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# Grant Thornton &

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Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856

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We are pleased to respond to the Proposed Statement of Financial Accounting Standards, Fair Value Measurements. We support the Board's decision to provide guidance about how entities should determine fair value estimations for financial reporting purposes. With an increase in the number of accounting pronouncements requiring fair value measurements and remeasurement of certain assets and liabilities to fair value each reporting period, improved guidance on how those measurements should be determined, together with implementation guidance on applying the proposed techniques, should enhance the quality and consistency of financial reporting. We support the direction the Board is going in its proposed Statement, for the most part basing its guidance on generally accepted valuation practices. The requirements are generally well conceived and consistent with valuation theory, although, as discussed below, we do have concerns about some provisions and believe others need additional clarification to enable entities to apply the provisions consistently. However, we would be concerned if this proposed Statement were finalized before the Board considered and addressed issues related to the relevance and reliability of fair value measurements. It would appear that issues related to the relevance and reliability of fair value measurements and ways to make the amounts more reliable should be taken into account in the Statement on how the measurements should be determined.

Valuation of financial instruments is well developed in financial theory. Accounting guidance is most needed for fair value estimates of assets and liabilities that are not financial instruments, for example, for reporting units and tangible and intangible assets and liabilities for which established markets do not exist. In the proposed Statement, often the identified factors in the implementation guidance and many examples are based on financial instruments. The final Statement should provide more guidance and examples that will be

applicable to measurements of assets and liabilities that are not financial instruments. It is for those measurements, in particular, that preparers, auditors, and users of financial statements have concern about the reliability of fair value estimates. Another area that could use more guidance is the valuation of restricted securities.

We have organized our comments under the issues listed in the notice for recipients of the Exposure Draft, omitting issues on which we did not have specific comments.

# Issue 2: valuation techniques

Paragraph 7 provides that valuation techniques consistent with the market approach, income approach, and cost approach must be considered for all estimates of fair value. However, paragraph 7 appears to be contradicted by the descriptions of level 1 and level 2 estimates in the fair value hierarchy and in paragraphs B8 and B9 of the implementation guidance. The fair value hierarchy provides that level 1 estimates "shall be estimated using quoted prices for identical assets or liabilities," level 2 estimates "shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences." However, the description of Level 3 in the fair value hierarchy states that "fair value shall be estimated using multiple valuation techniques...." There is no mention of multiple valuation techniques in the descriptions of level 1 or level 2. Because the statement in paragraph 7 that multiple valuation techniques should always be considered seems to be negated by the language describing the fair value hierarchy, the guidance in the ED is not clear about if, when, or how multiple valuation techniques would apply to level 1 or level 2 estimates. Paragraph 7 could be enhanced and the confusion eliminated by expanding the discussion of the three approaches to provide information from generally accepted valuation principles that provides more guidance on application of the use of the market approach, the income approach, and the cost approach. That discussion should provide examples of situations in which a particular valuation approach may provide the best information and other situations in which one or more approaches are likely not to be relevant. That discussion should provide general information about how judgments are made to determine the most relevant and reliable approach(es) and the determination of the fair value estimate when multiple valuation approaches are used.

It is difficult to distinguish how the information required to apply a discount rate adjustment technique differs from the information necessary for a level 2 estimate. Both appear to require a market price and observable information of relevant attributes, which in the case of a discount rate adjustment technique, can be observed in the marketplace. Is the difference primarily whether the price is quoted in an active market? The illustration of a level 2 estimate in paragraph 20 uses financial instruments. The illustration for the discount rate adjustment technique in paragraph A11 is simplified and merely states that assets are comparable with respect to dispersion of possible payoffs and credit rating. The final Statement should provide guidance and illustrative examples that relate to and illustrate assets and liabilities that are not financial instruments that clarify the difference in the observable data needed for a level 2 estimate from that required for use of the discount rate adjusted technique.

