods and data cannot be used because they are not available in active reference markets. This circumstance is most likely to occur with non-financial assets and non-financial liabilities, as well as with illiquid financial items, such private placements of equity and debt securities.

Valuation Techniques

Although valuation experts have at their command a variety of valuation tools and techniques, including those consistent with the market approach, income approach, and cost approach, all of which may be applied in a particular case, valuation practice ultimately requires a valuation expert to select that method that is most suitable in a particular case and which provides the most relevant and reliable estimate. When using the hierarchy in determining a fair value, we believe that the valuation technique selected should be closely aligned to the benchmark valuation, e.g., value-in-exchange objective, of the assets and liabilities while satisfying the relevance and reliability criteria.

Put slightly differently, we do not believe that requiring use of a plethora of valuation methods is consistent with the high standards set forth in this proposed standard. On the contrary,

- We do not see the benefit achieved by requiring multiple measurement methods to be employed concurrently for the same asset, particularly since users won't be informed of the different outcomes.

- We believe companies should use the *best* measurement method.

- Users need information about the preparer's selection process for the method, the method employed, the inputs into that model, the types of assets for which that model is appropriate and used consistently.

SFAC No. 7

We believe that Financial Accounting Concepts Statement No. 7 ("Statement 7") provides a sound starting point for fair value estimation in the absence of observable market prices for identical or similar assets. Although the technique is referred to in current accounting literature, it has not been widely applied in the past for certain assets, particularly those for which market inputs may not be readily available. If market inputs are not available, the measurement approaches in Statement 7 provide for significant entity input. As such, these inputs are more subjective by nature, and may not achieve key financial reporting objectives for consistency and comparability.

While we believe that Statement 7 should be incorporated into the fair value framework, we believe further guidance is needed for when entity specific data is used. Additionally, further guidance is needed on the selection and use of the risk free rate, the spread to the risk free rate, and the risk premium under the methods outlined in Statement 7. For example, currently several risk free rates are used, such as LIBOR and various U.S. Treasury rates. Greater specificity in this regard would be helpful. In addition, we believe that the rate should be disclosed to enhance the user's understanding of the valuation process.

Measurement of Blocks

Blockage factors, if they exist, are *not* an attribute of the asset or liability *per se*. Rather, they are characteristics of the *method by which the exchange transaction for the asset or liability is structured.* Different managers may choose to structure transactions differently. As we have indicated above in the discussion on value-in-use, management's intent for an asset or liability should not bias the accounting for the asset or liability. Furthermore, actions not yet taken and commitments not yet entered into should not affect the accounting for assets and liabilities.

Blockage factors should be accounted for separately at the time of the exchange transaction and consistent with principles for recognition of transaction costs. Where such blockage factors may be considered to be material, as in the possible case of a control interest, the estimated blockage factor should be disclosed and the related discussion should make clear how and why these costs or premiums arise.

Transition to a Full Fair Value Model

Our objective for comprehensive business reporting is that all assets and liabilities of the reporting entity would be measured at fair value with any periodic changes in their values flowing through a comprehensive statement of recognized income and expenses. However, we acknowledge that this objective will take some time to achieve given that the current mixed-attribute model is deeply embedded in business practices and financial reporting. However, we strongly urge standard setters to continue the trend towards fair value measurement, but also to eliminate the use of historic cost based measurements as existing standards are amended or new standards are issued. To provide more information about those items which are not measured at fair value, we recommend that standard setters require complete disclosure of fair value information, including those that are not presently recognized on the statement of financial position. Although the fair values disclosed may be viewed to be less reliable than the values recognized, we believe that users would find value if the degree of uncertainty in a particular measurement was explained.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comment to the IASB on its *Discussion Paper – Measurement Bases for Financial Accounting – Measurement on Initial Recognition.* If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

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