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IAFE Roundtable Discussion:  
The Move to Fair Value  
Accounting  
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# A Review of Accounting Objectives

- **Reliability** – Information should be free of bias and faithfully represent what it purports to represent
  - **Comparability** – Enables identification of when economic situations are similar or different
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# Is Fair Value Accounting Good Accounting?

- Debatable, but inevitable
  - Valuation policies will be at the crux of success or failure
  - Not a problem if prices are transparent
  - When not transparent, we're forced to rely on valuation methodologies
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# Price versus Value

- **Value is in the eye of the beholder**
  - **Professional option trading operations are driven by differing assessments of value**
  - **Inability to observe prices forces a reliance on value judgments**
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# Price versus Value

- **Technical sophistication leads us to believe our results**
  - **Model valuations are only as good as the reliability of the underlying assumptions – most acutely relevant wrt option valuation**
  - **We can't agree on whether estimated volatility is 20% or 30% and the current debate at FASB appears to be whether to use a Black-Scholes or a binomial model**
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# FAS 133 Cornerstones

- Derivatives are assets and/or liabilities
  - Fair value is the only relevant measure for derivatives
  - Only assets and liabilities should be reported as such on the balance sheet
  - Only transactions meeting qualifying criteria should be eligible for hedge accounting
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# Focus on Options

- Current practice fails reliability and comparability objectives, whether for hedgers or non-hedgers
  - We should distinguish between forward-type derivatives and options, and distinguish between an option's time value and its intrinsic value
  - (Don't confuse forward points with time value)
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# Option Hedges

- Purchased options to impose worst case constraints
  - For this class of users, interim values are of no consequence
  - Recognizing time value ratably is the only method that is consistent with the priorities of reliability and consistency
  - Time value may be unique because, at inception, the ending value is known
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# Conclusion

- Modify cornerstone number 2
    - “Fair value is the only relevant measure for derivatives”
  - For options, the carrying value on the balance sheet should be intrinsic value an historically-based “remaining time value” adjustment
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# Advantages

- Computationally easy
  - Consistent with priorities of reliability and comparability
  - Will mitigate the legal jeopardy that seems to be inherent in the current path to fair value accounting
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*Turn back, before it's too late!*

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# Turn back, before it's too late!

- An overstatement of my true feelings
- FASB has historically endorsed a mixed-attribute model, and options justify a continuance of this tradition



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