FINANCIAL EXECUTIVES INSTITUTE

June 15, 2000

Mr. Timothy Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (File Reference 204-B)

Dear Mr. Lucas,

The Financial Executives Institute Committee on Corporate Reporting appreciates the opportunity to comment on the Preliminary Views document *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value.*

In our letters commenting on the 1997 and 1999 Exposure Drafts of the Proposed Statement of Financial Accounting Concepts, *Using Cash Flow Information and Present Value in Accounting Measurements,* we expressed concern about the far reaching implications of the significant change in the measurement attributes to what most consider as constituting generally accepted accounting principles. Even within the scope of financial instruments to which this Preliminary Views document is directed, it is not clear that fair value is always the most appropriate measurement. Such a far reaching change would diminish the importance of the income statement due to the ensuing volatility from unrealized gains and losses that would make it more difficult for users of financial statements to judge management and predict future performance. Surveys of users, including that sponsored by FASB and AIMR, do not demonstrate overwhelming support of fair value recognition and measurement.

CCR does not support full fair value recognition of financial instruments, for reasons described in this letter. However, companies that manage certain activities on a fair value basis should be permitted to report those activities on a fair value basis. This would provide more relevant information to users of those company's financial statements since financial reports would reflect internal management information. Companies that manage similar financial instruments on a more traditional basis could continue to use the current accounting framework that is more relevant to both management and users of financial statements.

We believe that there are a number of issues that need to be overcome to create a comprehensive fair value model that would be relevant, reliable, and could be applied consistently. Comparability issues between entities and across industries would be problematic. Any further progress towards full fair value of financial instruments would require continued probing of the difficult issues of reliability and usefulness of the resulting financial statements. To that end we would encourage field testing by different industry groups. Overall, we do not believe there is sufficient justification to support a radical departure from the current accounting model, which has gained acceptance among investment analysts, regulators, and the user community.

Following are our comments on specific issues raised in the Preliminary Views document.

Issue 1: What should be reported at fair value?

The application of a fair value framework is more relevant for certain activities than others. We recommend that the scope of this document permit the inclusion of financial instruments, as well as nonfinancial assets and liabilities that are risk managed on a fair value basis, such as loan servicing rights. We disagree with the exclusion of insurance contracts that provide for delivery of goods and services since they are in substance similar to insurance contracts that are cash settled. The Board should further clarify the reasons for excluding all employee benefit plan obligations, since other financial instruments also are complex and face practical measurement issues. For example, while health care benefit plans might be excluded, pension plans might be included since they are managed using methods that are similar to a present value concept. Implied contracts should not be included in the scope since it would be extremely difficult to identify all such contracts.

Issue 2: What does fair value mean?

Even CCR members who support a fair value approach to measurement of financial instruments have concerns with the framework for defining fair value described in the Preliminary Views document. Fair value should reflect the market price that would be realized if a financial instrument was currently purchased or sold. Not all the measurement approaches described in this document are consistent with those used in practice by companies who manage certain activities in a fair value framework.

The concepts of "exit price" and "most advantageous" do not appear to be consistent. The exit price should reflect the price that can be realized. We support the consideration of business strategy in determining the price at which a position can be closed. It is inappropriate to record a gain by marking to a higher price, when the reality is that the firm will sell at a lower price.

Further, the prohibition of a blockage adjustment is not consistent with the concept of an exit price. A blockage adjustment may be necessary to arrive at the realizable price for a large concentration since it would consider liquidity and control factors in estimating the exit price.

For insurance contracts, market prices for new business may be set below expected costs for such business because of the expectation of future renewals. Therefore, a fair value that ignores this consideration may be materially different from the market price.

We are confused about the comments on valuations of prepayment options. It is general practice for the investor to value a bond to the nearest call date if it is advantageous to the borrower. Valuation reflecting the prepayment price would also be appropriate if prepayments could reasonably be estimated on a portfolio of loans. Further, it would be impossible to fair value mortgage backed securities without making a prepayment assumption.