Clarification is also needed for an understanding of how the discount rate in the discount rate adjustment technique differs from the risk adjusted discount rate in the expected present value technique, as both will incorporate market inputs. We understand that current

valuation practice uses a best estimate cash flow and a discount rate derived from public data, such as cost of capital for peer companies and/or industry groups. Practitioners, including valuation specialists, need additional guidance about when determination of a discount rate from publicly available information qualifies for the discount rate adjustment technique. Clarification and illustrations applicable to assets and liabilities that are not financial instruments are needed that provide guidance about the determination that the dispersion of possible payoffs is comparable and marketplace observations of price and attributes are what is intended for use of the discount rate adjustment technique.

Paragraph A12 explains that the discount rate used in an expected present value technique needs to include a risk adjustment commensurate with the risk inherent in the expected cash flows. A footnote states that models such as the Capital Asset Pricing Model can be used to estimate a risk-adjusted discount rate, but there is no other guidance explaining how an entity would apply portfolio theory to its fair value measurements. The final Statement should provide guidance about how the CAPM would be used to determine the risk adjusted discount rate for fair value measurements of assets and liabilities that are not financial instruments. As one of the intended goals of issuing a Statement on fair value measurement is to improve the consistency of such measurements among entities, the final Statement should provide a comprehensive illustrative example of the determination of a risk-adjusted rate when applying the expected present value technique to estimate the fair value of a reporting unit.

There appears to be an inconsistency between the guidance in paragraph A12 and Concepts Statement 7. Paragraph A12 provides that "an expected present value technique requires an adjustment for risk in either the expected cash flows or the discount rate." The guidance on risk and uncertainty in paragraphs 62-71 of Concepts Statement 7 indicates that a reliable estimate of a risk premium may not be obtainable and that in such cases, use of a risk-free interest rate may be the "best available estimate of fair value in the circumstances." Because the guidance in Concepts Statement 7 is incorporated into the proposed Statement, we believe Concepts Statement 7 should be amended at the time of issuance of the final Statement on fair value measurement so that the guidance in the Concepts Statement does not contradict guidance in the final Statement. If it is not amended, there could be confusion about the Board's view about use of the risk-free rate if it is difficult to obtain a reliable estimate of the risk adjustment. Amending the Concepts Statement for items that conflict with the proposed Statement will not preclude the Board from further amending it when it finishes its consideration of fair value measurements.

Paragraph A19 provides helpful, practical guidance on the number of cash flow scenarios used in an expected present value technique. That determination will be a significant practice issue in application of the final Statement. In some cases, a single cash flow scenario may be sufficient if additional cash flow scenarios and the related probability weightings would not provide more relevant information. Some additional information in this paragraph would make the guidance more useful. It would be helpful to have an example illustrating how "a limited number of discrete scenarios...capture[s] the array of possible cash flows." The paragraph mentions the use of a continuous probability distribution. It would be useful if that discussion could provide more guidance on how to determine whether a discrete or continuous probability distribution is needed.

Paragraphs A23-A27 discuss the effect of an entity's credit standing on liability measurement. The guidance should be expanded to provide considerations for determining the risk adjustment based on credit rating.

# Issue 5: fair value hierarchy

We support the level 1 estimate guidance in paragraph 18 pertaining to entities establishing a policy for determining how significant events occurring after the close of the market but before the end of the reporting period would affect the estimate of fair value. We suggest, however, that some of the guidance in paragraph C54 be included in the standard, such as the illustration of instruments trading in foreign markets and that an entity should not ignore any information that is available.

There is insufficient guidance for level 2 estimates, which will make it difficult for different entities to reach similar conclusions about whether a particular valuation is a level 2 or level 3 estimate. The term objectively determinable is of key importance for distinguishing between a level 2 similar asset or liability and a level 3 comparable asset or liability. What the Board intends by the term is not explained. The only example is in terms of financial instruments—securitized and unsecuritized receivables of the same type. Paragraph C55 provides that if "similar assets or liabilities can be observed in the marketplace, an entity should make the necessary assessments (of differences) before defaulting to other valuation techniques...." One might infer from this remark that objectively determinable refers to price effects of differences that can be observed in the marketplace. The Board should provide clarification and illustrations of its intent concerning how objectively determinable should be understood and applied.

