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Fair value disclosure requirements — a new era

by Peter J. Bondy

The Financial Accounting Standards Board has promulgated its Statement of Financial Accounting Standards No. 107 (SFAS 107), "Disclosures about Fair Value of Financial Instruments." This statement applies to 1992 reports for most stock and mutual life insurance companies. It requires disclosure of fair market value of certain assets and liabilities.

SFAS 107 does not identify each balance sheet item affected. It is broad in its requirements on coverage of the balance sheet items and in defining methodology to determine fair market value of those items. Other than requiring that fair market value be disclosed either within the financials or within the footnotes that follow the financials, SFAS 107 does not prescribe a set format for how disclosure is to be presented to the reader. Much of that decision is left to the individual company and its outside auditors.

Fair market value disclosure for all entries in the balance sheet, whether required by SFAS 107 or not, is not prohibited. As a result, it is likely companies will differ in the balance sheet items included in the disclosure, the methodology used in determining fair market value, or the format in which the disclosure is accomplished.

The asset side of the balance sheet

Assets like bonds and stocks clearly are subject to the requirements of SFAS 107. It is not entirely clear whether policy loans are subject to fair market value disclosure. One faction argues that they are because they fall within the definition of "financial instrument." Another side argues policy loans represent a portion of life insurance contract reserves reported on the liability side of the balance sheet, which is not subject to disclosure. The latter group believes it would be unreasonable to report a portion of the reserve on a fair market value basis while the more significant part, i.e., the liability side, is not.

The liability side of the balance sheet

Companies must disclose fair market value for all reserves on contracts that are classified as investment contracts under SFAS 97, i.e., contracts that do not provide for significant mortality risk. Types of contracts covered would include guaranteed investment contracts (GICs), certain-only immediate annuities, and single premium deferred annuities (SPDAs).

In addition to deciding whether a particular contract type is covered, a company needs to determine the methodology for arriving at the contracts's fair market value. Should it be based on that company's current pricing assumptions for similar contracts offered to the public? Or, should it be based on market interest rates available on, say, bonds with the same maturities as the benefits stream of the investment contract?

Format for information

How will each company choose to disclose fair market value information? This question has probably generated more discussion than other SFAS 107 topics. Two main concerns are: 1) that the public not be misled by the availability of this additional information and that it realize the shortcomings of that data; and 2) that the format and style chosen the first time, i.e., for the 1992 financials, be acceptable and useable for providing consistent information in subsequent financial statements.

At this point, two alternatives for the presentation format seem to exist. The first one discloses the numerical data and the limitations in using this data in one comprehensive footnote. The second approach is to disperse the information throughout the various footnotes now included with the financial statement, with one final footnote for information not covered elsewhere. Regardless of the alternative chosen, many companies will include a very extensive discussion of the use that may be properly made of the information provided.

Financial statements will vary in approach

This article has addressed only a small sample of the issues arising from SFAS 107 implementation. It will be interesting to review the financial statements of different companies to see how they have chosen to determine and disclose the fair market value of various items in their balance sheet. Because of the broad guidance provided in SFAS 107, it is likely that practices will vary, perhaps significantly, among companies.

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Early-release copies of *TSA* papers

The following papers have been accepted for publication in Volume 45 of the *Transactions*. Members who would like an early-release copy before it is published in a preprint should send $5 for each paper to the SOA Books and Publications Department.

"Multivariate Stochastic Immunization Theory" by Robert Reitano

This paper introduces a theory of immunization where the approach is multivariate and the goal is stochastic in the sense of minimizing stochastic risk. The risk measure used is reminiscent of the Markowitz approach of variance minimization but generalized to reflect also a measure of worst case risk. The approach is multivariate in that full yield curve risk to nonparallel shifts is reflected as in Reitano's earlier paper, by modelling the yield curve as a vector of yield curve drivers. Explicit solutions to the risk minimization problems are developed, subject to constraints on portfolio returns and various portfolio directional durations. In addition, solutions are

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