We do not generally support a requirement to recognize gains and losses on liabilities due to changes in the credit worthiness of the reporting entity. However, companies should be permitted to use this approach if they manage their activities on a fair value basis. The fair value model is more relevant for activities where debt instruments are funding assets that are managed at fair value, than for funding nonfinancial inventories and assets. While applying the fair value model consistently to all financial instruments is appealing, changes in the fair value of an entity's liabilities due to a change in its own credit rating give counterintuitive results. Investors and creditors reading financial statements should not see improving leverage and increases in income when an organization's risk profile is increasing nor when its financial performance is deteriorating. Likewise, an organization whose credit rating is improving should not book losses solely for that reason, if the contractual terms of the debt have not changed and the entity will not experience higher cash outflows solely due to its credit upgrade. For insurance contracts, liability is dictated by the actions of the policyholder and not the actions of the insurer and therefore, credit standing is irrelevant.

Issue 3: How should changes in fair value be reported?

Companies should be permitted to recognize the change in fair value of financial instruments in earnings if those particular activities are managed on a fair value basis. For other activities, CCR does not support recognition of gains and losses in the financial statements beyond those already provided for in other statements. It is not clear whether the volatility that would appear in the financial statements would provide more useful information to investors and creditors. Application of fair value accounting to the income statement may make the cash flow statement the primary focus of users of financial statements.

The next step should be expanded disclosures of changes in fair value, to determine the usefulness of the information and the difficulties observed in application of the potential

standard. Further consideration should be given to how the drivers of the changes in fair value should be disclosed. With the multiple disclosure requirements in effect and currently under consideration for financial instruments (e.g. FAS 107, FAS 125, FAS 133), the Board should determine which information is most relevant to users of financial statements. It is not apparent that users of financial statements are asking for further information or for fair value measurement of financial instruments.

Issue 4: Implementation

Measurement of financial instruments at fair value will by necessity include many judgmental factors. Two companies with similar financial instruments could potentially arrive at different measurements based on the judgments and methodologies used. Recent well publicized cases illustrate the difficulty in estimating fair values. Front end gains recognition of servicing rights that were soon determined to be impaired, and the difficulty of mark-to-model methods to consider changing liquidity and interrelationships among financial instruments are two recent examples. For users of financial statements, understanding characteristics of the financial instruments and the assumptions that are used to determine fair value is perhaps as important as the resulting value. The Board should consider wider disclosure of information about methods of valuation and the terms and structure of financial instruments by type, before imposing measurement standards that will significantly change current accounting standards. And, for certain financial instruments, alternative measures to fair value may be more appropriate, such as discussed in EITF Issue 99-20.

Issue 5: Customer relationships closely associated with financial instruments

CCR does not believe that customer relationships should be included in the fair value measurement project. Measurement of financial instruments at fair value alone is a difficult conceptual and practical issue as this Preliminary Views document fully recognizes. As this project moves forward, the Board should not attempt to expand its scope beyond financial instruments into that of customer relationships. Customer relationships are not generally recognized today, except under business combinations accounting. Customer relationship valuation issues should be excluded from this scope and considered as part of the general discussion of intangibles in the business combination project or future discussions of recognition of intangible assets in general.

Many financial instruments are part of customer relationship management pricing arrangements. However, the scope of this project should focus on the resulting financial instrument only. For example, if a customer receives a lower interest rate on a loan due to the total services used, the bank should report a lower fair value on the loan. For credit cards, the fair value of the receivables should be measured at fair value, rather than using a fair value that reflects credit cardholder account sales which look to the present value of customer profitability over the expected life of the relationship. For demand deposits, the value as a financial instrument is reflected in their use as funding alternative to the bank.

Corporate cash management monthly bank statements reflect this "earnings credit" on investable balances. For customers who choose to pay with fees and have no net investable balances (i.e. float and reserves offset deposit balances) there are no "financial instruments" with net value, only a customer relationship. Further, for interest bearing checking accounts, valuation as a funding instrument should be determined based on the variable or fixed rate paid.

Transaction costs and fee income streams exist with all financial instruments. It is not clear why the present value of the customer relationship should only be considered for credit cards and demand deposits while ignoring those for other financial instruments.

Issue 6: Items Similar to Financial Instruments

Single-entity credit cards should be included in the scope and treated the same as other credit cards. All insurance contracts should be treated alike, without distinguishing by the form of delivery between cash or goods and services. The characteristics of these instruments are similar to that of other financial instruments included in the proposed scope.

In conclusion, further progress towards full fair value of financial instruments in the income statement will require continued probing of the difficult issues of reliability, and usefulness of the resulting financial statements. For businesses that are not active traders of financial instruments, we are not aware of over-riding requests for financial statements to change from the current accounting standards.

Sincerely,

Philip D. Ameen

Philip D. Ameen
Chair
FEI Committee on Corporate Reporting