### Issue 8: measurement of blocks

We agree with the Board's decision to continue to permit broker-dealers and certain investment companies to follow the guidance in the AICPA Guides until the FASB considers those issues. In the Board's future project on blockage factors, a related issue is the valuation of thinly traded stock. Although there may be an active market for the stock, questions nonetheless arise about the fair value of a large block of thinly traded stock issued, for example, in a business combination.

## Issue 9: level 3 estimates

The discussion in example 7 does not appear to follow the guidance on the use of multiple valuation techniques that the differences between methods should be reconciled. Presumably a buyer would not pay more to acquire software than it would pay to replicate it. Because the values resulting from the two valuation methods are so different, the explanation of the differences—certain indirect development costs were not considered—does not seem adequate. A point that the example is making is worthwhile, that because the costs of the indirect development costs are highly speculative, considering the costs would not improve the relevance and reliability of the cost approach compared to the income approach. However, we suggest that the differences in the amounts derived from the two approaches be reduced so that the example does not provide misinformation about what should be considered reconciliation of differences between valuation estimates.

## Issue 10: restricted securities

The valuation of restricted securities has long been a difficult area. The SEC guidance incorporated into paragraph B18 primarily lists improper valuation practices. The guidance for valuing restricted securities is limited to the last sentence of paragraph B17: "the quoted price of an otherwise identical unrestricted security shall be adjusted for the effect of the restriction, considering factors such as the nature and duration of the restriction, the volatility of the unrestricted security, and the risk-free interest rate." More clarification on how to calculate the value of a restriction is needed. A couple of illustrations may be one way to explain how an entity would use the factors identified—nature of restriction, term, stock's volatility, and the risk-free rate—to calculate the value of the restriction.

#### Issue 11: fair value disclosures

We believe the following revisions to the proposed disclosures would enhance the usefulness of the information presented to financial statement users. We suggest that the disclosures be modified to clarify that information about assets and liabilities should be provided separately and that the information about fair value amounts at the end of the period, how fair value amounts were determined, and the effect of remeasurements on earnings be presented in meaningful categories, such as trading securities, available-for-sale securities, derivatives, and long-lived assets held for sale. The information about nonrecurring remeasurements should also be presented in meaningful categories.

#### Issue 12: effective date

Certain requirements in the proposed Statement for developing fair value estimates will require changes from current practice. Some entities will need to identify sources for market inputs; establish procedures for developing multiple, probability-weighted cash flow scenarios; or develop a more sophisticated methodology to calculate risk-adjusted discount rates. If the final Statement is issued in the first quarter of 2005, we believe entities should have more time to establish new methodologies and revise their systems to enable them to implement the new Standard. We suggest an effective date of fiscal years beginning after December 15, 2005, if the final Standard is issued as planned in the first quarter of next year.

#### Issue 13: other issues

We believe the Board should consider and address issues relating to the relevance and reliability of fair value measurements before issuing a Statement on how to calculate fair value measurements. It would appear that issues related to the relevance and reliability of fair value measurements and ways to make the amounts more reliable should be taken into account in developing a Statement on how the measurements should be carried out.

## Other matters

The amendment to FASB Interpretation 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, would delete the reference to Concepts Statement 7. We understand that deletion, but suggest retaining the concept that, in the absence of observable transactions for identical or similar guarantees, an expected present value technique may be an appropriate income approach to use in the estimate of fair value. It is sometimes difficult for preparers and their auditors to know where to begin in thinking about how to value, for example, an indemnification embedded in a contract. The current reference in paragraph 9(b) to consider the use of an expected present value technique has provided useful guidance to preparers in applying FIN 45.

The effective date in the summary and the Basis does not agree with the effective date stated in the rest of the proposed Statement.

We appreciate the opportunity to comment on the proposed Statement and would be pleased to discuss our comments with Board members or the FASB staff. Please direct your questions or comments to Joseph Graziano at (732) 516-5560 or Lailani Moody at (212) 542-9823.

Very truly yours,

Grant Thornton LLP